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Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Social Security: Time for Debate

The recent report of the President's Commission to Strengthen Social Security describes three alternative models for a reformed Social Security system using personal accounts. The Commission appeals for action to be taken soon to place Social Security on a fiscally sustainable course and recommends a period of discussion before legislative action to strengthen Social Security. This issue of *Commentary* is dedicated to identifying issues and posing some challenging questions for debate.

How serious is the financial problem facing the existing Social Security System? Is the system unsustainable in its present form? The Trustees' annual reports present a measure of the actuarial balance of the system over various projection periods from 10 years to 75 years on each of three different sets of economic and demographic assumptions. The actuarial balance concept compares the value of future income and current assets of the system to the value of future benefit and other costs plus a reserve of one year's benefit payments. Currently, the actuarial balance is above 100% over the next 30 years and equals 96% for 40 years, 93% over 50 years, and 88% over 75 years. On the Trustees' low-cost basis, the actuarial balance exceeds 100% over the full 75-year projection period. On the Trustees' high-cost basis, the actuarial balance exceeds 100% for more than 20 years, is equal to 98% over 25 years, and is projected at 81% and 74 % for 50 and 75 years respectively.

Can Social Security be made fiscally sustainable without personal accounts? In their 2001 report, the Social Security Trustees indicate that bringing the system into actuarial balance over the next 75 years would require an increase of 1.86% to the payroll tax rate. The Commission's report indicates that if just one single change were to be made to the system by modifying the basis for computing benefits from a wage-indexed system to a price-indexed system, current payroll taxes are sufficient to afford benefits that grow at least as fast as inflation.

Would personal accounts involve too much risk and diminish the effect of guarantees currently provided by Social Security and expose individuals to considerable uncertainties of investment, inflation and longevity? Are the potential risks and rewards involved identified and adequately addressed in the Commission's report? Their report includes assumptions such as "equities are assumed to provide an ultimate expected real rate of return of 6.5 percent." The Commission's report does not explore the impact of rates of return different from those assumed.

What are the orders of magnitude for the key fiscal measures associated with each reform model? How well are they explained, disclosed and communicated so that they can be readily appraised by policymakers? What effect will each reform model have on the financing of Social Security and the Unified Federal Budget? What transition financing is required to support the proposed reform models? Answers to these questions are to be found in the Commission's report and in a memorandum dated January 31, 2002 prepared by the Social Security Chief Actuary. This 85-page memorandum, with its extensive tables of financial projections, should be regarded as an essential supplement to the Commission's report and constitutes an item of "must-reading" for any serious participant in the Social Security debate and decision-making process. The transition costs would require substantial amounts of general revenue financing at a time when Medicare is also expected to make heavy demands on federal tax resources.

How reliable are the Commission's cost estimates and how sensitive are the key fiscal measures to changes in the assumptions upon which they are based? Unlike the Trustees' report, neither the Commission's report nor the Chief Actuary's memorandum present projections on the three alternative bases. Nor do they include a section that describes the sensitivity to changes in each of the key elements in the economic and demographic assumptions. Instead, both of these documents base all projections solely on the intermediate set of assumptions. Among the more speculative new assumptions are the cost to administer personal accounts, the future investment returns on stocks and bonds, and the extent to which workers would choose to participate in personal accounts.

How reliable are long-term projections of Social Security for strategic decision-making? It is widely acknowledged that projections based on economic and demographic assumptions, while inherently reliable over relatively short projection periods, such as 10 or even 20 years, become increasingly less reliable over longer periods. Moreover, the results of the projections on the three different sets of assumptions are subject to tremendously increasing divergence from each other as the period of the projection is lengthened. This divergence should not be ignored by exclusive reliance on the intermediate basis as a precise indicator of financial outcomes for very long-term projections such as 50 or 75 years. Much research is needed to explore this problem and to construct statistical models that recognize the nature of variability in each of the major elements in the economic and demographic assumptions and to produce long-term projections with associated measures of probability as indicators of the reliability of the projection results. Looking at the extent of the divergence of projections based on three different sets of deterministic assumptions makes it difficult to accept their validity as a sound basis for strategic decision-making involving trillions of dollars.

A commentator recently said that Social Security is too important to be left to the politicians. So, in this spirit, let the debate proceed and may professional and academic actuaries, statisticians, economists and other financial experts be stimulated to respond to the call of the President's Commission. Let us all become better acquainted with the facts about Social Security and the consequences of major reform. And may our elected representatives set aside pre-conceived notions and ideological agendas when the time comes to address the financial integrity of Social Security.

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