CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

Revised March 31, 2004

WHAT THE TRUSTEES' REPORT INDICATES ABOUT THE FINANCIAL STATUS OF SOCIAL SECURITY

by Robert Greenstein

On March 23, the Social Security Board of Trustees released the 64th annual report on the program's financial and actuarial status. This report shows no change from last year's report with regard to the year in which the Social Security trust fund reserves are expected to run out. The projection remains that this will occur in 2042. After that year, the program will be able to pay about 70 percent of scheduled benefits, rather than full benefits. The report also shows that the trustees' projection of the size of Social Security's 75-year financing shortfall, measured both as a percentage of payroll and as a percentage of the economy, has decreased very slightly from the projection of a year ago.

The Social Security trustees' report reaffirms that Social Security does not face a near-term crisis and can pay full benefits for the next 38 years but will eventually face a significant imbalance. The trustees' report includes three dates related to the imbalance.

- The Social Security actuaries project that in 2018, benefit payments will begin to exceed the combination of payroll tax revenues and the funds that Social Security receives from the taxation of a portion of the Social Security benefits received by higher-income beneficiaries. This is the least significant of the three dates because *total* Trust Fund income — which also includes the interest earnings that the Social Security Trust Fund receives on the Treasury bonds it holds — will continue to exceed benefit payments for a number of years after 2018. (Some analysts argue that, for this reason, this date has no significance.) Social Security will continue to pay full benefits during this period.

- The second date is the year in which the combination of annual tax revenues and interest earnings will no longer be sufficient to cover all benefit costs, and the trustees will have to begin redeeming Treasury bonds that the Trust Fund holds to raise the additional funds needed to pay full benefits. The trustees' report projects this will occur in 2028. As a result, in 2028, the size of the Social Security reserves will stop growing and start shrinking. Social Security will continue to pay full benefits for another 14 years after 2028; the combination of tax revenues, interest earnings, and income from redeeming Treasury bonds will be sufficient for the program to do so.

- The third and most significant date is the year in which the Social Security Trust Fund reserves will be exhausted. After that, the only income to the Trust Fund will be payroll tax revenue and revenues from the partial taxation of Social Security benefits, and annual revenues will not be sufficient to pay full benefits. As noted, the trustees project this year to be 2042.

	1997 Report	1998 Report	1999 Report	2000 Report	2001 Report	2002 Report	2003 Report	2004 Report
Long-term deficit as a percentage of taxable payroll	2.23%	2.19%	2.07%	1.89%	1.86%	1.87%	1.92%	1.89%
Year costs exceed tax revenue	2012	2013	2014	2015	2016	2017	2018	2018
Year costs exceed tax revenue and interest	2019	2021	2022	2025	2025	2027	2028	2028
Year in which Social Security surplus is exhausted	2029	2032	2034	2037	2038	2041	2042	2042

The trustees' report also contains one other key number related to Social Security's long-term imbalance — the size of the projected shortfall in Social Security over the next 75 years. The new report places the amount of the shortfall — that is, the amount by which Trust Fund income and revenues over the next 75 years will fall short of what is needed to pay full benefits over the period — at 1.89 percent of taxable payroll over the 75-year-period. This is a very slight decrease from last year's figure.

The shortfall also can be expressed relative to the size of the economy. By this measure, the shortfall over the next 75 years equals 0.70 percent of the Gross Domestic Product, a very slight decrease from last year's estimate.

The key dates and the long-term deficit projection represent improvement over the trustees' 1997, 1998, 1999, 2000 and 2001 reports, and little change from the 2002 and 2003 reports. The long-term deficit in Social Security declined from 2.23 percent of taxable payroll in the trustees' 1997 report to 1.89 percent in the 2000 report and 1.86 percent in the 2001 report. There has been little change in this measure since then. The date by which the Trust Fund is projected to be exhausted has moved farther into the future — from 2029 as forecast in 1997, to 2042 as projected in the current report and last year's report.

Implications for Action to Restore Long-Term Solvency

On the one hand, the trustees' report shows that Social Security does not face an immediate crisis. The report also shows that the system is not in danger collapsing and "not being there" for people who are young today, since even after 2042, Social Security's income would be sufficient to pay approximately 70 percent of the benefits promised under current law. (See box on page 3.)

On the other hand, the trustees' report demonstrates that the system faces a significant long-term financing shortfall. A 30-percent shortfall between Social Security income and Social

Without Action to Restore Solvency, 70 Percent of Benefits Could be Paid

There has been confusion about the meaning of the date on which Social Security becomes insolvent. This date sometimes is portrayed as the date on which Social Security runs out of money. Many Americans mistakenly think this means there will be no benefits for them after 2042.

That is not the case. Social Security will not be out of money when the Trust Fund surplus is exhausted in 2042. The Trust Fund will continue after that time to receive large sums from annual payroll tax collections. The problem is that, according to the trustees' calculations, the incoming revenues after that date will be sufficient to cover about 70 percent of benefit payments rather than 100 percent. That is what is meant when the term "insolvency" is used to describe the condition of the Trust Fund after 2042. (Initially, 73 percent of benefits could be paid, with this percentage projected to decline slightly over subsequent decades. Over the period from 2042 through 2078, an average of about 70 percent of the benefits due under the current benefit structure could be paid.)

That the revenues will be sufficient to defray about 70 percent rather than 100 percent of benefit costs signals the need for action to restore long-term actuarial balance to the Social Security system. The belief that revenues will cover *zero* percent of benefits after 2042, however, is incorrect.

Security benefit entitlements will not, and should not, be acceptable to the public or policymakers. Action is needed to restore long-term Social Security solvency.

The trustees' projection that the shortfall equals 1.89 percent of covered payroll over a 75-year period indicates the shortfall can be closed with relatively moderate steps if taken soon. Radical restructuring of the system is not necessary to close a gap of this size.

Tax Cuts Likely to Make Solvency More Difficult to Restore

Long-term Social Security solvency could be restored through a combination of modest benefit and payroll tax changes that shield current retirees from benefit reductions and phase in gradually over time. An important new book by two leading Social Security experts, *Saving Social Security* by Peter Diamond of M.I.T. and Peter Orszag of Brookings, sets forth such a plan.

Policymakers are unlikely, however, to be willing to make the full array of benefit and payroll tax changes Diamond and Orszag outline, or their equivalent. If not, a Social Security solvency plan will need to rely on transfers of general revenues from the rest of the budget, in combination with some changes in the program.

Substitution of private accounts for part of Social Security does not alter this situation. To the contrary, most partial privatization plans require even larger general revenue transfers for a number of decades to cover the large shortfall in Social Security revenue that would occur when payroll taxes currently being used to pay Social Security benefits were diverted into private accounts and thus were no longer available to pay benefits. (This shortfall is sometimes called a "transition cost.") The proposals made by the President's Commission to Strengthen Social Security would require transfers totaling more than $2 trillion. A plan favored by a number of conservative groups was found by the Social Security actuaries to require transfers of $6.9 trillion. There is no "free lunch" here. (These figures are presented in "present value" terms over the next 75 years, as are the estimates of the long-term shortfalls in Social Security and Medicare included in the trustees' report.)

Furthermore, the Medicare Hospital Insurance Trust Fund almost certainly will require substantial added resources. The trustees' report estimates that the long-term financing gap in the Medicare HI program is 3.12 percent of taxable payroll over 75 years, up substantially from a projected shortfall of 2.4 percent of payroll in last year's report. It likely will prove impossible to enact measures that restore long-term Medicare solvency without a combination of reforms in the program *and* the provision of significant additional resources to Medicare.

The tax cuts enacted in recent years will, if made permanent, substantially increase long-term budget deficits. As a result, they will make it more difficult to find resources to transfer to Social Security and Medicare as part of solvency plans. The revenue loss that will occur over the next 75 years if the 2001 and 2003 tax cuts are made permanent, as the Administration has proposed, is *three times* the size of the Social Security shortfall over this period and nearly as large as the Social Security and Medicare Hospital Insurance shortfalls combined.[1]

Relatively modest changes in the tax cut could produce revenues that would significantly shrink the Social Security shortfall and thereby reduce the size of the benefit reductions or payroll tax increases needed. For example, if the reductions in the estate tax scheduled to take effect through 2009 were implemented — with the estate tax exemption raised to $3.5 million per individual (effectively $7 million per couple) and the estate tax rates lowered — but the estate tax was not repealed and the estate tax revenues that continued to be collected were dedicated to the Social Security Trust Fund, about one-quarter of Social Security's long-term financing gap would be closed.

If this were done, only about one-half of one percent of estates would continue to owe any estate tax. Those estates that did owe the tax would receive substantial reductions in the amount owed, compared with what they would have owed under the estate-tax law that was in effect before the 2001 tax cut was enacted (and that is officially slated to go back into effect in 2011). By contrast, if policymakers retain virtually all of the 2001 and 2003 tax cuts and make the tax cuts permanent, the nation's long-term fiscal condition will be materially worsened, and it will become far more difficult to find resources in the rest of the budget that could be devoted to Social Security or Medicare Hospital Insurance as part of long-term solvency plans.

The data in the trustees' report thus should serve as a reminder that the responsible course for Congress and the President is to stop "digging the hole deeper" by imposing strict rules that require *both* entitlement expansions and tax cuts to be paid for, and that such a step should be followed as soon as possible by actions both to scale back the recent tax cuts and to restore long-term Social Security and Medicare solvency through measures that involve hard choices in these programs — that is, benefit reductions and/or payroll tax increases — along with the provision of some additional funding from the rest of the budget, at least for Medicare.

[1] The 2004 trustees' reports show a shortfall in the Social Security trust fund of $3.7 trillion over 75 years and a shortfall in Medicare's Hospital Insurance trust fund of $8.2 trillion over 75 years. Measured the same way (that is, in present value terms), the Bush tax cuts would cost $11.2 trillion over 75 years if made permanent. (Note: the trustees' reports provide a second set of estimates of the Social Security and Medicare Hospital Insurance shortfalls that include the cost of maintaining a reserve at the end of the 75th year that is equal to the cost of one full year of benefits. This second set of estimates is $4.0 trillion for Social Security and $8.5 trillion for the Medicare HI trust fund. The estimates of the actuarial deficits in Social Security and Medicare Hospital Insurance that are expressed as a percentage of payroll — 1.89 percent of payroll for Social Security and 3.12 percent of payroll for Medicare Hospital Insurance — include the cost of this one-year reserve.)