JUNE 2011

Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

United States Social Security: Cash Flow Adequacy Test

The Social Security Trustees publish a report every year on the financial condition of the system. When the trustees' results are released, the public is subjected to misrepresentations of the true financial position of the system by the popular media and by various opponents of the system. Headlines typically proclaim that the system is "bankrupt" or will face a "meltdown" in some future year. In fact the trustees' report contains the results of actuarial projections of expected income and outgo including payroll tax revenue and scheduled benefits. These projections, together with the value of interest income and the maturity values of assets held by the trust fund, provide a reliable measure of the ability of the system to meet its financial obligations to current and future generations. These projections are made over a short-term 10-year period and for longer periods of 25, 50 and 75 years. The report contains a clear statement to the effect that the longer-term projections become less reliable as the length of the projection period increases. The results of these projections are presented on the basis of three different sets of economic and demographic assumptions concerning the range of plausible future outcomes. These are generally referred to as the "intermediate", "low-cost" and "high-cost" projections. The "intermediate" results are widely regarded as the official assessment of the financial condition of the system, while the "low-cost" and "high-cost" projections may be regarded as representing the extremes of the range of plausible future outcomes.

It is important to note that the US Social Security system is a social transfer system; current payroll tax income is used to pay current benefits; the trust fund is merely a short-term reserve fund that serves as a means to stabilize the necessary payroll tax rate at a fixed level and provide a small buffer between cash flow income and cash flow outgo. The ability of the system to meet its financial obligations for future scheduled benefits may be assessed by comparing the relative values of the two cash flow streams over various projection periods with appropriate allowance for the accumulated reserves in the buffer fund. This cash flow adequacy or solvency test may be quantified in terms of the relative values of these income and outgo cash flow streams on a percentage scale where 100% represents full cash flow adequacy over the projection period and a percentage above or below 100% indicates that a future surplus or deficit is likely to emerge. This metric provides a response to the frequently-asked question from the public: "will there be enough money in the system to pay my benefits when I retire?" This cash flow solvency measure is readily computed from the results published in the trustees report for all three projection bases and for various projection periods.

The recently-published trustees' 2011 results on the "intermediate" basis indicate that the system has a solvency ratio of 100% for 25 years and corresponding solvency ratios of 90% and 87% for the 50-year and 75-year projection periods. On the low-cost basis, the 25, 50 and 75-year solvency ratios are 110%, 103% and 103% respectively. On the "high-cost" basis, the 25, 50 and 75-year solvency ratios are 91%, 78% and 72% respectively. It is apparent from these results that the system will almost certainly generate sufficient cash flow to meet obligations over the next 25 years and is projected to generate a very high percentage of the required cash flow over the next 50 and 75 years. On the "intermediate" basis the implied shortfalls in cash flow income of 10% over 50 years and 13% over 75 years will require some adjustments to the system in order to move the projected cash flow values into long-term balance. In percentage terms these adjustments are not large and do not mean that the system is unsustainable in its present form. Indeed, relatively modest adjustments to the payroll tax or benefits provisions would serve to achieve a 100% long-term cash flow balance between projected income and outgo for 50 or 75 years.

These cash flow solvency measures speak for themselves in terms of the ability of the system to meet its scheduled obligations. The future year at the end of the period for which the intermediate projection indicates the solvency ratio drops below 100% to 99.99% is the source of frequent misunderstanding and misrepresentation by the media and the system's opponents. In fact this point in time is merely the year in which the buffer fund will require increased projected incoming cash flow in order to maintain a modest reserve level sufficient to pay the then current benefits; it does not mean that the system is unsustainable. It simply provides an advance warning signal that adjustments will be required before that point is reached.

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