

Social Security's financial outlook: The 2006 update in perspective

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SOCIAL SECURITY'S FINANCIAL OUTLOOK: THE 2006 UPDATE IN PERSPECTIVE

BY ALICIA H. MUNNELL*

Introduction

The Social Security Trustees have just issued their 2006 Report on the financial outlook for the system. The Report uses three sets of cost assumptions — high, low, and intermediate. This *brief* focuses on the intermediate assumptions and puts this year's numbers in perspective.

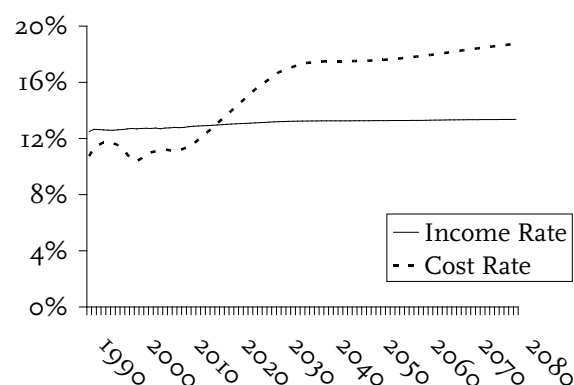
The 2006 Report

The economic and demographic trends in the 2006 Report are fully consistent with those in earlier Reports. Fewer births and longer life spans produce an aging population. The number of Social Security beneficiaries per 100 workers is projected to increase from 30 today to 54 in the future, and the costs of what is essentially a pay-as-you-go system will rise (see Figure 1).

Today Social Security is running a cash flow surplus of about \$70 billion. These surpluses, which were the result of reforms enacted in 1983, will last until 2017. Adding interest on trust fund assets to tax receipts produces enough revenues to cover benefit payments until 2027. From 2027 on, annual income 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 2040 (see Figure 2). The exhaustion date is one year earlier than in reported last year (see Table 1).

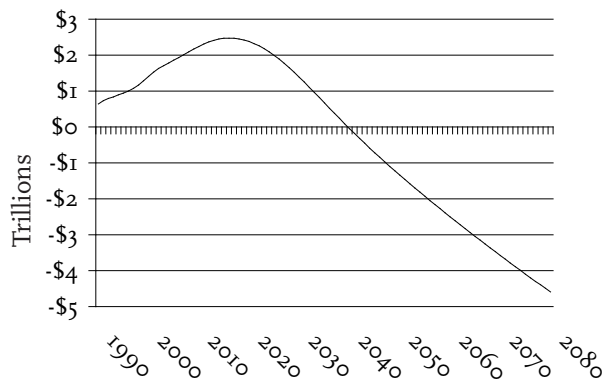
FIGURE 1. SOCIAL SECURITY INCOME AND COST RATES AS PERCENT OF TAXABLE PAYROLL, 1990-2080



Source: U.S. Social Security Administration (2006a).

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FIGURE 2. SOCIAL SECURITY TRUST FUND ASSETS, 1990-2080



Source: U.S. Social Security Administration (2006a).

Assuming no new legislation, what happens in 2040? This date is often described as the point at which Social Security is bankrupt, leaving the impression that there is no money at all. But tax revenues continue rolling in. So Social Security still has enough revenue to pay roughly 70 percent of currently legislated benefits.

TABLE I. KEY DATES FOR THE SOCIAL SECURITY TRUST FUND

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

Source: U.S. Social Security Administration (2006a).

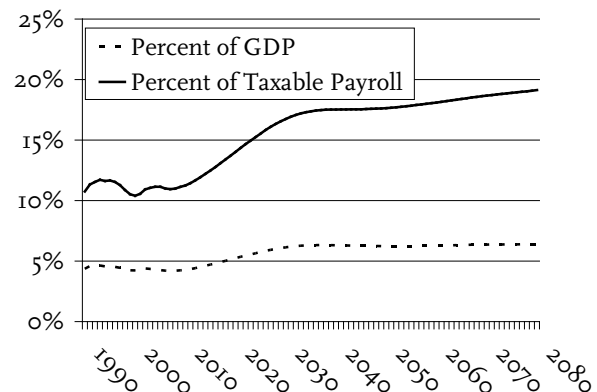
Over the next 75 years, Social Security's long-run deficit is projected to equal 2.02 percent of covered payroll earnings. That figure means that if the payroll tax rate were raised immediately by roughly 2 percentage points — 1 percentage point each for the employee and the employer — the government would be able to pay the current package of benefits for everyone

who reaches retirement age at least through 2080. The size of the tax increase needed to make the system solvent is a useful way to gauge the shortfall over the 75-year period.

Social Security's financing problem is somewhat more complicated than just described. Under current law, the tax rate is fixed while costs are rising. This pattern produces surpluses now and large deficits in the future. As a result of this profile, for each year the projection period moves forward, another year with a large deficit is added to the 75-year deficit. Assuming nothing else changes, this phenomenon will slightly increase the 75-year deficit each year (.07 percent of taxable payroll with today's deficits).

A different pattern of costs emerges when Social Security outlays are projected as a percent of Gross Domestic Product (GDP) rather than as a percent of taxable payroll (see Figure 3). The cost of the program is projected to rise from 4.3 percent of GDP today to 6.3 percent of GDP in 2045, where it remains through 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 payroll keep rising is that taxable payrolls are projected to decline as a share of total compensation due to continued projected growth in untaxed fringe benefits, such as health insurance.

FIGURE 3. SOCIAL SECURITY COSTS AS PERCENT OF GROSS DOMESTIC PRODUCT AND TAXABLE PAYROLL, 1990-2080



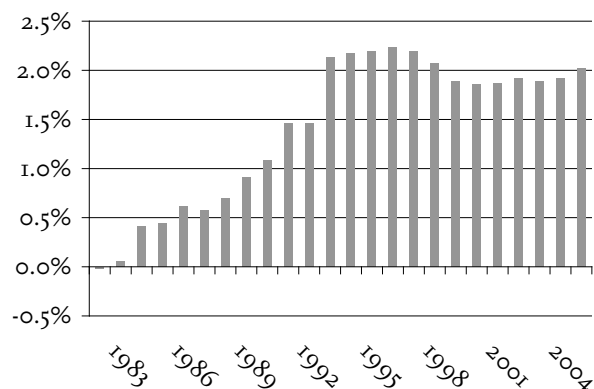
Source: U.S. Social Security Administration (2006a).

The 2006 Report in Perspective

Social Security's 75-year deficit is slightly higher from that reported a year ago: 2.02 percent versus 1.92 percent of taxable payroll. The increase is due to two factors: 1) moving the projection period forward to include a year with a large deficit, and 2) reducing the assumed long-term interest rate from 3.0 to 2.9 percent, which increases the present value of projected deficits later in the valuation period.

But recent numbers are in sharp contrast to the projection of a 75-year balance in 1983 when Congress enacted the recommendations of the so-called Greenspan Commission. Almost immediately after the 1983 legislation, however, deficits appeared and increased sharply in the early 1990s (see Figure 4). Why did the balance deteriorate? In the 1983 Report, the Trustees projected a 75-year actuarial surplus of 0.02 percent of taxable payroll; the 2005 Trustees

FIGURE 4. SOCIAL SECURITY'S 75-YEAR DEFICIT AS A PERCENT OF TAXABLE PAYROLL, 1983-2006



Source: Author's calculations.

project a deficit of 2.02 percent. Table 2 shows the reasons for this swing of 2.04 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 2006 Report is 2006-2080. 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. TARGET REPLACEMENT RATES BY INCOME GROUP AND HOUSEHOLD TYPE

Item	Change
Actuarial balance in 1983	0.02
Changes in actuarial balance due to:	
Legislation/regulation	0.16
Valuation period	-1.35
Demographic data and assumptions	0.77
Economic data and assumptions	-0.35
Disability data and assumptions	-0.70
Projection methods and data	-0.56
Other factors	-0.01
Total change in actuarial balance	-2.04
Actuarial balance in 2006	-2.02

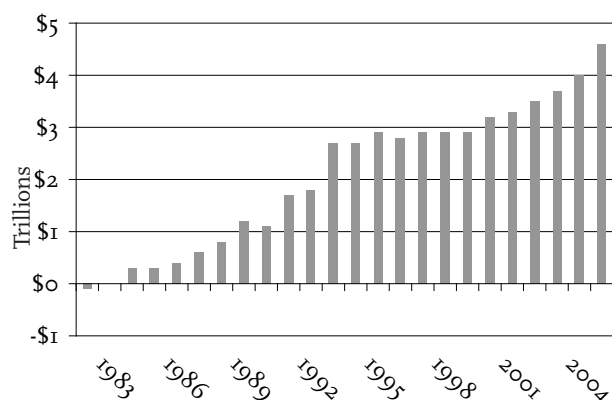
Source: Author's calculations based on earlier analysis by John Hambor, recreated and updated from Social Security Trustees Reports, 1983-2006.

The other major factors contributing to the increase in the deficit have been the change in methods of analysis used by the actuaries and unexpected increases in disability rolls. With respect to disability, the number of awards per 1,000 workers rose from 3 in 1983 to over 5 today.¹ Another contributor to the increased actuarial deficit over the past 23 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

The Trustees' Report presents the Social Security's shortfall in dollar terms, as well as a percent of either taxable payroll or GDP. The present discounted value of the difference between projected revenues and expenditures over the next 75 years is \$4.6 trillion. (Dividing this number — plus a one-year reserve cushion — by taxable payroll over the next 75 years brings us back to the 2.02 percent deficit discussed above). Figure 5 shows how the 75-year unfunded liability has changed over time.

FIGURE 5. SOCIAL SECURITY'S UNFUNDED OBLIGATIONS FOR THE 75-YEAR PROJECTION PERIOD, 1983-2006



Source: Goss et al (2004) and U.S. Social Security Administration (2006a).

An even larger number that appears in the Report is \$13.4 trillion. This number represents the present discounted value of the difference between revenues and benefits from now to infinity. Infinity is a very long time. And many 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 payroll over the infinite horizon produces a shortfall equal to 3.7 percent of taxable payroll (see Table 3).

TABLE 3. SOCIAL SECURITY'S FINANCING SHORTFALL

Period	Present discounted value (trillions)	As a percent of	
		Taxable payrolls	GDP
2006-2080	\$4.6	1.9	0.7
2006-infinity	\$13.4	3.7	1.3

Source: U.S. Social Security Administration (2006a).

*Note: The \$4.6 trillion is the difference between scheduled benefits and projected revenues; it excludes the amount 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 2.02 as reported earlier.

Both unfunded liability measures increased in the 2006 Report — from \$4.0 trillion in 2004 to \$4.6 trillion in 2006 for the 75-year period and from \$11.1 to \$13.4 trillion in 2006 for the period to infinity. In both cases, this increase is primarily due to the inflation and real interest rate impact of postponing the date of restoring balance for one year. The numbers as a percent of taxable payroll and as a percent of GDP remained virtually unchanged, however, because the present value of future payroll and GDP increased along with the unfunded obligations.

Conclusion

The 2006 Trustees Report reconfirms 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 immigration, disability, mortality, and real wage growth are uncertain, switching any of the individual assumptions to the Trustees “low cost” scenario closes only part of the gap. Therefore, this problem can be solved only by putting more money into the system or by cutting benefits. There is no silver bullet.

Endnotes

1 Social Security Administration (2004).

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About the Center

The Center for Retirement Research at Boston College was established in 1998 through a grant from the Social Security Administration. The Center's mission is to produce first-class research and forge a strong link between the academic community and decision makers in the public and private sectors around an issue of critical importance to the nation's future.

To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

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