
SOCIAL SECURITY'S FINANCIAL OUTLOOK: THE 2008 UPDATE IN PERSPECTIVE

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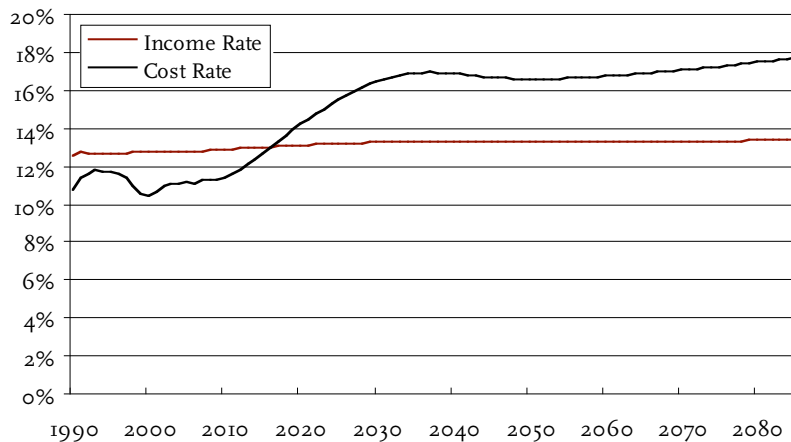
Introduction

The Trustees of the Social Security system have just issued the 2008 projections for the system over the next 75 years. The report contains two surprises. First, the 75-year deficit dropped to 1.70 percent of taxable payrolls from the roughly 2 percent it has been for the last 14 years. The decline was driven primarily by a change in the way Social Security projects immigration. Although the Trustees still project that the trust fund will be exhausted in 2041, the improved outlook enables scheduled payroll taxes to cover more than three-quarters of promised benefits after that point. The second noteworthy difference between this report and earlier ones is that it has not been signed by any public trustees. But this omission reflects a failure with the political process, not with the program itself.

The 2008 Report

As usual, the Social Security actuaries project the system's financial outlook under three assumptions — high cost, low cost, and intermediate. This *brief* focuses on the intermediate assumptions.

FIGURE I. PROJECTED SOCIAL SECURITY REVENUE AND BENEFIT RATES, 1990-2085,
(AS A PERCENT OF TAXABLE PAYROLL)



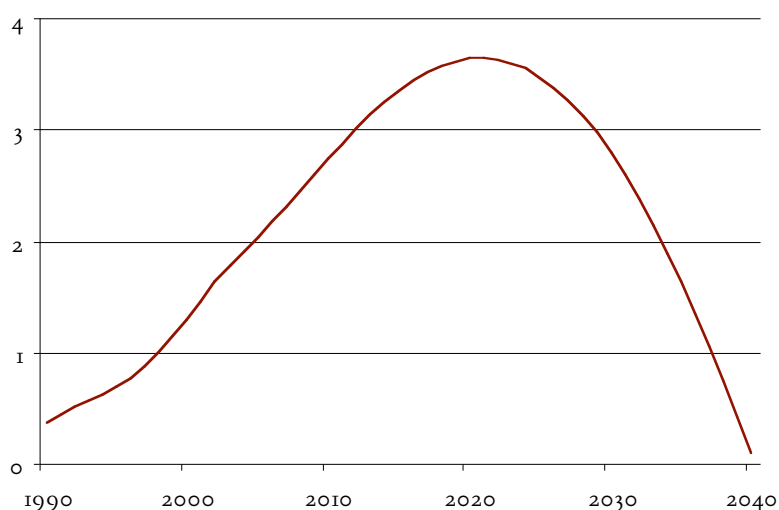
Source: 2008 Social Security Trustees Report, Table IV. B1.

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Social Security is financed primarily on a pay-as-you-go basis, so demographic trends are very important. Demographics, however, tend to change slowly. The aging of the population due to fewer births and longer life spans is virtually identical to that described in earlier reports. The number of Social Security beneficiaries per 100 workers will increase from 30 today to 51 in the future. The increasing ratio causes the cost rate of the system to rise above the income rate (see Figure 1).

Although costs will exceed income in the future, today the cost rate is below the income rate, and Social Security is running cash flow surpluses — including interest — of about \$190 billion per year. These surpluses began in response to reforms enacted in 1983 and will continue until 2017. In 2017, the cost rate starts to exceed the income rate and Social Security will have to tap the interest on trust fund assets to cover benefits. And in 2027, taxes and interest will fall short of annual benefit payments, so the government will be required to draw down trust fund assets to meet benefit commitments. The trust funds will be exhausted in 2041 (see Figure 2). These dates have remained virtually unchanged over the past five years (see Table 1).

FIGURE 2. SOCIAL SECURITY TRUST FUND ASSETS, 1990-2040 (TRILLIONS OF 2008 DOLLARS)



Source: 2008 Social Security Trustees Report, Tables V.B1, VI.A4, and VI.F8.

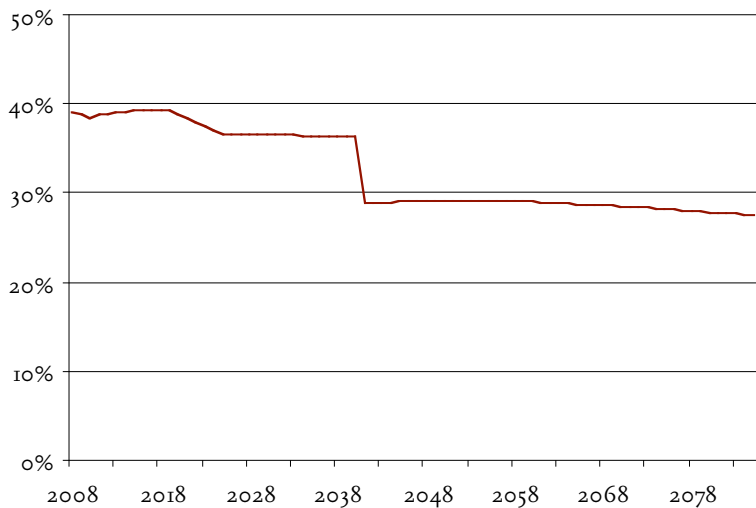
TABLE 1. KEY DATES FOR THE SOCIAL SECURITY TRUST FUND

Event	Trustees Report				
	2004	2005	2006	2007	2008
First year outgo exceeds income excluding interest	2018	2017	2017	2017	2017
First year outgo exceeds income including interest	2028	2027	2027	2027	2027
Year trust fund assets are exhausted	2042	2041	2040	2041	2041

Sources: Status of the Social Security and Medicare Programs: A Summary of the Annual Reports, 2004, 2006, and 2008.

The question is what happens in 2041 if Congress fails to pass legislation. It is incorrect to describe the system as “bankrupt,” because tax revenues continue rolling in. So the system will still have enough revenue to pay 78 percent (75 percent by 2082) of currently legislated benefits. Relying on only current tax revenues, however, means that in 2041 the replacement rate — benefits relative to pre-retirement earnings — for the typical worker would drop from 36 percent to 28 percent (see Figure 3). (Note that the replacement rate for those claiming at age 65 is already scheduled to decline from 39 percent today to 36 percent because of the ongoing increase in the Full Retirement Age from 65 to 67 enacted in 1983.)

FIGURE 3. REPLACEMENT RATE FOR THE MEDIUM EARNER AT AGE 65, 2008-2085



Source: 2008 Social Security Trustees Report, Tables IV.B1 and VI.F10.

Over the next 75 years, Social Security’s long-run deficit is projected to equal 1.70 percent of covered payroll earnings. The change in the actuarial deficit from last year was driven primarily by a change in the way Social Security projects undocumented and temporary legal immigration. The new method resulted in a larger number of working-age immigrants — who pay payroll taxes — relative to the number of older immigrants who will be eligible to receive Social Security retiree benefits. The increased number of younger immigrants also results in additional children, who will grow up and also pay payroll taxes — but not draw benefits during the 75-year period.

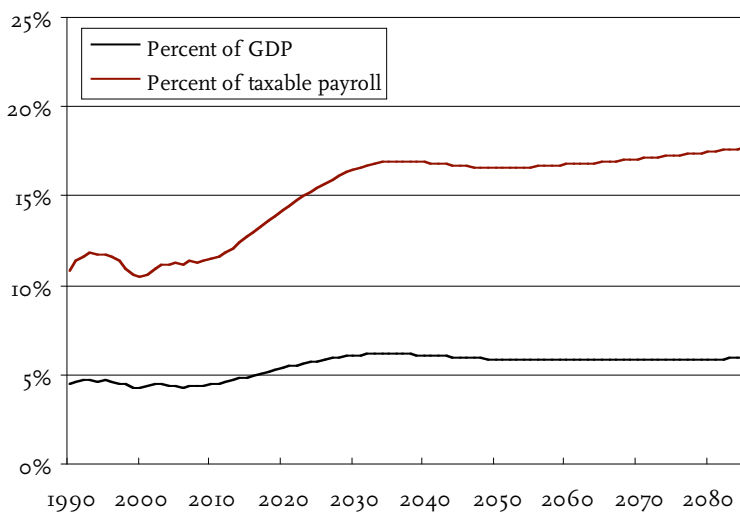
The easiest way to interpret the meaning of the 75-year deficit is in terms of the size of the tax increase required to restore solvency. That is, if the payroll tax rate were raised immediately by roughly 1.70 percentage points — 0.85 percentage point each for the employee and the employer — the government would be able to pay the current package of benefits for everyone who reaches retirement age at least through 2082.

A lasting fix for Social Security would require additional changes. Solutions that focus just on the next 75 years typically involve the build up of Trust Fund assets in the near term and the sale of those assets to pay benefits in the out years. Since the trust funds have no further bonds to sell in the 76th year, the program is suddenly short of money. Lasting solvency would require either a pay-as-you-go system with substantially higher payroll tax rates/lower

benefits or the build up of a trust fund larger than that required for 75-year solvency, the returns from which could cover some of the costs. Realistically, eliminating the 75-year shortfall should probably be viewed as the first step towards long-run solvency.

The challenge of Social Security's shortfall looks considerably less daunting when Social Security outlays are projected as a percent of Gross Domestic Product (GDP) rather than as a percent of taxable payrolls (see Figure 4). The cost of the program is projected to rise from 4.3 percent of GDP today to 6.0 percent of GDP in 2040 and drop back to 5.8 percent by the end of the 75-year projection period. The reason why costs as a percent of GDP more or less stabilize — while costs as a percent of taxable payrolls keep rising — is that taxable payrolls are projected to decline as a share of total compensation due to continued projected growth in fringe benefits, such as health insurance. The reason that the long-run cost drops by the end of the projection period is mainly the result of changing immigration assumptions that result in more younger immigrants paying payroll taxes and fewer older immigrants collecting benefits.

FIGURE 4. SOCIAL SECURITY COSTS AS A PERCENT OF GROSS DOMESTIC PRODUCT AND TAXABLE PAYROLL, 1990-2085

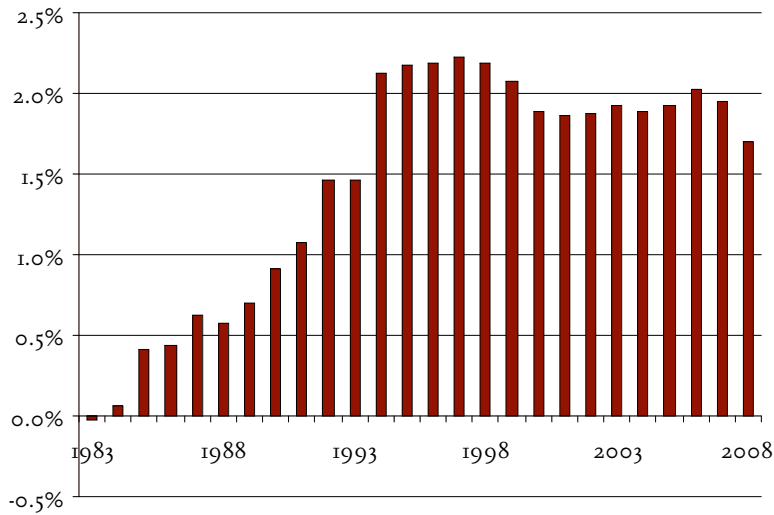


Source: 2008 Social Security Trustees Report, Figures II.D5 and IV.B1.

The 2008 Report in Perspective

Even with the decline in the 75-year deficit, today's shortfalls are in sharp contrast to the projection of a 75-year balance in 1983 when Congress enacted the recommendations of the National Commission on Social Security Reform (often referred to as the Greenspan Commission). Almost immediately after the 1983 legislation, deficits appeared and increased markedly in the early 1990s (see Figure 5).

FIGURE 5. SOCIAL SECURITY'S 75-YEAR DEFICIT AS A PERCENT OF TAXABLE PAYROLLS, 1983-2008



Source: 2008 Social Security Trustees Report, Table VI.B1.

In the 1983 Report, the Trustees projected a 75-year actuarial surplus of 0.02 percent of taxable payrolls; the 2008 Trustees project a deficit of 1.70 percent. Table 2 shows the reasons for this swing of 1.72 percent of taxable payrolls. Leading the list is the impact of changing the valuation period. That is, the 1983 Report looked at the system's finances over the period 1983-2057; the projection period for the 2008 Report is 2008-2082. Each time the valuation period moves out one year, it picks up a year with a large negative balance. That is the reason that policymakers insist on looking beyond the 75-year projection period when considering ways to restore solvency.

TABLE 2. REASONS FOR CHANGE IN SOCIAL SECURITY 75-YEAR DEFICIT AS A PERCENT OF PAYROLL, 1983-2008

Item	Change
Actuarial balance in 1983	0.02
Changes in actuarial balance due to:	
Valuation period	-1.47
Disability data and assumptions	-0.64
Projection methods and data	-0.16
Economic data and assumptions	-0.33
Legislation/regulation	0.16
Demographic data and assumptions	0.74
Other factors	-0.02
Total change in actuarial balance	-1.72
Actuarial balance in 2008	-1.70

Source: Author's calculations based on earlier analysis by John Hambor, recreated and updated from Social Security Trustees Reports, 1983-2008.

Persistent increases in disability rolls and the change in methods of analysis used by the actuaries also contributed to the increase in the deficit. Another contributor to the increased actuarial deficit over the past 25 years has been a worsening of economic assumptions — primarily a decline in assumed productivity growth. Offsetting the negative factors has been a reduction in the actuarial deficit due to changes in demographic assumptions — primarily higher mortality for women.

Unfunded Liabilities

Although the Trustees Report focuses on Social Security's financial shortfall as a percent of either taxable payrolls or GDP, it also reports the financing shortfall in dollars. One measure of the shortfall — the present discounted value of the difference between projected revenues and expenditures over the next 75 years — amounts to \$4.3 trillion. Although this number appears very large, the economy will also be growing. So dividing this number — plus a one-year reserve cushion — by taxable payrolls over the next 75 years brings us back to the 1.70 percent deficit discussed above.

Another measure of the financing shortfall is the present discounted value of the difference between revenues and benefits from now to infinity. This amounts to \$13.6 trillion. Most analysts think this number places too much weight on what may happen in the very distant and uncertain future. Nevertheless, dividing even this infinite shortfall by the present discounted value of taxable payrolls over the infinite horizon produces a shortfall equal to 3.2 percent of taxable payrolls (see Table 3).

TABLE 3. SOCIAL SECURITY'S FINANCING SHORTFALL

Period	Present Discounted Value (Trillions)	As a percent of	
		Taxable payrolls	GDP
2008-2082	\$4.3*	1.6	0.6
2008-Infinity	\$13.60	3.2	1.1

* The \$4.3 trillion is the difference between scheduled benefits and projected revenues; it excludes another \$387 billion required to bring the trust fund to 100 percent of annual cost by the end of the period. If this latter amount were included, the deficit relative to payrolls is 1.70 as reported earlier.

Source: 2008 Social Security Trustees Report, Tables IV.B5 and IV.B6.

Conclusion

Despite the reduced deficit in the 2008 Trustees Report, the numbers confirm what has been evident for two decades — namely, Social Security is facing a long-term financing shortfall. Changes in the underlying assumptions are unlikely to eliminate the problem. Although future rates of disability, mortality, and real wage growth are uncertain, switching any of the assumptions to the Trustees' "low cost" scenario closes only part of the gap. This problem can be solved only by putting more money into the system or by cutting benefits. There is no silver bullet. Despite the political challenge, stabilizing the finances should be a high priority to assure people they will receive the income they need in retirement.


References

U.S. Social Security Administration. 2004, 2006, and 2008. *Status of the Social Security and Medicare Programs: A Summary of the Annual Reports*. Washington, DC: U.S. Government Printing Office.

U.S. Social Security Administration. 2008. *The 2008 Annual Report of the Board of Trustees of the Federal Old Age, Survivors and Disability Insurance Trust Funds*. Washington, DC: U.S. Government Printing Office.

FOR MORE INFORMATION ON SOCIAL SECURITY, CHECK OUT:

the
SOCIAL SECURITY
FIX-IT book

A stylized illustration of a person with a large white head, wearing a blue dress and a red bow tie, holding a yellow umbrella. The background is orange with white polka dots.

http://crr.bc.edu/special_projects/the_social_security_fix-it_book.html

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