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# Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

## The Ten-Trillion-Dollar Solution for Social Security

The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance (OASDI) and Disability Insurance (DI) Trust Funds stated that the combined OASI and DI funds are projected to become exhausted in 2042 based on the best-estimate intermediate set of economic and demographic assumptions. In order to maintain the solvency of the trust funds over the official 75-year projection period, general revenue transfers with a present value of $3.7 trillion will be required or, alternatively, an increase of 1.89 percent to the payroll tax rate would sustain the system. When projected beyond 75 years to an infinite time horizon, Social Security is estimated to require general revenue transfers of $10.4 trillion to maintain solvency or, alternatively, an increase of 3.50 percent to the payroll tax rate. The assets of the trust funds amounted to $1.53 trillion at the end of 2003. According to the trustees' projections, if no action is taken to strengthen Social Security, the following scenario will occur: in 2018 benefits and expenses will exceed tax income thus requiring current interest income to be applied to benefit payments; in 2028 benefits and expenses will exceed tax income plus interest income thus requiring redemption of trust fund assets to meet benefit payments; in 2042 the entire assets of the trust funds will be used up leaving a zero balance in the fund and insufficient future tax income to meet scheduled benefits.

In 2001, a bipartisan Commission was established with a mandate to make recommendations to restore fiscal soundness to Social Security. This Commission to Strengthen Social Security (CSSS) was provided with six guiding principles. Included in these principles were requirements that the entire Social Security surplus be dedicated only to Social Security, that payroll taxes must not be increased, that the government must not invest Social Security funds in the stock market, and that individually controlled, personal retirement accounts must be included in the modernization of Social Security. With the constraints imposed by the six guiding principles, the Commission did not consider the implications of investing Social Security funds in the stock market or the sustainability of the existing Social Security system without the introduction of individual accounts. These alternative concepts should merit due consideration and study in combination with the other four original guiding principles, including the requirements for no increases in payroll taxes and the dedication of the entire surplus exclusively to Social Security. Under the existing arrangements for the investment of the trust funds, any surplus, representing the excess of income over benefit payments and expenses, is invested in special issue U.S. Treasury securities.

It is noteworthy that Canada has already begun the process of investing assets of the Canada Pension Plan (CPP) in equities. The CPP Investment Board was established in 1997 and began investing in 1999 with a mandate to invest in the best interests of contributors and beneficiaries and to maximize long-term investment returns without undue risk of loss. The CPP Investment Board is an independent entity operating at arm's length from the Canadian federal and provincial governments. CPP investments are selected passively, generally reflecting broad market indices. If the investment policy of the U.S. Social Security funds were modified to permit investment by an independent Investment Board in the equity and fixed-income securities markets, the key principle of the CSSS that the entire surplus be dedicated only to Social Security, could be satisfied with respect to future surplus amounts.

The 2004 Trustees' Report presents the projected amounts of trust fund assets, starting at $1.53 trillion at the end of 2003, increasing to a maximum value of $6.57 trillion at the end of 2025 and declining thereafter to zero in 2041. When the report of the CSSS was published, it included projections for individual account features based on certain rate of return assumptions for fixed-income and equity securities. Equities were assumed to provide an ultimate expected real rate of return of 6.50 percent above inflation. The implied annual rate of return on the Social Security trust fund assets through 2041 with the existing special issue Treasury securities is 5.76 percent. If a projection is made using an assumed annual rate of return of 8.00 percent on the mixture of assets chosen for future surplus amounts, the result is a fund in excess of $10 trillion in 2041 in conformity with the Commission's stated principles of dedicating the entire surplus exclusively to Social Security and no increases in payroll taxes.

The accumulation of a $10 trillion fund in 2041 to replace the existing projected zero balance would certainly represent a significant strengthening of Social Security without exposing individual beneficiaries to the risks inherent in individual private accounts, namely, longevity risk, inflation risk and market risk.

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