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## WHAT THE NEW TRUSTEES' REPORT SHOWS ABOUT SOCIAL SECURITY

By Jason Furman and Robert Greenstein

### Executive Summary

On May 1, the Social Security Board of Trustees released the 66th annual report on the program's financial and actuarial status. The report projects that Social Security's trust fund reserves will be exhausted in 2040, one year earlier than last year's projection. After that year, Social Security will be able to pay 74 percent of scheduled benefits, rather than full benefits. (On June 14, the Congressional Budget Office (CBO) issued its new projection showing the trust fund would be exhausted in 2046 and would be able to pay 79 percent of benefits immediately after that date.)

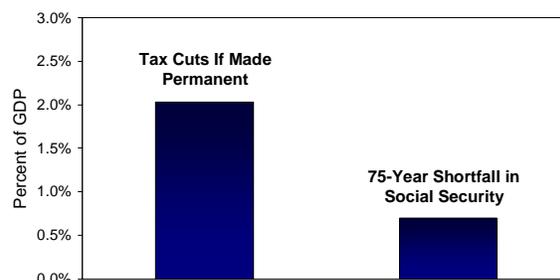
This CBPP analysis highlights several points about the trustees' report:

- The trustees' report reaffirms that Social Security does not face a near-term crisis and can pay full benefits for the next 34 years but will eventually face a significant imbalance. A sizeable shortfall between Social Security income and Social Security benefit entitlements should not be acceptable to the public or policymakers, and action is needed to restore the program's long-term solvency.
- The report finds some measures of Social Security's financial status to be a little weaker than was projected last year, but other measures to be a little stronger this year. Social Security is projected to face a slightly larger imbalance than was projected last year and to have its trust funds be exhausted a year earlier "largely because of a lower assumed ultimate real interest rate." But on a cash flow basis, the long-term outlook for Social Security is slightly more favorable than last year; Social Security tax revenues will be sufficient to pay 70 percent of scheduled benefits in 2080. Last year's report estimated that Social Security taxes could

**FIGURE 1**

### Cost of Tax Cuts If Made Permanent Is More than Three Times the Size of the Social Security Shortfall

75-Year Cost



Source: Social Security Trustees Report estimate of Social Security shortfall, CBPP calculation of tax cut costs based on Joint Committee on Taxation and CBO estimates

cover 68 percent of benefits in 2079. According to the report, this improvement is “largely due to a higher assumed birth rate.”

- Anyone concerned about Social Security’s long-term impact on the federal budget ought to be even more concerned about the long-term fiscal impact of extending the 2001 and 2003 tax cuts. If made permanent, the tax cuts will cost nearly three times as much, over the next 75 years, as the 75-year deficit in Social Security (see Figure 1). Any attempt to address the looming fiscal challenges should include Social Security, Medicare (and the U.S. health care system as a whole), *and* overall government revenues.
- Private accounts financed by borrowing would aggravate the problem, as they would drain resources from Social Security and increase its deficits for at least several decades.

## **An Overview of the Projections in the New Trustees’ Report**

The new trustees’ report contains several key figures that document the challenge Social Security faces:

- The trustees project that in 2017, benefit payments will begin to exceed Social Security’s *tax* revenues. At this point, Social Security will start using some of the interest it earns on its trust fund bonds to pay benefits. Nevertheless, the trustees project that in 2017, the trust fund will have \$4.7 trillion in assets, and that these assets will increase by another \$1.2 trillion over the ensuing 9 years.<sup>1</sup>
- The balances in the trust fund will peak in 2026. After this date, Social Security will start redeeming the bonds in the trust fund in order to raise the additional funds needed to pay full benefits. The combination of tax revenues, interest earnings, and income from redeeming Treasury bonds will be sufficient for Social Security to pay full benefits after 2026.
- The trustees project that the Trust Fund will be exhausted in 2040. After that, the trust fund will continue to receive annual revenues from payroll taxes and from the partial taxation of the Social Security benefits that higher-income beneficiaries receive. This revenue, however, will not be sufficient to pay full benefits.
- After the trust fund is exhausted, Social Security’s tax revenue will be sufficient to pay 74 percent of promised benefits. This percentage will fall gradually to 70 percent of benefits in 2080.
- The new report places the amount of the 75-year shortfall — that is, the amount by which the trust fund’s income and revenues over the next 75 years will fall short of what is needed to pay full benefits over the period — at \$4.6 trillion in net present value.<sup>2</sup> That is 2.02 percent of

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<sup>1</sup> Technically, Social Security has two distinct trust funds: one for old-age and survivors benefits and one for disability benefits. This report follows the standard convention in referring to the combined balance as the Social Security trust fund.

<sup>2</sup> Net present value is the equivalent amount that today, with interest, would exactly cover these future costs.

taxable payroll over the 75-year period, or 0.7 percent of GDP.<sup>3</sup>

- The new report places the “infinite horizon” shortfall at 1.3 percent of GDP and 3.7 percent of taxable payroll, which is up from last year’s estimate. The infinite horizon measure was first included in the 2003 report and has been strongly criticized by the American Academy of Actuaries and other Social Security analysts for reasons described, in part, in the box on page 5. Among other issues, more than two-thirds of the infinite horizon deficit would be incurred after 2080, making it very sensitive to small changes in assumptions and consequently of very limited reliability for policymakers.

The projections in the trustees’ report differ from those released by the Congressional Budget Office in June 2006. CBO projects that the trust fund will be exhausted in 2046 (rather than 2040), after which tax revenues will be sufficient to pay 79 percent of benefits.

### **How the Projections Compare to Those Made In Previous Years**

The Social Security trust fund exhaustion date is one year earlier than was projected last year, occurring in 2040 rather than 2041. This is largely because the trustees lowered their projection of the real interest rate: they are now projecting it to be 2.9 percent above inflation, compared to a projection of 3.0 percent above inflation in last year’s trustees’ report. The lower the interest rate, the less income the Trust Fund earns on its bonds. The lower interest rate also results in higher estimates of the Social Security shortfalls as measured over 75 years and over an “infinite horizon” (i.e., through eternity).

At the same time, the cash flow outlook for Social Security improved somewhat, largely because of the assumption of a higher birth rate. (This year’s report is based on the assumption that the ultimate fertility rate will be 2.00, compared to 1.95 projected in last year’s report.<sup>4</sup>) The result will be slightly more workers whose taxes help support Social Security beneficiaries. As a result, the cash flow deficit in 2080 is projected to be 5.38 percent of the Gross Domestic Product, down from the 5.75 percent level projected in last year’s report.

In general, the key dates and the overall financial picture in the trustees’ report represent improvement over the trustees’ 1997-2001 reports and little change from the 2002-2005 reports (see Table 1). The long-term deficit in Social Security declined from 2.23 percent of taxable payroll in the 1997 report to 1.89 percent in the 2000 report and has drifted up somewhat 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 2040 as projected in the current report.

The principal reason that Social Security’s financial outlook changes over time is that the trustees revise their assumptions about future economic and demographic variables and their projection methodologies. The passage of time itself, absent methodological changes, also alters some measures of the financial outlook for Social Security. The 75-year deficit worsens, largely for purely

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<sup>3</sup> Note that, per the trustees’ convention, the shortfall as a share of taxable payroll includes the cost of a “target fund” — that is, a trust fund balance at the end of 2080 that would be sufficient to pay full benefits in 2081 even in the absence of any trust fund income.

<sup>4</sup> The fertility rate is essentially the average number of children per woman.

**TABLE 1: History of Social Security Trustees' Estimates**

Report Year	75-year Deficit as a Percent of Payroll	Infinite Horizon Deficit as a Percent of Payroll	Year When Costs Exceed Tax Revenues	Year When Trust Fund is Exhausted
1997	2.23%	NA	2012	2029
1998	2.19%	NA	2013	2032
1999	2.07%	NA	2014	2034
2000	1.89%	NA	2015	2037
2001	1.86%	NA	2016	2038
2002	1.87%	NA	2017	2041
2003	1.92%	3.8%	2018	2042
2004	1.89%	3.5%	2018	2042
2005	1.92%	3.5%	2017	2041
2006	2.02%	3.7%	2017	2040

Source: Trustees Reports, various years.

technical reasons: the 75 year window shifts, and this year a surplus year (2005) was dropped from the measure and a deficit year (2080) was added.

The passage of time by itself also results in a small increase in the “infinite horizon” shortfall, reflecting the fact that solving Social Security’s challenges grows over time. Properly measured, the passage of each year adds an additional \$2 billion annually — or 0.02 percent of GDP (or 0.05 percent of taxable payroll) — to the cost of fixing Social Security. This small worsening occurs because there is one fewer 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.)<sup>5</sup>

### **Social Security’s Imbalances Are Dwarfed by the Cost of the Tax Cuts**

The Social Security shortfall contributes to the government’s long-term fiscal challenge, but it is by no means the primary source of this challenge. Nevertheless, eliminating Social Security’s shortfall would be an important step in addressing America’s overall fiscal challenges.

Over the next 75 years, the Social Security shortfall amounts to 0.7 percent of GDP, a relatively modest share of the total federal budget shortfall that is projected for this period. Recently enacted policies, particularly the tax cuts (if made permanent) and the prescription drug benefit, will have a larger impact on the long-term fiscal deficit.

- The tax cuts since 2001 (if they are made permanent and relief from the Alternative Minimum

<sup>5</sup> For more details see Richard Kogan, Robert Greenstein, and Jason Furman, “Will the Administration Claim the Cost of Fixing Social Security Rose \$700 Billion Because Congress Did Not Act Last Year?” Center on Budget and Policy Priorities, April 28, 2006.

Tax is continued) are projected to cost 2.0 percent of GDP over the next 75 years, or \$14 trillion in net present value.<sup>6</sup>

**TABLE 2: The Shortfall in the Social Security Trust Fund Compared to Other Sources of Deficits**

	Shortfall or cost as a percent of GDP through 2079	In trillions of dollars through 2079 <sup>a</sup>
Shortfall, Social Security Trust Fund (CBO est.) <sup>b</sup>	0.5%	NA
Shortfall, Social Security Trust Fund (Trustees estimate) <sup>c</sup>	0.7%	\$4.6 trillion
Cost of the new Rx Drug Benefit (Trustees estimate) <sup>d</sup>	1.1%	\$8.0 trillion
Shortfall, Medicare Hospital Insurance Trust Fund	1.6%	\$11.0 trillion
Cost of the tax cuts enacted since 2001, if made permanent <sup>e</sup>	2.0%	\$13.6 trillion
Tax cuts for top 1 percent, if made permanent <sup>f</sup>	0.6%	\$4.1 trillion

a. Measured in present value in 2006 dollars.

b. Source: Calculations from data supporting, Congressional Budget Office, *Updated Long-Term Projections for Social Security*, June 2006. CBO's data show that the 0.5-percent-of-GDP Social Security shortfall is equivalent to a \$2.1 trillion shortfall. Because CBO uses GDP and discount rate assumptions that differ from those used by the Trustees, CBO's \$3.5 trillion estimate is not comparable to the Trustees' \$4.6 trillion estimate. However, CBO's 0.5 percent-of-GDP figure is comparable to the Trustees' 0.7 percent figure.

c. Source: Calculations from the Trustees' report, *2006 Annual Report of the Old-Age and Survivors Insurance And Disability Insurance Trust Funds*.

d. Source: *2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance And Federal Supplementary Medical Insurance Trust Funds*, page 112. The figure represents the net federal cost of the drug benefit, i.e., the benefit payments minus premium payments from beneficiaries and "clawback" payments from states.

e. Source: Center on Budget and Policy Priorities. The estimate of the cost of the tax cuts enacted since 2001 — 2.0 percent of GDP — is based on cost estimates of the Joint Committee on Taxation for tax cuts enacted to date, and estimates issued by CBO for the cost of extending the 2001 and 2003 tax cuts, as proposed by the President, and continuing relief from the Alternative Minimum Tax.

f. Source: Center on Budget and Policy Priorities. The estimate is based on the cost of the tax cuts, estimated as noted above, and distributional estimates from the Urban Institute-Brookings Institution Tax Policy Center. In 2006, the top 1 percent of households are those with incomes above \$400,000.

- This is nearly three times as great as the Social Security trustees' estimate of the Social Security shortfall (see Table 2).
- Just the cost of the tax cuts for the top 1 percent of Americans, those currently making more than \$400,000, is nearly as large as the trustees' estimate of the 75-year Social Security shortfall.

<sup>6</sup> In order to compare it with the Social Security shortfall on a conceptually equivalent basis, we measure the (present-value) cost of the tax cuts since they were enacted in 2001 and display this cost as a share of (the present value of) total GDP, 2006-2080. The long-term estimates of the cost of the tax cuts cited here are based on the standard procedure of assuming that the cost of tax cuts as a share of GDP remains constant once the tax cuts are fully in effect (assuming they are extended). These estimates reflect the cost of the 2001 and 2003 tax cuts and the associated cost of the portion of AMT relief that is necessitated by the tax cuts (as distinguished from the full cost of AMT relief). These estimates do not include the cost of extending the temporary tax cuts in law prior to 2001 that have since been extended. The Center on Budget and Policy Priorities' estimate is slightly smaller than the 2.2 percent of GDP estimate of the cost of the tax cuts through the next 75 years made by Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "Sources of the Long-Term Fiscal Gap," *Tax Notes*, May 24, 2004. For more details, see Richard Kogan and Robert Greenstein, "President Portrays Social Security Shortfall As Enormous But His Tax Cuts and Drug Benefit Will Cost At Least Five Times As Much," Center on Budget and Policy Priorities, February 11, 2005.

The prescription drug benefit also will cost more than the Social Security shortfall, totaling \$8.0 trillion over the next 75 years.

### **Private Accounts Would Make the Problem Worse**

Private accounts, unless financed by contemporaneous benefit reductions or tax increases, entail trillions of dollars of borrowing. Accounts thus add to Social Security's financing problems rather than reducing them.

The proposal that the President made last year to allow workers to divert four percent of taxable earnings into private accounts each year would raise the government's total debt. Last year CBPP estimated that the President's accounts would add \$1.4 trillion over the first 10 years of the plan (2009-18) and \$4.9 trillion over the first 20 years of the plan (2009-2028). Large reductions in traditional Social Security benefits would be required to repay this debt over time. (The President's plan called for reducing Social Security benefits for those opting for the private accounts.) The combination of diverting money into private accounts and then repaying the resulting debt would not leave the trust fund any better off than it is now. Still larger cuts in traditional defined benefits would be necessary to restore solvency.

The President's accounts also would advance the date at which Social Security needs to draw on the trust fund to pay Social Security benefits. Diverting payroll taxes into private accounts would reduce the revenue available to pay Social Security benefits and thereby *advance* the date when the program's benefit costs exceed its non-interest income. Last year, a conservative estimate by the Center on Budget and Policy Priorities indicated that the President's accounts, together with his proposed benefit reductions, would advance the insolvency of Social Security by 11 years, from 2041 to 2030.

### **Conclusion**

The new trustees' report is consistent with previous reports. It shows that Social Security faces a significant but manageable challenge. While acting sooner rather than later will help reduce the size of the eventual adjustments, the trustees' report indicates that Social Security does not face a deep structural crisis requiring drastic changes.

Putting the trustees' report in a broader fiscal context suggests that the sources of the future large imbalances in the federal budget as a whole need to be addressed. The sources of these imbalances include not only Medicare and Social Security, but revenues as well. If the 2001 and 2003 tax cuts are made permanent, they will contribute far more to budget deficits than Social Security will.

In 1983, Congress and President Reagan acted on recommendations made by the Greenspan Commission and strengthened Social Security's financial status through a combination of benefit and revenue measures. Various combinations of modest benefit reductions and revenue increases have been proposed by economists Peter Diamond and Peter Orszag, economists Henry Aaron and Robert Reischauer, former Social Security Commissioner Robert Ball, and AARP. Such steps could restore Social Security solvency while beginning to reduce federal deficits and debt immediately, rather than entailing substantial new borrowing and additional debt.