

SOCIAL SECURITY'S FINANCIAL OUTLOOK: THE 2010 UPDATE IN PERSPECTIVE

BY ALICIA H. MUNNELL*

Introduction

After being held up for four months while estimates were modified to reflect the expected effects of the Affordable Care Act (ACA), the 2010 Trustees Report for the Social Security system finally emerged in early August. The report contains no surprises, which may explain the relative lack of attention it has received in the press. But the fact that the future of Social Security has been relatively untouched by the market collapse and ensuing recession is itself newsworthy. Despite reduced revenues and increased benefit claims in the short run, the system continues to face a 75-year deficit equal to about 2 percent of taxable payroll.

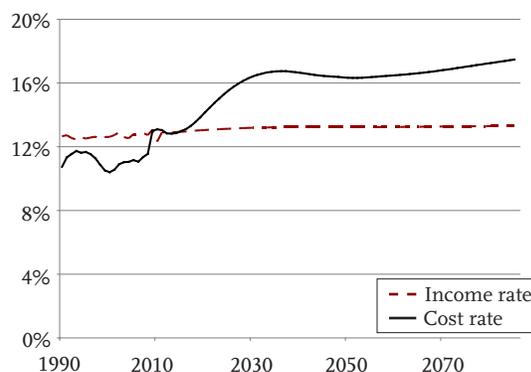
This *brief* puts the current report in perspective and discusses a few interesting wrinkles, such as the outlook for a cost-of-living adjustment in 2011 and the implications of a decline in the Average Wage Index. Unfortunately, for the third year in a row, the Social Security Trustees Report has not been signed by any public trustees. The absence of these independent voices from the valuation process reflects a persistent failure of the political process, but not of the program itself.

The 2010 Report

As usual, the Social Security actuaries project the system's financial outlook over the next 75 years under three assumptions – high cost, low cost, and intermediate. This *brief* focuses on the intermediate assumptions.

Since Social Security is financed primarily on a pay-as-you-go basis, demographic trends are very important. The fact that the baby boom has begun to retire, however, is not news. These individuals were born between 1946 and 1964, so the actuaries have known of their whereabouts for a long time. As a result, the increasing ratio of beneficiaries to workers due to the aging of the population is virtually identical to that described in earlier Trustees Reports. As in earlier reports, this increasing ratio – rising from 34 beneficiaries per 100 workers today to 51 in the future – causes the cost rate of the system to rise above the income rate (see Figure 1).

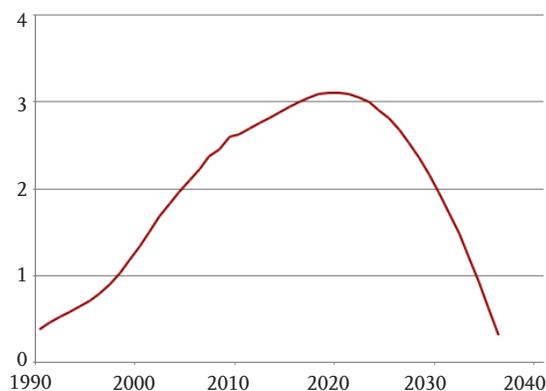
FIGURE 1. PROJECTED SOCIAL SECURITY INCOME AND COST RATES, 1990-2086 (AS A PERCENT OF TAXABLE PAYROLL)



Source: 2010 Social Security Trustees Report, Table IV.B1.

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FIGURE 2. SOCIAL SECURITY TRUST FUND ASSETS, 1990-2040 (TRILLIONS OF 2010 DOLLARS)



Source: 2010 Social Security Trustees Report, Tables V.B1, VI.A4, and VI.F8.

While headlines have focused on the squiggles in 2010 and 2011, the big picture is that for the last two decades the cost rate has been below the income rate and Social Security has run cash flow surpluses. These surpluses began in response to reforms enacted in 1983 and were scheduled to continue for several more years. Because of the recession-induced decline in payroll taxes and surge in benefit claims, the cost rate slightly exceeded the income rate in 2010 and 2011. The pattern is scheduled to reverse itself for the years 2012-2014, after which the cost rate starts to exceed the income rate on a steady basis. At that time, Social Security will have to regularly tap the interest on trust fund assets to cover benefits. And in 2025, 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 fund will be exhausted in 2037 (see Figure 2). These dates have not changed very much over the past five years (see Table 1).

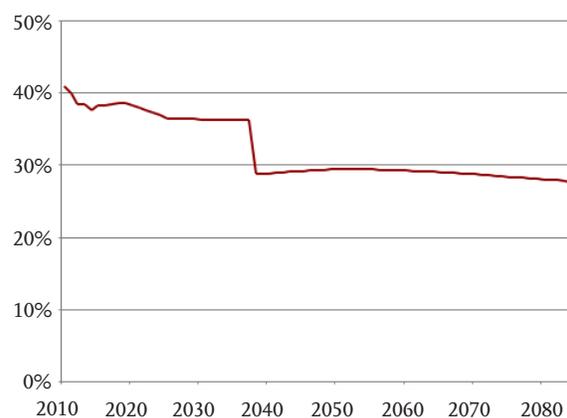
TABLE 1. KEY DATES FOR SOCIAL SECURITY TRUST FUND

Event	Trustees Report				
	2006	2007	2008	2009	2010
First year outgo exceeds income excluding interest	2017	2017	2017	2016	2015
First year outgo exceeds income including interest	2027	2027	2027	2024	2025
Year trust fund assets are exhausted	2040	2041	2041	2037	2037

Sources: 2006-2010 Social Security Trustees Reports.

Assuming no new legislation, what happens in 2037 when the trust fund is exhausted? Some commentators describe the program as “bankrupt,” leaving the impression that Social Security has no money at all. But payroll tax revenues continue rolling in. So the system will still have enough revenue to pay 78 percent of currently legislated benefits after exhaustion of reserves in 2037. Relying on only current tax revenues, however, means that in 2037 the replacement rate – benefits relative to pre-retirement earnings – for the typical worker would drop from 36 percent to 29 percent (see Figure 3). (Note that the replacement rate for those claiming at age 65 is already scheduled to decline from 41 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 FROM EXISTING TAX REVENUES, 2010-2085



Source: 2010 Social Security Trustees Report, Tables IV.B1 and VI.F10.

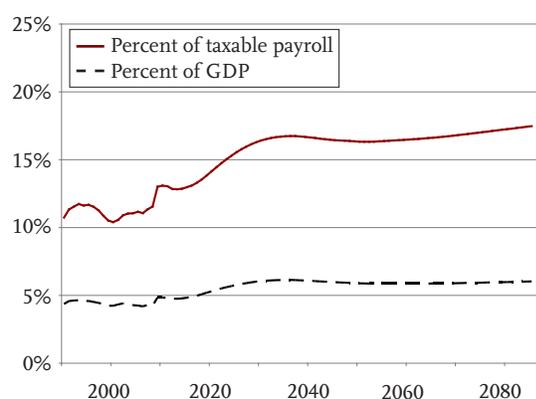
Over the next 75 years, Social Security’s long-run deficit is projected to equal 1.92 percent of covered payroll earnings. That figure means that if payroll taxes were raised immediately by 1.92 percentage points – 0.96 percentage point each for the employee and the employer – the government would be able to pay the current package of benefits for everyone who reaches retirement age at least through 2086.

A lasting fix for Social Security would require additional changes. Solutions that focus just on the next 75 years sometimes involve the buildup of trust fund assets in the near term and the sale of those assets to pay benefits in the out years. Since the trust fund would have no further bonds to sell in the 76th year under this approach, the program would suddenly be

short of money. Lasting solvency would require either a pay-as-you-go system with substantially higher payroll tax rates/lower benefits or the buildup 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 toward long-run solvency.

Social Security’s shortfall looks even less daunting when outlays are shown as a percent of Gross Domestic Product (GDP). The cost of the program is projected to rise from 4.8 percent of GDP today to 6.0 percent of GDP in 2040, where it remains even after the retirement of the baby boom (see Figure 4). The reason why costs as a percent of GDP more or less stabilize – while costs as a percent of taxable payroll keep rising – is that taxable payroll is projected to decline as a share of total compensation due to continued growth in fringe benefits.

FIGURE 4. SOCIAL SECURITY COSTS AS A PERCENT OF GROSS DOMESTIC PRODUCT AND TAXABLE PAYROLL, 1990-2086



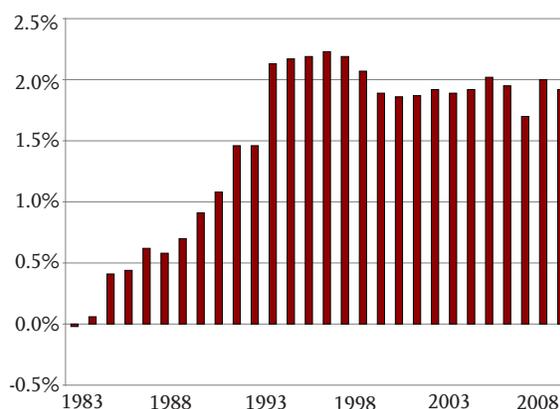
Source: 2010 Social Security Trustees Report, Figures II.D5 and IV.B1.

The 2010 Report in Perspective

Social Security’s 75-year deficit is slightly lower than that reported a year ago: 1.92 percent versus 2.00 percent of taxable payroll. At the risk of some oversimplification, the decrease is due to two offsetting factors: 1) moving the projection period forward to include a year with a large deficit; and 2) increasing the proportion of compensation paid in taxable cash wages due to a projected reduction in employer-provided group health insurance as a result of the 2010 health care legislation.

But recent 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 PAYROLL, 1983-2010



Source: 2010 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 payroll; the 2010 Trustees project a deficit of 1.92 percent. Table 2 on the next page shows the reasons for this swing of 1.94 percent of taxable payroll. 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 2010 Report is 2010-2084. Each time the valuation period moves out one year, it picks up a year with a large negative balance.

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. Another positive factor has been the effect of legislation/regulation, such as the recent health care legislation.

TABLE 2. REASONS FOR CHANGE IN SOCIAL SECURITY'S 75-YEAR DEFICIT AS A PERCENT OF PAYROLL, 1983-2010

Item	Change
Actuarial balance in 1983	0.02
Changes in actuarial balance due to:	
Valuation period	-1.58
Disability data and assumptions	-0.67
Projection methods and data	-0.06
Economic data and assumptions	-0.48
Legislation/regulation	0.30
Demographic data and assumptions	0.58
Other factors*	-0.03
Total change in actuarial balance	-1.94
Actuarial balance in 2010	-1.92

* Discrepancies due to rounding.

Sources: Author's calculations based on earlier analysis by John Hambor, re-created and updated from *Social Security Trustees Reports*, 1983-2010.

Unfunded Obligations

Although the Trustees Report focuses on Social Security's financial shortfall as a percent of either taxable payroll 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 \$5.4 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 payroll over the next 75 years brings us back to the 1.92 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 measure amounts to \$16.1 trillion. Most analysts think that 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 payroll over the infinite horizon produces a shortfall equal to 3.3 percent of taxable payroll (see Table 3).

TABLE 3. SOCIAL SECURITY'S FINANCING SHORTFALL

Period	Present value (trillions)	As a percent of	
		Taxable payroll	GDP
2010-2085	\$5.4*	1.8	0.6
2010-infinity	\$16.1	3.3	1.2

* The \$5.4 trillion is the difference between scheduled benefits and projected revenues; it excludes another \$441 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 payroll is 1.92 percent as reported earlier.

Source: 2010 *Social Security Trustees Report*, Tables IV.B5 and IV.B6.

Interesting Wrinkles

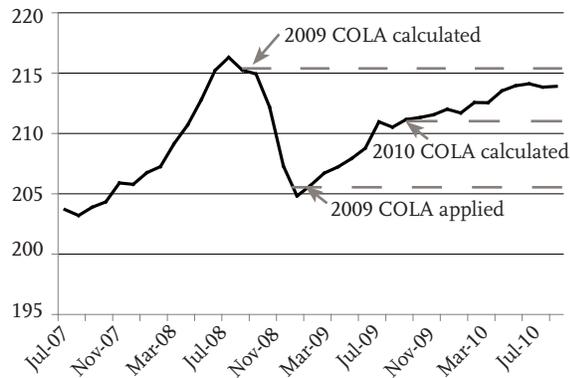
The Trustees Report also contains projections of: 1) the cost-of-living adjustment (COLA), which is used to increase benefits; and 2) the Average Wage Index, which is used to adjust the contribution base, limits for the earnings test, and factors in the benefit formula.

No Projected COLA for 2010

The Trustees Report suggests that Social Security beneficiaries will receive no COLA for the second year in a row. Social Security COLAs are calculated every October by comparing the third-quarter data of the Consumer Price Index for Urban Workers (CPI-W) with the previous year's numbers, and then the adjustment is made for the following December. In the case of the 2009 adjustment, rising energy prices called for a 5.8 percent COLA. However, before the 2009 COLA could even be paid, prices had dropped back below their 2008 levels (see Figure 6 on the next page). To make up for this "overpayment," Social Security will not make any COLA payments until the CPI-W rises above the level at the third quarter of 2008. (Social Security never reduces benefits when prices decline.) Recent data suggest that the CPI-W may not reach this target until 2011.

Although some beneficiaries might feel they are being treated unfairly, this procedure is equitable. The cost of living is not yet higher than it was in the third quarter of 2008. In fact, most beneficiaries come out a little bit ahead because the real value of their benefits has increased for a while. Moreover, for all but the richest beneficiaries, Medicare premiums are not allowed to increase in a year without a COLA.

FIGURE 6. CONSUMER PRICE INDEX (CPI-W),
JULY 2007-JULY 2010



Source: U.S. Bureau of Labor Statistics, *Consumer Price Index for Urban Wage Earners and Clerical Workers, 2007-2010*.

Decline in Average Wage Index for 2009

The 2010 Trustees Report also shows a decline for 2009 in the Average Wage Index, a unique occurrence since the program was automatically adjusted for wage growth. Two implications of this decline are that the maximum contribution base will stay at its current level of \$106,800 in 2011 and the exempt amount for the earnings test will stay at \$14,160. The decline in average wages will also affect the indexation of taxable earnings and the bend points in the benefit formula, so it will have a complex, but small, effect on benefit levels.

Conclusion

The 2010 Trustees Report confirms what has been evident for two decades – namely, Social Security is facing a modest long-term financing shortfall. The recession following the financial crisis has had some short-term effects on revenues and benefits, but has not adversely affected the long-run outlook. The long-run deficit can be eliminated only by putting more money into the system or by cutting benefits. There is no silver bullet. Despite the political challenge, stabilizing the system's finances should be a high priority to assure people they will receive the income they need in retirement.

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