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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Social Security back in the Spotlight

The financial crisis has created an economic environment characterized by fiscal stimulus initiatives and an expansion of government debt. President Obama has recently established a National Commission on Fiscal Responsibility to recommend ways of addressing the US budget deficits. Inevitably, "entitlement" programs such as Medicare and Social Security are in the spotlight for debate about their long-term costs, solvency, sustainability and affordability. This issue of *Commentary* is devoted to clarifying some misperceptions that have surfaced recently concerning the Social Security Trust Fund, the impact of increasing longevity, the nature of the Social Security long-term financial projections, and budget deficits.

The Social Security Trust Fund has assets of two and a half trillion dollars invested in special issue Treasury Bonds at market rates of interest. Annual reports of the Social Security Trustees disclose the amounts of each bond, interest rate and maturity date. These bonds are routinely redeemed in full on maturity. The Social Security Trust Fund represents the accumulated excess of Social Security revenue receipts over the amounts of benefits and expenses paid. It is a stabilizer fund that results from setting the payroll tax rate at a constant rate to finance the payment of benefits that are projected to increase from year-to-year in the future. The Social Security system does not have any borrowing power to finance any future shortfall in the actuarial balance of the system. Social Security does not contribute to the US budget deficit. The challenge to the US Treasury of funding the maturities of the special issue bonds is the borrower's problem; it is not a problem created by the lender.

It is evident that improvements in longevity, combined with declining birth rates, have produced a demographic shift towards an aging society. This has brought into sharp focus the trend in the ratio of the number of active workers to the number of beneficiaries under Social Security. As a result questions have been raised concerning the long-term financial sustainability of the system. However, the reality is that the expected increasing longevity is already recognized in the official 75-year financial projections. The system currently has a projected solvency ratio in excess of 100 percent all the way to 2037. The "baby boomer" generation's effect on Social Security is not unanticipated; by 2037 most of that generation and their beneficiaries will have died; there is no truth to the assertion that the increasing longevity of the baby boomers is causing a deficit problem or that it was not recognized in advance.

The effect of the overall future economic outlook and demographic change do, however, pose a challenge. The long range implications of this secular change will require a higher level of financing over the long-term to maintain the level of currently scheduled benefits after 2037. Some experts advocate cutting benefits so as to preserve the payroll tax rate at its current level and recommend, in particular, accomplishing this by changing the eligibility age for retirement beyond the current law's scheduled age. A more realistic approach would be to acknowledge the emergence of an aging society, consider the affordability of maintaining the present system of scheduled benefits, and move away from the concept of a fixed payroll tax rate. The current system is projected to have an actuarial imbalance of approximately two percent of taxable payroll over the next 75 years. This problem could have easily been avoided, if at the time of the 1983 reforms to the system, the effect of the projected long-range demographic change in the "out years" beyond the 75-year projection period had been recognized. An automatic annual escalation of the payroll tax rate by an amount of 0.04 percent for both employer and employee, over the last twenty-five years, added to the then current tax rate, would have resulted in the rate rising by small steps to 7.2 percent currently, exactly meeting the level required to eliminate the current projected 75-year shortfall.

The concept of financing a system of defined scheduled benefits for a dynamically changing population with a fixed payroll tax rate is clearly untenable and leads to the misguided idea that social and economic policy for old-age income security should be driven by the requirement to maintain a permanently level payroll tax rate so as to achieve actuarial balance over a specific time horizon. Henry Wadsworth Longfellow wrote in one of his poems "it is never too late to do what is right." In our opinion it is time to consider abandoning the concept of a fixed payroll tax rate and introduce incremental annual adjustments of perhaps 0.05 percent so as to correct a defect in the structure of the Social Security financing mechanism. The question of affordability is a quite separate issue that merits consideration in terms of the nation's social and economic priorities.

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