



The Concord Coalition's Series On Social Security Reform

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Social Security's Financial Problems: How Should We View Them?

One of the most confusing things about the current Social Security debate is the many and sometimes divergent descriptions of the program's financial problem. Numbers are thrown about fast and furious to support one side or the other's contention about the seriousness of the problem.

A few samples—

"The Social Security trust funds will keep the system solvent until 2041..."

"But expenditures will exceed receipts beginning in 2017..."

"The trust funds have a reserve of \$1.7 trillion; in 20 years, it will be \$6 trillion..."

"But the trust funds only hold IOUs..."

"A 1 percent increase in payroll taxes for workers and employers each would solve the problem..."

"No, taxes will have to go up by 50 percent..."

"The long term funding gap is \$13 trillion..."

"No, that's an exaggeration; the real number is \$4 trillion..."

In considering Social Security's condition many years ago, former Senator Pat Moynihan once said "we are all entitled to our own opinions, but not our own facts..." What's veiled in the various statistics above is that while they are "facts," they are used in ways that portray different opinions about the problem. And most interesting about them is they are all derived from the same set of actuarial projections: they come from the central projections of the Social Security trustees.

The foundation of those projections—often referred to as the "intermediate" outlook—is a stream of income and expenditures projected out for 75 years. The year-by-year differences between them are either surpluses or deficits... surpluses through 2016 and widening deficits thereafter. That's the basic forecast.

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First, A Little History about the Problem

Before delving into the confusion, it should be recognized that there is little debate about Social Security having projected financial problems. For the past 17 years, the Social Security boards of trustees under both Republican and Democratic Administrations have projected that the program will have a major financing problem, large enough to fail their test of long-range balance.¹ While there has been some suggestion in recent years that the situation has improved and that the problem has been exaggerated, the overall outlook is not much different today than it's been over much of the past two decades. But if one views the significance of the problem by how close we are to it, things have worsened considerably.

In 1983 and 1984, shortly after the last round of major changes to Social Security were enacted, the trustees' reported that the Social Security trust funds were in "close actuarial balance" over the following 75 years... meaning that the program's finances were deemed sound. However, a small problem emerged in the 1985 report and beginning in 1989, the trustees began reporting that the trust funds were no longer in close actuarial balance.

If one measures the seriousness of the problem by how close we are to the year in which the trust funds are exhausted, the problem is actually much worse than 20 years ago. In 1985, the trust funds were projected to be depleted in 2049, or 64 years away from the time of the report. The trustees now project that the trust funds will be depleted in 2041, or in 36 years. Also notable is that the estimated deficits, measured as a percent of expected 75-year trust fund receipts, have changed little over the past fourteen years, ranging from 11 percent in the 1992 report to a high of 17 percent in the 1997 report. In the 2005 report, it was nearly 14 percent.

Most significant, however, is the point at which Social Security tax receipts are expected to fall below expenditures. In 1984, the trustees projected that taxes would exceed expenditures until 2021, or for 36 years into the future. They now project that tax receipts will exceed expenditures until 2017, or for just 12 more years. This is the shortest such projection since the 1983 reforms were enacted.

A 21-Year History of Adverse Social Security Forecasts

Year of trustees' report	Shortfall of income (75-year average) in percent	Projected year in which trust funds depleted	Number of years before trust funds depleted	Number of years before expenditures exceed taxes
1985	3.2	2049	64	30
1986	3.4	2051	65	34
1987	4.8	2051	64	28
1988	4.5	2048	60	32
1989	5.4	2046	57	28
1990	7.0	2043	53	27
1991	8.2	2041	50	27
1992	11.2	2036	48	25
1993	11.1	2036	47	25
1994	16.1	2029	35	20
1995	16.4	2030	35	19

¹ By the trustees' definition, Social Security fails this test when it is not in "close actuarial balance." This means that the projected imbalance between income (plus current trust fund assets) and outgo is more than 5 percent over the next 75 years.

1996	16.4	2029	33	16
1997	16.7	2029	32	15
1998	16.3	2032	34	19
1999	15.3	2034	35	15
2000	14.0	2037	37	15
2001	13.7	2038	37	15
2002	13.6	2041	39	15
2003	13.9	2042	39	15
2004	13.6	2042	38	14
2005	13.8	2041	36	12

Social Security trustees' report, 1985-2005, central forecasts.

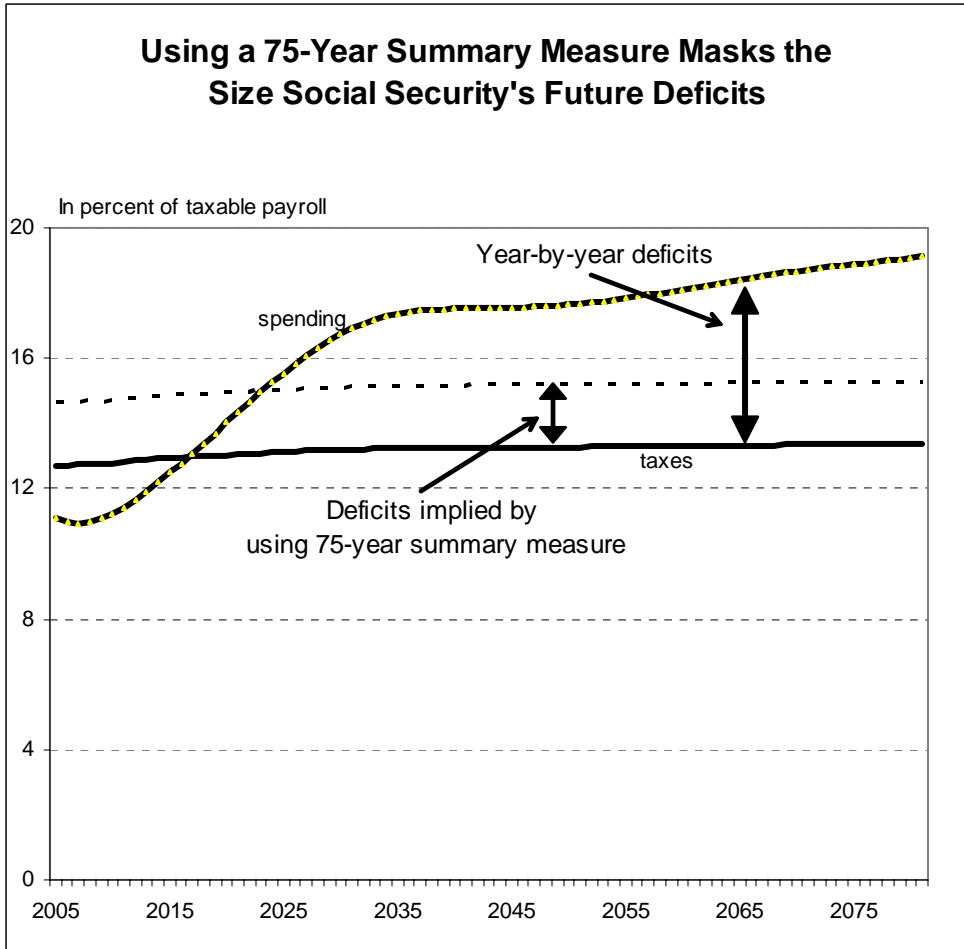
Unraveling the Confusion

Much of the confusion about the problem is created by attempts to summarize the 75-year figures... i.e., to boil them down to a single number expressing them either as an aggregate deficit for the 75 years as a whole or as a lump sum amount of money that would close the gap. Confusion also stems from people counting different things as resources available to pay benefits. And finally, some of the confusion comes from mixing up measures of:

- (1) what Social Security is “permitted to spend” (spending authority granted by law) and,
- (2) the actual resources that are projected to come into the Treasury to cover the benefits.

The Problem with Attempting to Summarize the Deficits of the Next 75 Years

Typically the trustees express the deficits as an amount by which the Social Security tax rate is inadequate to cover the system’s expected expenditures. For example, in their latest report, they project that this year taxes earmarked for Social Security will equal 12.72 percent of the nation’s payrolls, spending will equal 11.13 percent, and the difference between them is a surplus of 1.59 percent. In 2030, a much worse outlook is projected: taxes will equal 13.20 percent of the nations payrolls, spending will equal 16.74 percent, and the difference will result in a deficit of 3.54 percent.



That sort of year-by-year assessment is fairly straightforward. Confusion emerges when the trustees express the problem in terms of “actuarial balance,” which is a summary measure of the deficits projected over the next 75 years. In their latest report, this figure is 1.92 percent of payroll. What it implies is that solvency could be restored by raising the Social Security tax rate (now 12.4 percent) by 1.92 percentage points throughout the period, or alternatively, reducing benefits by an equivalent amount.

The framework of actuarial balance implicitly assumes that surpluses projected in the early years will be saved and earn interest, which will help cover the later deficits. However, the government doesn’t really save surplus Social Security receipts. They go into the Treasury, and because the government typically runs deficits, they are used immediately to cover whatever other expenses the government has. The Treasury credits the trust funds with the surpluses and interest by posting federal bonds to them, but those bonds are merely one account of the government giving an IOU to another. The trustees project that the trust fund balance will grow from \$1.7 trillion at the beginning of this year to a peak of \$6 trillion in 2026. The trust fund balance, however, does not represent an economic asset that is being stored up to meet future benefit payments. It simply represents permission for the Treasury to spend for Social Security.

If instead of looking at a 75-year summary of the problem (i.e., the actuarial imbalance), one looks at the projected year-to-year escalation of Social Security’s costs, a more realistic and troubling picture

emerges. Once the period of cash surpluses ends—which is projected to occur in 2017—there would be uninterrupted deficits that grow from 1 percent of payroll in 2020 to 4.26 percent of payroll in 2040, 4.79 percent in 2060, 5.75 percent in 2080 and larger ones indefinitely thereafter.

A 75-year aggregate number, such as reflected by the calculation of actuarial balance, may make sense when you have peaks and valleys in your cash flow, but when you have growing deficits for as far as the eye can see, condensing them into one summary measure is misleading because it obscures the timing and magnitude of the growing annual shortfalls. It’s an old summarizing technique that dates back to the early years of Social Security, but for the problems that now lie before the program, it has little utility.

Different Views of Emerging Deficits: Counting All Trust Fund Income Versus Just Social Security Tax Receipts						
	Income and expenditures			Surplus or deficit (-)		
	Counting taxes and interest	Counting just Taxes	Expenditures	Counting taxes and interest	Counting just Taxes	
	(In billions, constant 2005 dollars)					
2005	690	596	527	163	69	
2010	810	680	600	210	80	
2020	1,016	814	878	138	-64	
2030	1,110	943	1,199	-89	-256	
2040	1,105	1,088	1,441	-336	-353	

The Problem with Counting Interest as Income and Trust Fund Balances as Real Assets

The way people view the program’s income stream and trust fund balances also is a source of confusion. The income recorded to the trust funds includes both taxes and interest. Thus, when the program’s stream of future income and expenditures are viewed from a trust fund perspective, it indicates that the program would have surplus receipts until 2026. And with a trust fund balance projected then to be at \$6 trillion, there would appear to be ample resources to pay all promised benefits until 2041.

In contrast, if one recognizes that the interest and trust fund balances are simply “paper” recordings from one account of the Treasury to another—that no one is paying that interest to the government and that there are no economic assets—the point at which real funding deficits occur is 2017 when Social Security tax receipts fall below program expenditures. The program may have sufficient “authority to spend” in 2017 and later years because those balances exist, but their existence doesn’t mean the government has the resources on hand to cover the deficits.

The Problem with Expressing the Deficits as a Lump Sum Amount

Yet further confusion occurs when the program’s deficits are expressed in one lump sum as an unfunded liability. As the term suggests, it reflects an amount of benefit obligations that a plan lacks resources to cover. Usually, unfunded liabilities are calculated in present value terms, which is a technique that shows what sum of money, if invested immediately, would equal a given stream of future payments. If a pension plan’s current assets and the present value of its projected receipts

matches the present value of its projected obligations, the plan is said to be funded. If it is less, the plan is said to have an unfunded liability.

Ideally with traditional pension plans, the resources to pay workers their promised benefits are set aside and invested as workers accrue them. This protects those benefits, which in practice, are a form of deferred compensation that workers have earned. If the company curtails its workforce or goes out of business, the plan’s assets remain available to cover the vested benefits. With Social Security, there is little expectation that the government will go out of business or that new workers will not enter the program. Lawmakers in the past have thus seen less necessity to set resources aside as workers accrue future benefits. More importantly, Social Security is not deferred compensation—it is a legislated entitlement program that can be amended at any time.

While some argue that an implicit compact exists for the government to pay Social Security benefits in exchange for workers paying taxes, the link between what is paid and what is received is not a direct one and in any event is not binding on the government. As a program established for the “general welfare” of the nation, Social Security’s taxes could be raised or its benefits cut to shore up its financing. Thus, in a strictly legal sense, Social Security’s projected deficit represents an unfunded public policy rather than an unfunded liability. Indeed, this crucial distinction explains why the trustees use the term “unfunded obligation” instead of “unfunded liability” to describe Social Security’s lump sum shortfall. As Chief Actuary Stephen Goss puts it, “liability generally indicates a contractual obligation (as in the case of private pensions and insurance) that cannot be altered by the plan sponsor without the agreement of the plan participants.”²

While the benefit obligations can be altered, calculating the Social Security’s unfunded benefits in present value terms gives policymakers and the public a sense for the aggregate amount of resources it lacks to meet its scheduled benefits. However, attempting to show the problem in this fashion carries its own form of confusion and contentiousness.

Two approaches are typically used. One, referred to as an open-group method, assumes that new workers will continue to join the system in the future and that an ongoing stream of income from all participants—current and future—will be available to pay the benefits of any and all recipients. No distinction is drawn as to what workers pay for what benefits. The open-group method thus measures the lump sum present value cost of continuing to pay promised benefits under the current pay-as-you-go financing system. It does not address how much of that expected cost would be borne by current participants and how much by future participants.

That generational perspective is reflected in the other approach, referred to as a closed-group method. It attempts to distinguish the amounts that specific age cohorts, or generations, pay for their benefits. For instance, an approach used by the trustees separates current from future

Different Measures of Social Security’s Unfunded Commitments	
(\$s in trillions)	
Open-group basis: ^a	
Counting 1/1/05 trust fund balances	\$4.0
Not counting fund balances	\$5.7
Closed-group basis: ^b	
Counting 1/1/05 trust fund balances	\$11.1
Not counting fund balances	\$12.8
2005 Social Security trustees’ report	

^aPresent value as of 1/1/05 based on 75-year projection

^bPresent value as of 1/1/05 based on 100-year projection

² Social Security Administration, Actuarial Note #2004.1, *Unfunded Obligation and Transition Cost for the OASDI Program*, Steve Goss, Alice Wade and Jason Schultz, August 2004 p.1.

participants. It assumes everyone age 15 and older is part of the current participant population, and those ages 14 and younger are future participants. It then compares the present value of the income and benefits of the two groups separately. In this way, it serves as a rough measure of the subsidy that today's participants expect to receive from future participants under the current system.

Are Social Security's Projected Deficits "Unfunded Liabilities"?

With traditional pension systems, funding is typically evaluated and set separately for each age group or cohort of participants. When the Social Security trustees assess the system through this method, referred to as a closed-group method, they typically differentiate participants by whether they are under or over a given age—say age 15—as of a certain date. It presents the status of the system from a multi-generational perspective, with a division made between those who are currently participating (either as covered workers or beneficiaries), and those who would join the system as future workers—the two each representing separate or “closed” groups. Each group is presumed to make sufficient contributions to build up a supply of resources to cover their eventual benefits. If the projected supply of resources is less than the projected benefits to be paid, the difference is an unfunded liability. While Social Security is not a pension system, and thus has no unfunded liabilities in a legal sense, the closed group approach may be used to demonstrate the magnitude of benefit obligations to be borne by the prospective recipients of each group. Because an unfunded liability is now computed for the group consisting of current workers and recipients, the closed group number can be viewed as a measure of the generational transfer inherent in the current system.

In assessing Social Security's financing problems through an open-group measure, whether the benefits for a particular age cohort of participants are fully financed by them is irrelevant. The law does not address the issue of whether the system should be evaluated on an open group or closed group basis, but in setting the system's future tax schedule in a manner that produces revenues sufficient only to meet the outgo as it arises, Congress effectively adopted what is termed a “pay-as-you-go” process. Using this method, the system is thought to have a financing deficiency if over the next 75 years its income is projected to be lower than its spending by 5 percent or more. It is built on a view of Social Security as a legislated entitlement or transfer payment—a social commitment not a contractual one—whose benefits and financing are adjusted as policymakers see a need to do so. The taxes people pay are for the benefit of society in general, not for each worker individually or their particular age cohort. One could build a fund to help meet future commitments but not necessarily out of any desire to make the system's benefits more related to what people pay in taxes.

Under the open-group method, the trustees project unfunded commitments of \$4 trillion over the next 75 years. They caution, however, that limiting the analysis to 75 years “can lead to incorrect perceptions and policy that fail to address sustainability for the more distant future.” They also point out that “continued and possibly increasing annual shortfalls after the period are not reflected in the 75-year summarized measures.”³ To give a more complete picture, the trustees include an estimate of Social Security's shortfall over the infinite horizon. In the 2005 trustees' report, that number is \$11.1 trillion.

Importantly, both lump sum numbers (\$4 trillion and \$11.1 trillion) count the existing balances of the Social Security trust funds as resources that reduce the unfunded commitments. In other words, the trust fund balances are treated as genuine funding. As of January 1, 2005 (the starting date of the calculation), those balances totaled \$1.7 trillion. If it is assumed that the holdings of the trust

³ 2005 Social Security trustees' report, p.58.

funds, as obligations that the government has made to itself, are not real resources available to finance future benefits, the trustees would have understated the unfunded commitments by \$1.7 trillion. Excluding the trust fund balances, the open group unfunded commitments would be \$5.7 trillion over 75 years and \$12.8 trillion over the infinite horizon.

Under the closed-group method, the trustees project unfunded commitments of \$12.8 trillion over the next 100 years (\$13.7 trillion arising from current recipients, and a surplus of \$.9 trillion coming from persons under age 15 at the time of the valuation). Subtracting the starting trust fund balances of \$1.7 trillion reduces that figure to \$11.1 trillion.⁴

In effect, the trustees show a range of potential unfunded commitments of \$4 trillion on the low side to nearly \$13 trillion on the high side. Moreover, the present value numbers may understate the size of the future tax hikes or benefit cuts that may ultimately be required to balance the system because they implicitly assume that any savings generated by reforms will be set aside and earn interest to finance future benefits. But that would require lawmakers to somehow isolate the resources resulting from the changes they make and ignore them when making subsequent decisions about the federal budget, which experience shows they are not likely to do.

If, for instance, a proposal to raise Social Security taxes or constrain benefits was estimated to cut the program's unfunded liability in half, that reduction would only be as good as the commitment to save those resources. If they are not saved, the long-range sustainability of the program could be little different than under current law.

The utility of expressing the problem as a lump sum figure is that it may give the public a better realization of its magnitude and the necessity of addressing it now. However, as illustrated by the variance between the trustees' open- and closed-group figures, to get to that number, critical distinctions have to be made and assumptions have to be adopted.

Whether one uses an open- or closed-group method evolves from one's perspective on whether Social Security should remain a legislated pay-as-you-go entitlement or be converted at least in part to an advanced funded system that is more contractually based. The open-group method fits the former; the closed-group method is relevant to the later because it gives an idea of what might have to be paid in "transition" costs to a new system without reducing the benefit promises assumed under the existing system. Choosing an appropriate method also requires suppositions about whether existing balances of the trust funds are real resources, about how long the valuation period should be, what rates of return are appropriate, and, if to be reflected as a periodic draw from the economy, what amortization period should be used. All of those factors can greatly affect the outcome, rendering very different dimensions of the long-range problem.

Unfunded liability numbers, while useful as indicators of fiscal sustainability and generational transfers, are less useful as guides to specific reforms. They say nothing about annual spending levels, and hence when the fiscal burden becomes acute. Nor do they tell us the government's annual borrowing needs, and hence its impact on savings, investment, and the growth of living standards. Moreover, over-emphasis on unfunded liabilities may mislead people into thinking that the problem is "too big to fix." Knowing that up to \$13 trillion would be needed immediately to

⁴ The fact that this number is the same as the open-group infinite horizon number does not mean that it is measuring the same thing.

shore up the program presents the problem as a vast amount of money. It's nearly three times the size of the current federal debt held by the public and approaches one year's worth of the nation's gross domestic product (GDP). The federal government does not have that amount of money to invest, and no one would expect Congress to extract such resources from the economy by immediately imposing higher taxes or borrowing it from the public.

How Best to View the Problem

Over-simplified measures of Social Security's long-range financing problems create debates that can be distracting. Regardless of how the program's future deficits are presented, the program's benefits are entitlements that are financed by taxing the nation's economic output. Ultimately, the resources the program requires will have to be drawn from the economy of the future, and it is the dimension of that draw then that best reflects the problem

If the federal government could eliminate its budget deficits and use excess Social Security receipts to buy down the federal debt, then the idea that excess Social Security taxes could be saved would be plausible. But there is nothing in the post World War II period that suggests the government will run budget surpluses for any sustained period of time — particularly those equaling the size of the Social Security surpluses. And there is nothing to suggest that a commitment by one Congress to set them aside will be binding on the next. As budget developments of the past few years year amply demonstrate, Congress' "lockbox" promises in no way guarantee prudent fiscal behavior.

Looked at this way, it is not the deficits between income and outgo that best reflect the Social Security problem — it is Social Security's rising costs. If allowed to grow as scheduled, the share of the nation's payrolls that the program requires will grow from 11 percent today to 17 percent over the next 25 years, and to more than 19 percent over the next 75 year. As a share of what the nation produces, it will grow from 4.26 percent of GDP today to 6.14 percent of GDP in 2030 and 6.39 percent in 2080. Either way one looks at those numbers, it means that Social Security's draw from the economy will rise by 50 percent or more over the next few decades... that's the problem.

The bottom line is that, no matter how it is measured, there are just two ways to address Social Security's financing gap without over burdening tomorrow's workers and taxpayers: reduce Social Security's long-term cost and make the remaining cost more affordable by increasing national savings and hence the size of the future economy. A workable reform plan should do both.