Social Security Implicit Debt Not Binding

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European proposal to add public pension implicit debt not relevant to U.S.

At a recent OECD meeting on public pensions, I was asked to consider whether public pension implicit debt is a useful measure to assess fiscal sustainability. Apparently with the endorsement of the European System of Accounts 2010, European countries will have to report data on their public pension entitlements. This new requirement forced me to think about the extent to which such disclosure would be relevant and helpful in the United States.

At the state and local level, it seems like adding unfunded public pension promises to outstanding general obligation debt to evaluate a state's fiscal well-being does make sense. State governments provide defined benefit plans for their public sector workers, and the accrued benefit promises are a legal commitment. They are protected by law, and states cannot go bankrupt, so they generally have no mechanism for escaping these payments. Given that these payments are as fixed as the obligation associated with government debt, adding the two together provides a meaningful measure of the demand on future state revenues. Companies that rate the quality of debt issued by various states routinely combine, either implicitly or explicitly, unfunded liabilities with general obligation bonds.

But it is not clear that such an exercise makes sense with regard to our Social Security system. In the United States, Social Security can only spend what it has collected. That is, we are covering current benefits by annual payroll tax revenues and by drawing down reserves in the trust fund; once the trust fund reserves are exhausted, benefits will have to drop to levels that can be funded by the payroll tax alone. Thus, in a legal sense, the U.S. social insurance system does not have an unfunded liability. Since it is not a fixed obligation, it should not be treated like government debt.

Facts aside, assume that implicit debt were added. That would mean adding Social Security's unfunded liability to the roughly $13 trillion of debt in the hands of the public. But what is Social Security's unfunded liability? The number regularly calculated by the actuaries is an open group unfunded obligation over the next 75 years. Open group valuation, which includes non-interest income and the cost of past, current, and future participants through 2088, equals $10.6 trillion. This is a very different concept than that used for a funded plan, which measures only the accrued benefits of current retirees and plan participants. In any event, adding the unfunded liability would almost double our debt; raising the total from 72 percent of GDP to 134 percent. I'm not sure what to make of that.

I do know that we could eliminate the Social Security deficit over the next 75 years by raising the combined employee-employer payroll tax from 12.4 percent of payroll to 15.4 percent – a 1.5-percentage-point increase for the employee and the employer.

The area where our projected spending is likely to outrun available revenues is in health care. Because of rising health care costs and, to a lesser extent, an aging population, spending for Medicare and Medicaid is scheduled to increase rapidly. No Social-Security-type trigger exists to align spending with available revenues, except for the portion of Medicare that pays for hospital care. These programs are the major source of future deficits, as expenditures will grow more quickly than revenues.

It does make sense to look at future commitments compared to future revenues to see whether our debt-to-GDP ratio is stable or increasing. The Congressional Budget Office does this exercise regularly. And, with current policies, deficits and debt are heading to dangerously high levels. The levels are dangerous because increased government borrowing crowds out investment in productive capital; reduces the government's ability to use fiscal policy to combat recessions; and increases the chance that investors lose confidence in the government's ability to manage its finances, driving up interest rates.

Over the long term, we need to raise additional revenues and continue to look for ways to hold down increases in health care costs. Simply adding Social Security's non-binding unfunded liability to current debt sheds little light on the sustainability of U.S. government finances.