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

The Social Security Board of Trustees today released the 61st annual report on the program's financial and actuarial status. The report shows improvement in the program's long-term fiscal status for the fourth consecutive year — although the year's improvement is small — due primarily to the continued strong performance of the U.S. economy and improved prospects for the economy's future performance.

The Social Security trustees' report reaffirms that Social Security does not face a near-term crisis. Payroll tax revenues currently exceed benefit payments and are resulting in the accumulation of a steadily growing surplus that will allow benefits to be paid in full for the next 37 years. In the long term, however, the system will face an imbalance. The 2001 trustees' report includes three important dates related to the imbalance.

- The Social Security actuaries project that in 2016, benefit payments will begin to exceed the combination of payroll tax revenues and funds that Social Security receives from the taxation of a portion of the Social Security benefits that higher-income beneficiaries receive. Nevertheless, annual trust fund income — which includes the interest earnings the trust funds receive on the Treasury bonds they hold, as well as the income from tax revenue — will continue to exceed benefit payments for a number of years after 2016. Social Security will continue to pay full benefits during this period.

- The second key 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 they hold to raise the additional funds needed to pay full benefits. The trustees' report projects this will occur in 2025. During the years between 2025 and the third key date, Social Security will continue to pay full benefits, because the combination of tax revenues, interest earnings, and income from redeeming Treasury bonds will be sufficient 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 funds will be from payroll tax revenue and funds from the partial taxation of benefits, and annual revenues will not be sufficient to pay *full* benefits. Instead, after this date, annual revenues will be sufficient to pay about 70 percent of promised benefits. The trustees project this year to be 2038.

The trustees' report also contains one other important 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 that period — at 1.86 percent of taxable payroll over the 75-year-period.

The key dates and the long-term deficit show improvement over the trustees' 1997, 1998, 1999 and 2000 reports, which the trustees attribute primarily to better actual and expected economic performance. As indicated in the table, the long-term deficit in Social Security has declined from

	1997 Report	1998 Report	1999 Report	2000 Report	2001 Report
Long Term Deficit	2.23%	2.19%	2.07%	1.89%	1.86%
Year Costs Exceed Tax Revenue	2012	2013	2014	2015	2016
Year Costs Exceed Tax Revenue and Interest	2019	2021	2022	2025	2025
Year in Which Social Security Surplus is Exhausted	2029	2032	2034	2037	2038

2.23 percent of taxable payroll in the trustees' 1997 report, 2.19 percent in the 1998 report, 2.07 percent in the 1999 report, and 1.89 percent in the 2000 report to 1.86 percent in the new report. The date by which the trust funds are projected to be exhausted has moved back from 2029, as forecast in 1997, to 2032 as projected in 1998, 2034 as projected in 1999, 2037 as projected last year and 2038 in the new report.

The trustees' reports regularly provide three sets of projections due to the uncertainty of making estimates over a period as long as 75 years. One set of projections incorporates fairly optimistic economic and demographic assumptions. A second set is based on pessimistic assumptions. The third set consists of intermediate estimates, regarded by the trustees as the "best estimates." The dates referred to above are the best estimates (i.e., the dates based on the intermediate assumptions).

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 the system is not in danger of collapsing and of "not being there" for people who are young today, since even after 2038, Social Security's income would be sufficient to pay approximately 70 percent of the benefits promised under current law. (See box on page 4.)

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 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 1.86 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.

Raising Rates of Return

One element of a solvency plan could be the inclusion of measures to raise rates of return. Such measures can not be the entirety of a solvency plan, however; by themselves, they will leave Social Security with a substantial funding shortfall. Such measures must be combined with reductions in benefits, increases in payroll taxes, infusion of funds from the non-Social Security budget, or some combination of those approaches if long-term solvency is to be restored. The notion sometimes espoused or implied by policymakers (especially during campaigns) that rates of return can be raised enough to avert any reduction in benefits, increase in taxes, or transfer from the rest of the budget (which itself would ultimately require reductions in other programs, increases in other taxes, or deficit financing) is not valid.

There also has been confusion about whether radical restructuring of Social Security is necessary to raise rates of return. It is not. The contention that raising rates of return requires replacing part of Social Security with individual accounts has been examined and rejected by leading economists who have studied this issue, including economists who favor individual accounts.[1] Rates of return are raised *not* by individual accounts *per se* but by two other factors. First, rates of return are raised by financing retirement benefits on an advance-funding basis rather than a pay-as-you-go basis. This enables the funds accumulated in advance to earn interest that compounds over time. Second, rates of return can be raised by investing a portion of the assets accumulated through advance funding in equities, since equity investments are likely to yield higher average rates of return over time than the Treasury bonds in which Social Security's assets currently are fully invested. Providing advance funding and investing a portion of such funding in equities can be accomplished *either* through the Social Security trust funds or through individual accounts. (Moreover, equity investment is likely to provide a higher net rate of return if accomplished through the trust funds, since a smaller portion of the return will be consumed by administrative costs that way than if the equity investment is accomplished through private accounts.) Privatization approaches are not necessary to raise rates of return.

Advance-Funding Through the Social Security Trust Fund

Advance-funding can be provided to the Social Security trust funds by transferring some general revenue from the non-Social Security budget to the Social Security trust funds. Almost *all* of the major proposals developed over the last few years to restore solvency to the Social Security program — including plans that maintain the current Social Security structure *and* plans that partially privatize the program — have included a transfer of general revenue to the trust funds. The one reform plan that did not contain provisions for a general revenue transfer proposed to reach solvency through very large benefit reductions that almost certainly would be politically infeasible.

Improving the solvency of Social Security by transferring general revenue to the trust funds will be virtually impossible, however, if surpluses currently projected in the non-Social Security budget are consumed by large tax cuts. The Congressional Budget Office projects a surplus of \$3.1 trillion in the non-Social Security budget over the next 10 years.

Since \$400 billion of this amount, however, is the surplus that is building in the Medicare Hospital Insurance trust fund; it is not available to bolster Social Security solvency. Of the remaining \$2.7 trillion, more than \$500 billion is expected to be used to maintain current payments to farmers, extend various tax credits that are scheduled to expire every two years or so and always are extended on a bipartisan basis, and remedy problems in the Alternative Minimum Tax so it does not encroach heavily upon the middle class.

The President's proposed tax cut would consume virtually all of the non-Social Security surplus that remains. The President's budget shows the tax cut would consume \$2.0 trillion of the projected surpluses over the next ten years, counting the increased interest payments on the debt that would result from the tax cut. Estimates that the Joint Committee on Taxation issued in early March on the cost of the reductions in income tax rates in the President's package (including the acceleration of the phase-in of the proposed 10 percent bracket included in the rate reduction bill the House of Representatives passed March 8) add nearly \$200 billion to the cost. Enactment of the proposed tax cut thus would leave no surpluses available outside Social Security to transfer to the Social Security trust funds as part of an effort to restore long-term solvency.

If a portion of the Administration's tax cut that is directed towards very high-income individuals were dropped or substantially scaled back — and

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

There has been some confusion and misunderstanding about the meaning of the date on which Social Security becomes insolvent. It 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 2038.

That is not the case. As the trustees have said, Social Security will not be out of money when the trust fund surplus is exhausted in 2038. The trust funds 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 funds after 2038.

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 widespread belief that revenues will cover *zero* percent of benefits after 2038, however, is incorrect.

the resources in question were transferred instead to the Social Security trust funds — the long-term financial status of Social Security would be improved significantly. For example, one of the tax cuts the Administration has proposed is elimination of the estate tax. This tax is levied on the estates of the wealthiest two percent of people who die each year, with half of the estate tax being paid by the estates of the wealthiest one of every 1,000 people who die. Only estates exceeding $675,000 ($1.35 million for a married couple) are subject to this tax in 2001; this threshold will rise to $1 million ($2 million for a married couple) by 2006.

Some members of Congress have offered alternatives to the Administration's proposal to eliminate the estate tax entirely. Such alternative proposals would increase significantly the amount of an estate that is exempt from taxation and also eliminate estate taxes on many of the small number of businesses and farms that are subject to them. If such a proposal were adopted (instead of eliminating the estate tax and losing all of the revenue it generates) and amounts equal to the revenue the scaled-back estate tax produced were transferred to the Social Security trust funds,[2] Social Security's finances would be strengthened. This one action alone would eliminate more than one-fourth of the long-term deficit in Social Security.

A Warning Light

The trustees' report should act as a warning light to policymakers of all political persuasions who favor taking actions that would consume most or all of the projected non-Social Security surplus before Congress and the White House make any significant progress in determining what steps to take to restore long-term Social Security and Medicare solvency. The past few years have witnessed a growing trend toward policymakers pledging not to reduce any Social Security benefits or raise any Social Security taxes. If no benefits can be reduced and no additional revenues raised (a course we believe to be unwise), restoring Social Security solvency will require substantial transfers from the non-Social Security budget. This is true for both privatization and non-privatization approaches; there is no "free lunch" here.

Furthermore, the Medicare trust fund also will require substantial additional resources. Even the proposals of the Breaux-Thomas commission — a number of which are quite controversial — would close only a small fraction of the long-term Medicare financing gap, which the trustees' report (using new assumptions) estimates to be 63 percent larger than last year's trustees' report did. It is extremely unlikely that a package restoring long-term Medicare solvency could be enacted that does not include the infusion of significant additional resources, as well as changes in the Medicare program.

If most or all of the projected non-Social Security surpluses are used now for tax cuts or a combination of tax cuts and program increases, that would preclude substantial budget transfers to Social Security and Medicare. And that, in turn, could render it difficult, if not impossible, for the foreseeable future to fashion legislation to restore long-term Social Security or Medicare solvency that can pass. The data in the trustees' report should serve as a reminder that the responsible course is to defer enactment of very large tax cuts or spending increases until overall decisions can be made, in the context of deliberations on national priorities, regarding how much of the non-Social Security surpluses to reserve for use as part of broader Social Security and Medicare solvency proposals.

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1. John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Would a Privatized Social Security System Really Pay a Higher Rate of Return?" in R. Douglas Arnold, Michael J. Graetz, and Alicia H. Munnell, eds., *Framing the Social Security Debate: Values, Politics, and Economics (*Brookings Institution Press: Washington, 1998), also available as NBER Working Paper Number 6713, August 1998; and John Geanakoplos, Olivia Mitchell, and Stephen P. Zeldes, "Social Security Money's Worth," available as NBER Working Paper Number 6722, September 1998, and published in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of PA Press: Philadelphia, 1999). For a less technical summary of the Geanakoplos, Mitchell, and Zeldes papers, see Peter R . Orszag, *Individual Accounts and Social Security: Does Social Security Really Provide a Lower Rate of Return?*, Center on Budget and Policy Priorities, March 1999.

2. It is assumed that provisions to protect family farms and businesses would reduce revenue from the estate tax by 25 percent.