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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

The Outlook for Social Security: A Second Opinion

The Congressional Budget Office (CBO) has issued a report *The Outlook for Social Security* that addresses the potential range of Social Security outlays and revenues under the current law. This report presents an informative second opinion on the future financial status of the US Social Security program. The Social Security Trustees publish an annual report on the financial status of the Social Security program based on projections and analysis prepared by the Office of the Chief Actuary of the Social Security Administration. The CBO report addresses the same issues of solvency and sustainability that the trustees' report addresses, but there are important differences in both the methodology and assumptions used in the development of the two reports as well as the way in which results are presented.

The CBO report emphasizes its preference for assessing the cost of the Social Security program in relation to Gross Domestic Product (GDP). This approach clearly indicates the economic significance of the program in relation to the total economy and its relevance to long-term economic policy considerations. CBO applies a simulation methodology that generates a range of possible outcomes; the CBO results are shown in terms of the range containing 80% of the simulated outcomes. For example, Social Security outlays are projected to equal 6% of GDP in 2030 with an 80% chance that the outlays will fall within a range from 5.2% to 7.0% of GDP. Assigning probability measures and ranges in this fashion is more meaningful to policymakers than the trustees' approach of presenting three estimates designated as intermediate, high-cost and low-cost, without an indication of the associated probabilities for the projections. The trustees' presentation has resulted in a tendency for policymakers to regard the intermediate projection as an absolute measure, as though carved in stone, seemingly precisely accurate and not subject to a degree of variation for a probable range of plausible outcomes. The high-cost and low-cost estimates have, to a large extent, been ignored in practice by policymakers.

The CBO report utilizes an objective projection methodology based on a large number of simulations of "lifetime pathways" for individual participants in the Social Security program. By contrast, the trustees' methodology is more subjective and is based on deterministic projections of aggregated demographic data. Simulation techniques are widely accepted as the preferred methodology for modeling demographic projections in a variety of social and medical research studies.

Another significant feature of the CBO projections that differs from the trustees' projections is the use of economic assumptions that are consistent with those adopted for the Federal Budget projections. CBO sets its assumptions for the rate of real earnings growth, the real interest rate, the inflation rate and the unemployment rate equal to or consistent with the values assumed at the end of the CBO's 10-year projection horizon as published in *The Budget and Economic Outlook: Fiscal Years 2005-2014.*

For Social Security projections, the two most important economic variables are the rate of earnings growth and the interest rate on Treasury bonds held in the trust funds. CBO assumes that real earnings will grow by an average of 1.27% annually. CBO also assumes an annual real interest rate of 3.3%. The CBO assumes that annual inflation will be 2.2% and the unemployment rate will be 5.2%. CBO adopts the same demographic assumptions as the trustees for the fertility rate, the rate of decline in mortality and the level of immigration, but the CBO assumes differential mortality rates that are set to reflect the correlation with earnings that is observed in the population.

The major results from the CBO analysis are that the Social Security program is projected to be more than 100% solvent over the next 49 years until 2052 (compared to 2042 for the trustees' projections). The CBO projects that an increase of 1.00% of covered payroll will be required to maintain at least 100% solvency over the next 75 years (compared to 1.89% as projected by the trustees). The CBO projects that outlays for Social Security will rise from about 4.4% of GDP currently to about 6% of GDP 30 years from now. In later years the CBO projects a slowing in the growth rate for Social Security as a percentage of GDP, falling within a probable range of 5% to 8% over the next 100 years.

The CBO report represents several improvements and refinements in projection methodology and assumptions compared to the approaches that have been utilized historically by the trustees. The manner of presentation of the CBO results, in terms of their relationship to GDP and their range of plausible outcomes, represents significant improvements that should prove valuable to policymakers in formulating decisions about the future direction of the Social Security program in the United States.

Buffin Partners Inc.

P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067
Email: kenbuffin@buffinpartners.com