IRET Congressional Advisory

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SOCIAL SECURITY STILL NEEDS FIXING

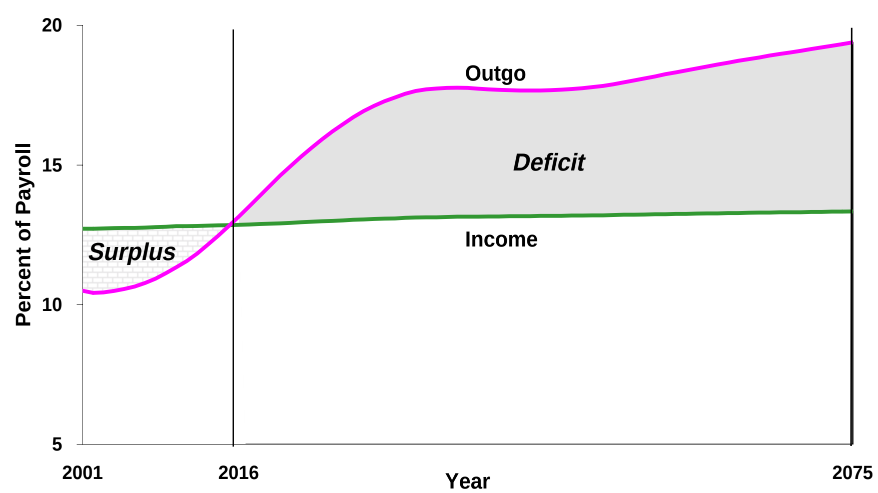
The slightly improved outlook in the 2001 Social Security Trustees Report does not change the fact that the Social Security retirement and disability programs still need fixing.

Thanks largely to recent strength in the economy, the Social Security Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs, together referred to as OASDI, are projected to run operating surpluses — taxes in excess of outlays — through 2016, a year longer than in last year's Report. The deficit spending authority given by the System's trust funds is expected to cover subsequent deficits until 2038, a year longer than in last year's Report. At that point, however, OASDI revenue from payroll taxes and taxing benefits will cover only 73% of benefits, and the system will not be able to make its payments on time.

After the baby boom has retired, the annual OASDI shortfalls are projected to grow very large. The deficit will exceed 4.5 percent of taxable payroll in 2038, and reach 6.05 percent of taxable payroll by the end of the 75-year planning period. Tax revenue will cover only 67% of benefits in 2075.

Put another way, by 2038, the payroll tax rate would have to be raised by 37% or benefits would have to be cut by 27% to balance the OASDI system. By 2075, the payroll tax rate would have to be raised by 49% or benefits would have to be cut by 33% to balance the OASDI system.

Social Security: Short Run Surpluses, Long Run Deficits



Data from The 2001 Annual Social Security Trustees Report, Table IV.B1, Combined OASI and DI Trust Funds, Intermediate Assumptions, year by year projections for 2001-2075, accessed at www.ssa.gov/oact/tr/tr01/1r4b-2.html.

Ultimately, either the payroll tax will have to be boosted by more than 6 percentage points, or benefit growth will have to be trimmed, or some other tax revenue will have to be diverted to OASDI. (Add in the 7.35 percent of payroll deficit projected for Medicare's Hospital Insurance program in 2075, and the payroll tax increase would have to be 13.4 percentage points.)

It is not true, as some may claim, that a hike in the payroll tax of less than 2 percentage points would fix the OASDI system. The status of OASDI is sometimes summarized (unfortunately) by its 75-year average annual surplus or deficit. This 75-year "actuarial balance" adds together the starting trust fund totals, projected annual surpluses through 2015, continued deficits thereafter (cut off at 75 years in 2075), and a target end-of-period trust fund balance. The result is expressed as a percent of 75 years of taxable payroll. The 75-year actuarial balance is now a negative 1.86 percent of payroll, leading some advocates of the status quo for Social Security to claim that the system is not in serious trouble, and that an immediate but (in their opinion) modest hike in the payroll tax of a bit under 2 percentage points would fix the system "for the long term".

> ***This trigger, tied to the budget surplus, would let Congress block the tax cut just by spending too much... [W]hy haven't they proposed a trigger on federal spending instead of tax cuts?***

A simplified example may help explain why this sort of average is misleading. Suppose a business has revenues of $10,000 and costs of $8,000 in year 1, revenues of $10,000 and costs of $12,000 in year 2, and revenues of $10,000 and costs of $16,000 in year 3 ***and every year thereafter***. Suppose an average is taken for years 1 through 3. According to the 3-year average, average income is $10,000, average cost is $12,000, and the average loss is $2,000. Can the business avoid going broke if it increases revenues by $2,000 or reduces costs by $2,000? No, because ultimately it has to deal with yearly losses of $6,000.

> ***[In 2038] OASDI revenue from payroll taxes and taxing benefits will cover only 73% of benefits, and the system will not be able to make its payments on time.***

The 3-year average is too optimistic about the firm's finances even by year 2 unless the business saves its surplus in the first year and uses it to cover the year 2 deficit. But if the business has spent that first year surplus on dividends or debt repayment, it will not be available even to cover year 2 outlays. Also notice that as time advances the years in the average move forward. The 3-year average in year 2 would cover years 2 through 4, and in year 3 would cover years 3 through 5. With surplus years dropping from the average and deficit years being added, the 3-year average cash flow will worsen until the steady state is reached. Thus, even if the 3-year average deficit in year 1 were "fixed", additional fixes would be required in years 2 and 3.

> ***[B]y 2038, the payroll tax rate would have to be raised by 37% or benefits would have to be cut by 27% to balance the OASDI system.***

The Social Security Trustees Report does a disservice to policy makers and the public by displaying the meaningless 75-year average calculation and giving credence to the phony "1.9 percent solution". As for the trust fund balances included in the average, there is no money there. The trust funds (past OASDI surpluses plus interest) are only a record of money that the government has spent on other federal programs. Similarly, the projected near-term surpluses will be spent to reduce the national debt. None of that money will be available to pay benefits when OASDI moves into deficit. The so-called "trust fund" notwithstanding, if Social Security is in deficit in a given year, the Treasury must borrow, raise taxes, or cut other spending in that year to make ends meet. In 2075, the OASDI deficit will exceed 6% of payroll. Boosting the current surplus with a 1.86 percentage point tax hike would only pay down the national debt faster, and would still leave the system short of balance by more than 4% of payroll at the end of the period.

It is not true, as some may claim, that a hike in the payroll tax of less than 2 percentage points would fix the OASDI system... [Long term,] the [yearly] OASDI deficit will exceed 6% of payroll.

The Summary of the Trustees Report is referring to the 75-year actuarial balance of -1.86 percent of payroll when it states, "This deficit means bringing Social Security into actuarial balance over the next 75 years could be achieved by either a permanent 13 percent reduction in benefits or a 15-percent increase in payroll tax income, or some combination of the two." But in the very next paragraph, the Summary admits that, at the end of the period, the system would be severely out of balance, saying, "On a year-by-year basis, cash-flow deficits are projected to rise to levels in excess of 6 percent of taxable payroll by the end of the 75-year period primarily because of the upward shift in the average age of the population." Those deficits will require far larger tax hikes (49%) or benefit cuts (33%) to balance the system longer term.

Ultimately, either the payroll tax will have to be boosted by more than 6 percentage points, or benefit growth will have to be trimmed, or some other tax revenue will have to be diverted to OASDI... Put another way, by...2075, the payroll tax rate would have to be raised by 49% or benefits would have to be cut by 33% to balance the OASDI system.

The 75-year actuarial balance misleads policy makers. Every few years, the current system's defenders push for a one or two percentage point payroll tax hike, increased taxation of benefits, or other changes to "fix" the system by bringing the 75-year average into balance. Then, as the calculation period moves forward, additional years of deficit are brought into the average, the long term imbalance reemerges, and the system's advocates ask for another one or two percentage point "fix". In this manner, Congress and the public are tricked into a series of gradual tax increases to fund the system. The 1977 and 1983 Social Security Amendments and the 1993 Budget Act are cases in point.

The only correct way to view the Social Security system is to look at its future surpluses and deficits on a year-by-year basis. Long term, the system is projected to run large permanent deficits. Those deficits will require drastic action, the new Trustees Report notwithstanding. If the Congress and the public were more aware of the full scope of Social Security's costs and imbalances, they might opt for a real change. Ideally, that change would involve reduced reliance on the pay-as-you-go Social Security tax-transfer system, and increased reliance on real private saving for retirement.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.