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WILL THE ADMINISTRATION CLAIM THE COST OF FIXING SOCIAL SECURITY ROSE $700 BILLION BECAUSE CONGRESS DID NOT ACT LAST YEAR?

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Summary

President Bush and other Administration officials often claim that delaying action on Social Security by "...just one year adds $600 billion [or $700 billion] to the cost of fixing Social Security."[1] Such claims may be repeated on May 1 when the Social Security Trustees release their annual report on the program's finances. Such claims, however, are not accurate.

The figures used in support of these claims are greatly exaggerated; they merely reflect inflation — i.e., the fact that a dollar is worth less from one year to the next — and a year of interest costs. The figures do *not* reflect a deterioration in Social Security's finances. Because a dollar is worth less with each passing year, over time, more dollars are needed to fill the shortfall in the Social Security system even if the magnitude of the shortfall has not changed.[2] When Social Security's shortfall is expressed in 2006 dollars, the shortfall *appears* to be substantially larger than when it is expressed in 2005 dollars, even if there has been little or no real change in the shortfall's dimensions.

The Administration's past claims of a $600 billion or $700 billion deterioration with each passing year used the effects of inflation (the fact that the dollar declines in value over time) and a year's worth of interest to create a misleading impression that Social Security's finances were deteriorating. The American Academy of Actuaries, the nation's leading professional association of actuaries, has specifically warned against this misuse of Social Security financial data. The Academy has explained that using the data in this manner is likely to mislead the public "into believing that the program's financial situation is deteriorating and the cost of restoring actuarial balance is increasing even if this is not the case."

The Academy has stressed that the best measure of year-to-year changes in the size of the Social Security shortfall is the measure that shows whether the share of the U.S. economy that would have to be devoted to closing the shortfall has increased or decreased. Last year's Trustees' report

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[1] George W. Bush, "Radio Address by the President to the Nation," January 15, 2005, available at http://www.whitehouse.gov/news/releases/2005/01/20050115.html.

[2] The present-value measurement is the standard way of presenting financial transactions occurring over long periods of time. One dollar in the future is worth less than one dollar today, and the present-value calculation takes into account this "time value" of money.

showed that the cost of closing the shortfall was essentially unchanged between 2004 and 2005 — it stood at 1.2 percent of the Gross Domestic Product in both years. (It is likely to remain at about this same level in the new Trustees' report to be released May 1.)

To be sure, there is some increase in Social Security's financing challenge from year to year, but it is very small. Properly measured, the passage of each year adds an additional $2 billion annually — or 0.02 percent of GDP — to the cost of fixing Social Security. This small worsening occurs because there is one less year in which to impose benefit reductions or payroll tax increases. (Of course, no policymakers, including the President, proposed cutting benefits or raising taxes in 2005, anyway.) By comparison, making the 2001 and 2003 tax cuts permanent will cost about 2 percent of GDP.

Analysis

The Administration's claims of large deterioration from one year to the next rest on the changes in a statistic in the annual Social Security Trustees' report that reflects the Trustees' estimate of the size of the Social Security shortfall when the shortfall is projected over an "infinite horizon" (that is, into eternity). Last year's Trustees' report placed this shortfall at $11.1 trillion (in present-value terms). The year before, the 2004 Trustees' report estimated this shortfall at $10.4 trillion. The Administration used the apparent increase from $10.4 trillion to $11.1 trillion to argue that failure to act had added $700 billion to the cost of fixing Social Security.

But the $11.1 trillion figure was expressed in *2005 dollars*, while the $10.4 trillion figure was expressed in *2004 dollars*. In addition, the 2005 figure discounted future shortfalls to January 2005, while the new 2004 figure discounted future shortfalls to 2004. Both the 2004 and 2005 reports showed that the shortfall equaled 1.2 percent of the Gross Domestic Product, projected into eternity. In other words, the size of the shortfall did not change as a share of the economy. If the same flawed approach were applied to the Administration's tax cuts, it would indicate that the passage of another year had added $1.1 trillion to the cost of making the tax cuts permanent (see box below).

Did the Cost of Making the Tax Cut Permanent Go Up by $1.1 Trillion This Year?

Based on estimates from the Congressional Budget Office and the Joint Committee on Taxation, the tax cuts enacted since 2001 are projected to cost 2 percent of GDP if they are made permanent and related AMT relief is continued. Over an infinite horizon, this will cost $18.4 trillion in present value, expressed in 2005 dollars. With the passage of a year, the cost of the tax cuts would be roughly $19.5 trillion in 2006 dollars.

To say, however, that the President's proposal to make the tax cuts permanent has gone up in cost by $1.1 trillion since last year would be misleading, just as it would be misleading to say that the cost of fixing Social Security has gone up $700 billion. In both cases, the supposed increase would largely be an artifact of inflation and the growth in interest rates, not an increase in the cost of extending the tax cuts or restoring Social Security solvency.

The misleading nature of the claim of a $700 billion deterioration can be easily seen. In the 2004 report, the Trustees projected that the Gross Domestic Product would be $844 trillion over an infinite horizon. In 2005, they projected it would be $921 trillion, or $77 trillion more. The nation did not magically get $77 trillion richer in one year; most of this change simply reflected presenting the projection of future GDP in 2005 dollars rather than in 2004 dollars and discounting to a later date. And for exactly the same reason, the Social Security outlook did not deteriorate by $700 billion.

Last year's Trustees' report showed that the Social Security deficit remained essentially unchanged both as a share of the economy and as a share of taxable payroll. This means that the magnitude of the tax increases or benefit reductions required to restore solvency was the same as it had been the year before. As the American Academy of Actuaries has explained, this is the best way to evaluate changes in Social Security's financial outlook from one year to the next — by seeing whether the size of the policy changes needed to restore solvency has changed. If it has not, the magnitude of the problem cannot reasonably be said to have grown from one year to the next.

This is one of the reasons that the Academy of Actuaries has urged that "infinite horizon" estimates not be included in the Trustees' report. (These estimates were added to the report for the first time in 2003.) The Academy has warned that the infinite horizon measure, when cited in dollar terms, can be misused to create the impression that the system's unfunded obligations are increasing each year even if this is not so. (See box on page 3.)

The fostering of such a misimpression is, unfortunately, precisely what the Administration has been doing. Hopefully, when the new Trustees' report is issued next week, the Administration will refrain from again making this misleading claim.

American Academy of Actuaries: Figure is Misleading*

The following is from the letter written by the American Academy of Actuaries to the Social Security Trustees.

"For the first time, in their *2003 Annual Report*, the Trustees included OASDI's [Social Security's] unfunded obligations…for an infinite time period…. The Committee [the Social Insurance Committee of the American Academy of Actuaries] believes that the new measures of OASDI's unfunded obligations included in the 2003 report provide little if any useful information about the program's long-range finances and indeed are likely to mislead anyone lacking technical expertise in the demographic, economic and actuarial aspects of the program's finances into believing that the program is in far worse financial condition than is actually indicated.

"…The infinite-time-horizon unfunded-obligations estimate [in dollar terms] increases each year…. The public, seeing annual large increases in unfunded obligations, is likely to be misled into believing that the program's financial situation is deteriorating and the cost of restoring actuarial balance is increasing, even if this is not the case. If experience matches the Trustees' assumptions, the program's financial situation will remain about the same, and changes to the program that would have restored solvency a year ago would still do so if enacted today, or a year from now, even though estimated unfunded obligations have increased."

* Letter from the American Academy of Actuaries to the Trustees of the Social Security System, December 19, 2003, available at http://www.actuary.org/pdf/socialsecurity/tech_dec03.pdf.