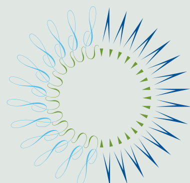
Social Security Shortfall Warrants Action Soon

BY CHARLES BLAHOUS AND ROBERT GREENSTEIN



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This paper was authored by:

Charles Paul Blahous III, a public trustee for Social Security and Medicare and a research fellow at the Hoover Institution, formerly a deputy director of the National Economic Council for President George W. Bush; and Robert Greenstein, executive director of the Center on Budget and Policy Priorities.

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TEAM MEMBERS

Douglas Hamilton, Deputy Director, Pew Economic Policy Group

Ingrid Schroeder, Director, Pew Fiscal Analysis Initiative

Scott S. Greenberger, Senior Officer

Ernest V. Tedeschi, Senior Associate

Douglas Walton, Associate

Evgeni Dobrev, Administrative Associate

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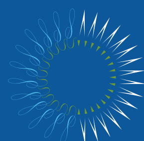

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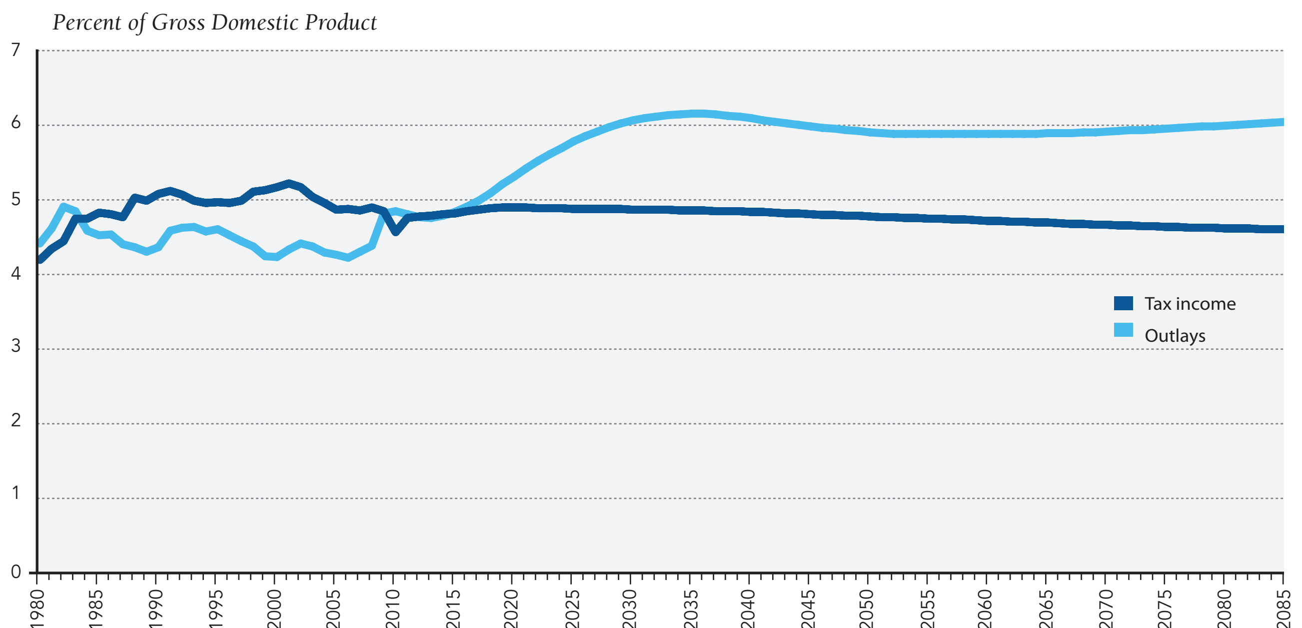
1 Social Security Shortfall

For more than two decades, the Social Security trustees have reported that there is a significant long-term gap between the program's benefits and revenues under current policies. Policy makers have not yet corrected this imbalance in part because of the difficulty of finding an acceptable compromise resolution. Reasonable individuals disagree about the best policy, as do the authors of this paper.

Beyond this disagreement over solutions, some have questioned the certainty of the projected shortfall and the necessity of making changes in the near future. Some projection error is indeed inevitable, but future outcomes are extremely unlikely to deviate from current projections by enough—and in the right direction—to eliminate the need for legislative action. Policy makers should not delay action in hope of a spontaneous correction.

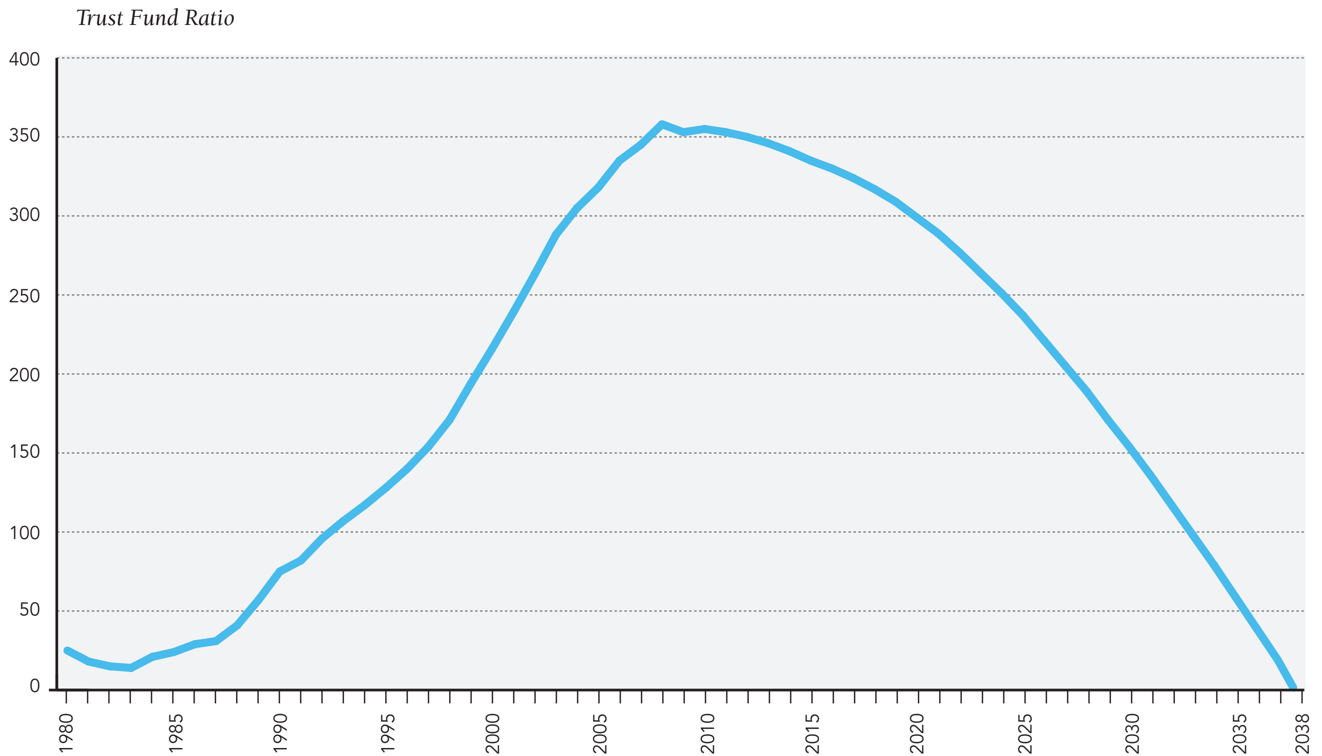
The 1983 Social Security reforms ushered in an era of substantial annual surpluses (see Figure 1).[1] The amounts of these surpluses are credited to the Social Security trust fund, which is currently projected to remain solvent through 2037 even as the retirement of the large "baby boom" generation moves the program from annual surpluses to growing annual deficits (see Figure 2).[2]

Figure 1 Social Security Faces a Long-Run Deficit



Source: 2010 Annual Report of the Social Security Trustees

Figure 2 Social Security Trust Fund Faces Depletion Within Three Decades



Source: 2010 Annual Report of the Social Security Trustees
Note: The trust fund ratio, a measure of trust fund adequacy, is defined as the assets at the beginning of a year expressed as a percentage of the cost during the year. For example, a ratio of 200 would mean that there were sufficient assets on hand to finance exactly two years' worth of benefit payments, even without relying on incoming tax revenue.

As long as the trust fund retains a positive balance, benefit payments can continue without interruption. This does not, however, argue for delaying corrective legislation. Continued delay in closing the projected shortfall constrains the available policy options and tends to place more of the burden of adjustment on younger generations. This is particularly true in view of the millions of baby boomers who will leave the workforce within the next several years.

Under current law, if no action is taken, at the point of trust fund exhaustion benefit payments would be reduced to the level that incoming tax revenues can support. According to the latest trustees' projections, this would mean a sudden 22-percent reduction in benefits for all beneficiaries (including those already receiving benefits) in 2037. (Restoring solvency by raising taxes would, even at that time, require congressional action.)

The "no-action" scenario represents the most precipitous of possible outcomes for Social Security participants. Taking action soon, in contrast, would allow tax increases or reductions in scheduled benefits to be phased-in gradually, providing beneficiaries and taxpayers with advance notice and more opportunity to adjust their plans for work, saving and retirement.

Taking action to improve Social Security solvency does not mean that changes must be fully implemented right away. Even if they are phased in over many years, enacting them into law will strengthen public confidence in the program. It also will provide a modest first step toward closing the federal government's long-run fiscal gap.

2 Sources of Uncertainty in the Projections

Each year the Social Security trustees project the program's financial operations over both the short term (defined as 10 years) and the long term (defined as 75 years). The Congressional Budget Office (CBO) also produces long-run projections for Social Security in the context of the entire federal budget. These projections rely on assumptions about a range of demographic and economic variables that influence program finances. The trustees and CBO generally attempt to predict specific annual fluctuations in these variables only in the early years of the projection, allowing each individual variable to thereafter converge to an "ultimate" annual assumption over the long term.

Each year the trustees develop a best-guess (intermediate) assumption for the relevant economic and demographic variables, as well as low-cost and high-cost alternative assumptions which, as their names imply, would respectively decrease or increase the cost of financing Social Security. The trustees also publish an analysis of the degree of sensitivity of the overall Social Security projections to each individual assumption. The trustees' intermediate assumptions for key variables, as well as the sensitivity of the projections to each individual variable, are summarized in Table 1. It shows, for example, that if real wage growth—that is, the amount by which wage growth per worker exceeds inflation—averages 1.8 percent a year rather than the intermediate assumption of 1.2 percent, that alone would delay the trust fund's exhaustion from 2037 to 2046; but if real wage growth averages only 0.6 percent, that would move the exhaustion date up to 2034.

Demographic factors such as fertility, longevity and immigration affect the projections through their impact upon the relative numbers of beneficiaries and contributing workers. The higher the ratio of contributing workers to beneficiaries in any given year, the greater the relative amount of incoming payroll tax revenue to finance benefit payments. Thus, increases in fertility and immigration rates generally improve Social Security solvency.[3] Conversely, the higher the fraction of the population that is receiving benefits, the higher the annual cost of benefit obligations as a percentage of taxable wages. Thus, reductions in mortality rates (that is, increases in longevity) worsen Social Security's finances.

Economic factors such as real wage growth, inflation and real interest rates also affect program finances. Initial benefit levels for new beneficiaries (retired and disabled workers as well as spouses and survivors) increase each year with growth in the national Average Wage Index. An increase in real wage growth extends the period of trust fund solvency because it increases payroll tax revenues immediately but increases benefit payments only gradually, as the share of beneficiaries whose benefits reflect those higher wages grows. Once a beneficiary begins receiving benefits, annual benefit adjustments are tied to inflation as measured by the growth in the

Table 1 Social Security Projections Depend on Key Assumptions

LOW-COST ASSUMPTIONS

Variable	Trust Fund Exhaustion	75-Year Balance	In 75th Year
Fertility (2.3)	2037	-1.56	-2.30
Mortality (0.33)	2040	-1.30	-2.70
Net Immigration (1,370)	2039	-1.72	-3.75
Real Wage Growth (1.8)	2046	-1.09	-2.59
CPI Growth (1.8)	2036	-2.12	-4.39
Real Interest Rate (3.6)	2039	-1.58	-4.12

Trustees Intermediate Assumptions

Assumption	Value
Fertility (children per woman)	2.0
Mortality (average decline per year, percent)	0.79
Net Immigration (thousands)	1,065
Real Wage Growth (annual average, percent)	1.2
CPI Growth (annual average, percent)	2.8
Real Interest Rate (percent)	2.9

Trustees Intermediate Projections

Projection	Value
Year of Trust Fund Exhaustion	2037
75-year Actuarial Balance	-1.92
Balance in 75th Year	-4.12

HIGH-COST ASSUMPTIONS

Variable	Trust Fund Exhaustion	75-Year Balance	In 75th Year
Fertility (1.7)	2038	-2.29	-6.37
Mortality (1.32)	2036	-2.58	-5.52
Net Immigration (780)	2037	-2.12	-4.52
Real Wage Growth (0.6)	2034	-2.74	-5.82
CPI Growth (3.8)	2039	-1.71	-3.82
Real Interest Rate (2.1)	2036	-2.30	-4.12

Source: 2010 Annual Report of the Social Security Trustees
Note: "75-year balance" is defined as the difference between the program's summarized income rate and cost rate over a 75-year period. These balances are expressed as a percent of taxable payroll. "Balance in 75th Year" refers to the difference between annual program income and costs in just the 75th year, again expressed as a percent of taxable payroll. All estimates are for the combined trust funds. Estimates for individual variables are for "ultimate" (long-term) individual assumptions. High- and low-cost variations for individual variables assume that all other assumptions remain at their intermediate value. CPI is the Consumer Price Index.

Consumer Price Index. Changes in inflation have a relatively small effect on program finances because they increase both payroll tax revenues and benefit payments almost simultaneously.

As Table 1 shows, the Social Security shortfall is extremely unlikely to vanish due to inaccurate projections for any *single* variable. None of the individual low-cost assumptions would by itself eliminate even half of the Social Security shortfall, whether measured in terms of the actuarial imbalance or annual cash deficits; nor would any postpone the date of projected trust fund exhaustion by so much as a decade. Moreover, for every low-cost assumption under which the projections improve, there is an equally plausible high-cost assumption under which they worsen.

Only if the demographic and economic outcomes proved *systematically* more favorable than the intermediate assumptions could Social Security's financial outlook improve sufficiently to avoid the need for programmatic changes. How likely is that? To answer that question, we turn to analyses that consider the likelihood of more or less favorable financial outcomes when all of the important assumptions vary at the same time.

3 Quantifying the Range of Uncertainty

In recent years, both the trustees and CBO have performed annual analyses to measure the degree of uncertainty in their intermediate projections. As with all such studies, the precision of this analysis is limited by the quality of the methodology and the number of variables permitted to fluctuate. Nevertheless, these studies demonstrate that it is highly unlikely that the projected Social Security shortfall will disappear without legislative action.

According to the trustees' analysis, there is an 80 percent likelihood that the trust fund will be exhausted between 2032 and 2045. Moreover, under a scenario that is more optimistic than nine-tenths of likely outcomes, half of the projected 75-year actuarial imbalance would remain. Even under an extremely unlikely scenario, more optimistic than 97.5 percent of the possibilities, there would still be a fiscal shortfall of some amount (see Table 2).

Table 2 The Trustees Have Weighed the Probabilities

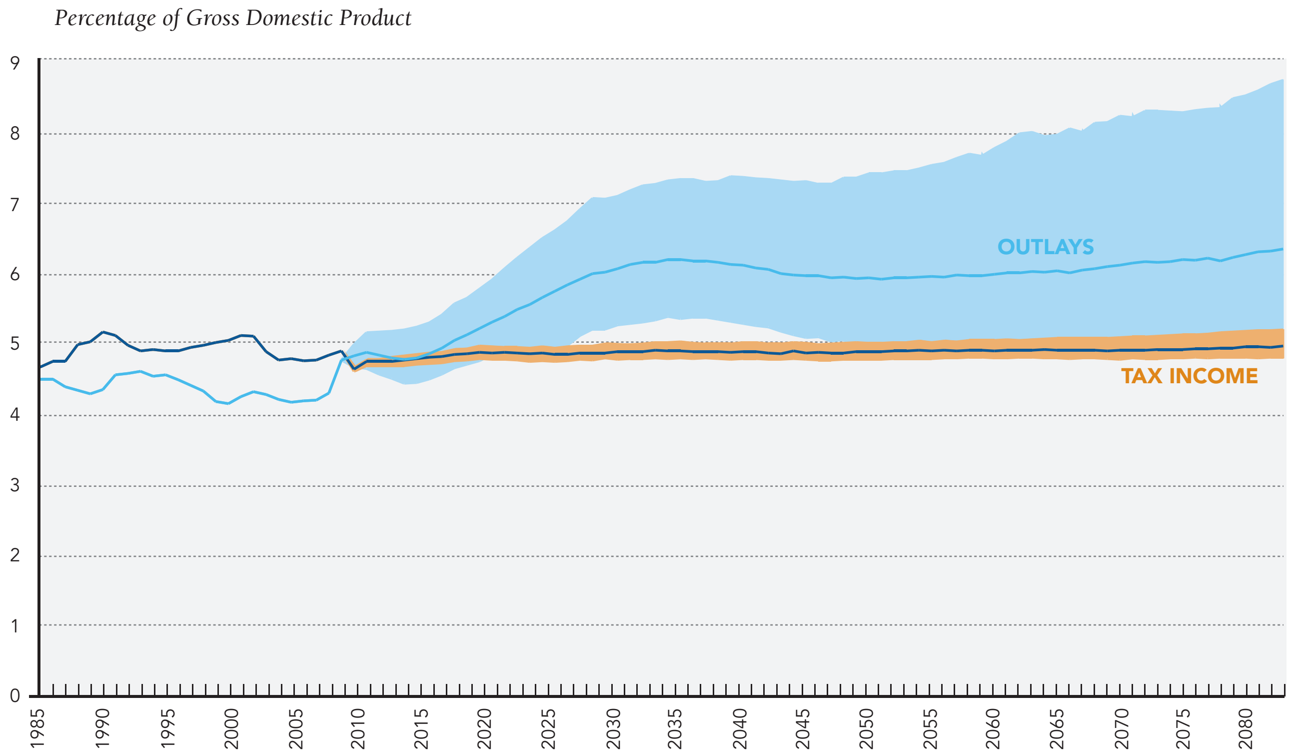
Probability Percentile	2.5th	10th	50th	90th	97.5th
Year of exhaustion	2030	2032	2037	2045	2055
75-year actuarial balance (as percent of taxable payroll)	-3.75	-3.12	-1.92	-1.00	-0.51
Annual balance in 75th year (as percent of taxable payroll)	-10.68	-8.06	-4.30	-1.26	+0.04

Source: 2010 Annual Report of the Social Security Trustees
Note: The figures in Table 2 are derived from the "Stochastic Projections" that appear in the Annual Report of the Social Security Trustees. This analysis provides an estimate of the likelihood of different financial outcomes for Social Security that reflects potential variation from the assumptions underlying the basic projections.

Although there are few scenarios in which the projected shortfall vanishes completely, there are many in which it is substantially worse than in the trustees' intermediate scenario. The trustees' intermediate projection is that the shortfall will equal 1.92 percent of all wages subject to the Social Security tax—so-called taxable payroll—over the next 75 years. In one very gloomy scenario (more pessimistic than 90 percent of the possibilities), this shortfall would increase by more than 60 percent, requiring corrective measures equal to 3.12 percent of such wages. At the even more pessimistic 2.5th percentile, the projected actuarial imbalance would be roughly twice the intermediate projection. While neither of these disturbing scenarios is at all likely, they are both more likely than scenarios in which the shortfall vanishes entirely without legislative action.

While differing on certain assumptions, CBO generally echoes the trustees' conclusions. CBO projects that the trust fund will be exhausted in 2037, and judges that there is only a tiny chance that the fund will not be depleted in the next 75 years (see Figure 3).[4]

Figure 3 Social Security is Very Unlikely to Remain in Balance Without Policy Changes



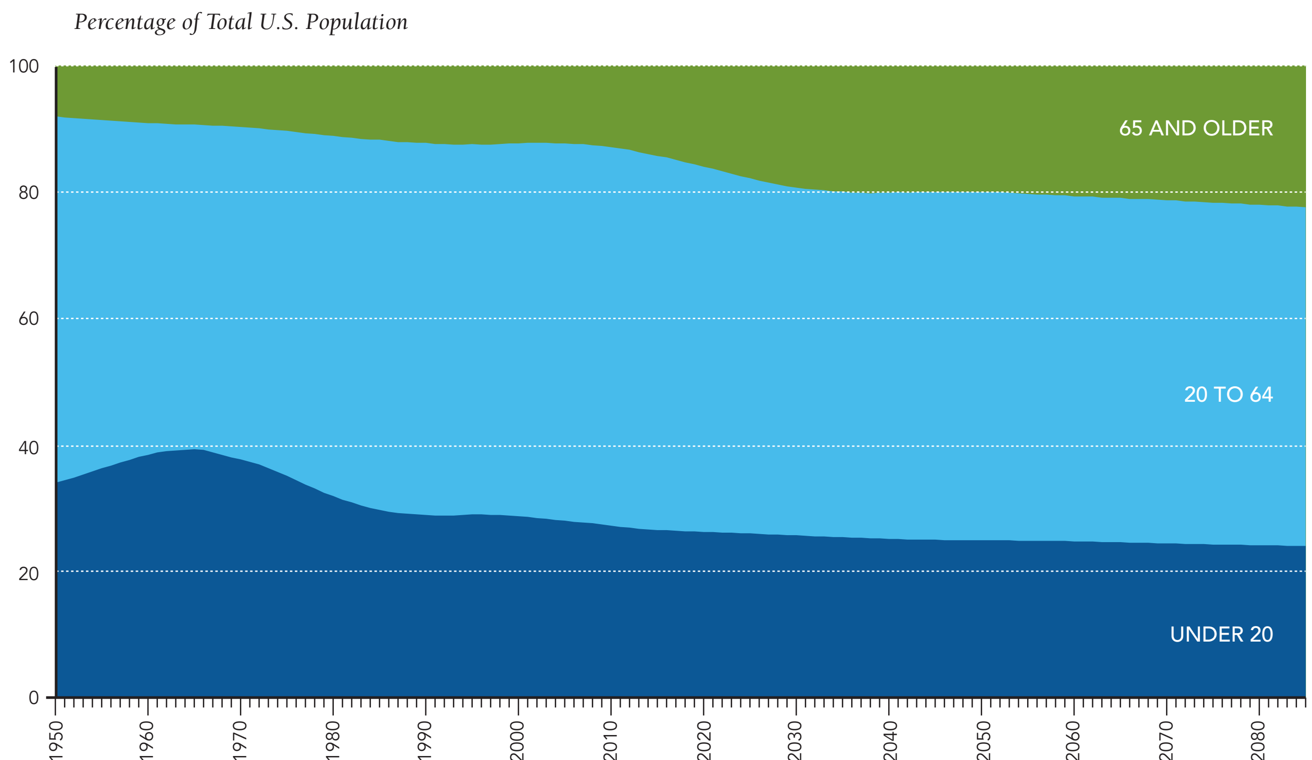
Source: Congressional Budget Office, CBO's 2010 Long-Term Projections for Social Security, Additional Information (October 2010).
Notes: The dark lines indicate CBO's projection of expected outcomes; the shaded areas depict the 80 percent range of uncertainty. Revenues include payroll taxes and income taxes on benefits but exclude interest credited to the Social Security trust funds; outlays include scheduled Social Security benefits and administrative costs. Under current law, following trust-fund exhaustion, scheduled benefits cannot be paid in full. The 10th and 90th percentiles are based on 500 simulations.

4 Are the Projections Too Conservative?

In recent years, some commentators have suggested that the trustees are unduly conservative in their projections, specifically in their projection of the rate of growth of the overall economy. No one can state with certainty whether the projections are too conservative (or too optimistic). However, the trustees' projection that aggregate economic growth will slow in coming decades rests not on an assumption that the growth of output *per worker* will slow but rather on widely acknowledged trends regarding the other component of aggregate economic growth—growth in the labor force.

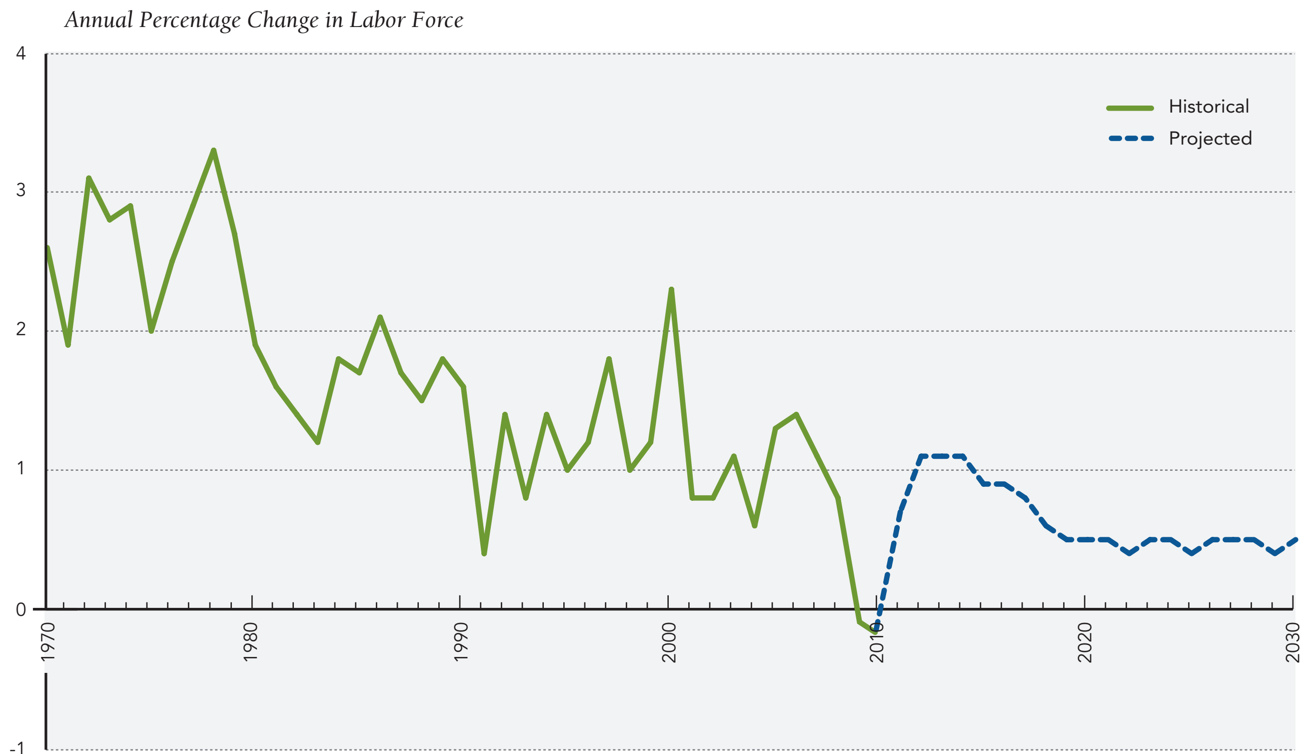
Due to increasing longevity, accelerated by the entry of the baby boom generation into their senior years, America's population is aging, as Figure 4 shows. From the late 1960s through the early 1980s, labor force growth rates were exceptionally high as the baby boomers—the huge number of people born between 1946 and 1964—entered the work force. These net growth rates moderated in the 1990s as members of the boomer generation continued their working careers. Women also entered the paid labor force in increasing numbers. But over the next few years—after a temporary blip that marks recovery from the recent recession—labor force growth rates are projected to drop as the baby boomers retire (see Figure 5).

Figure 4 The Age Composition of the U.S. is Changing



Source: 2010 Annual Report of the Social Security Trustees

Figure 5 Labor Force Growth Will Slow Markedly in Coming Decades



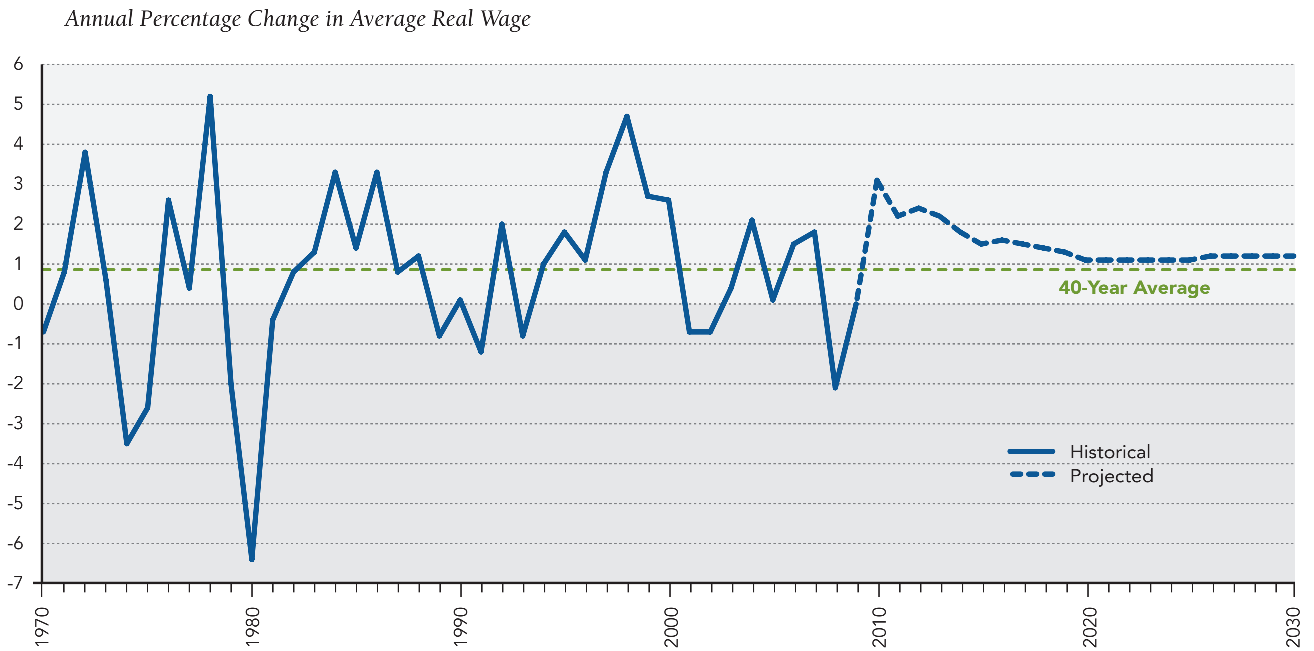
Source: 2010 Annual Report of the Social Security Trustees

The expected slowing of aggregate economic growth rates reflects the slowing of labor force growth as a consequence of demographic change. Thus, the suggestion that simply maintaining historic patterns of productivity growth will sustain Social Security clearly is incorrect: to counter the effects of population aging, future real wage growth per worker would have to be *much faster* than in the past. As Figure 6 shows, the trustees reasonably project that per-capita real wage growth will remain roughly consistent with historical averages.

Moreover, an examination of previous trustees' reports does not support the criticism that the trustees' projections have been too conservative in the past. While some trustees' reports, particularly those of the mid-1990s, appear too conservative in light of subsequent data, at least as many other reports, including those from the 1980s, the early 1990s and 2000s, have turned out to have been too optimistic.

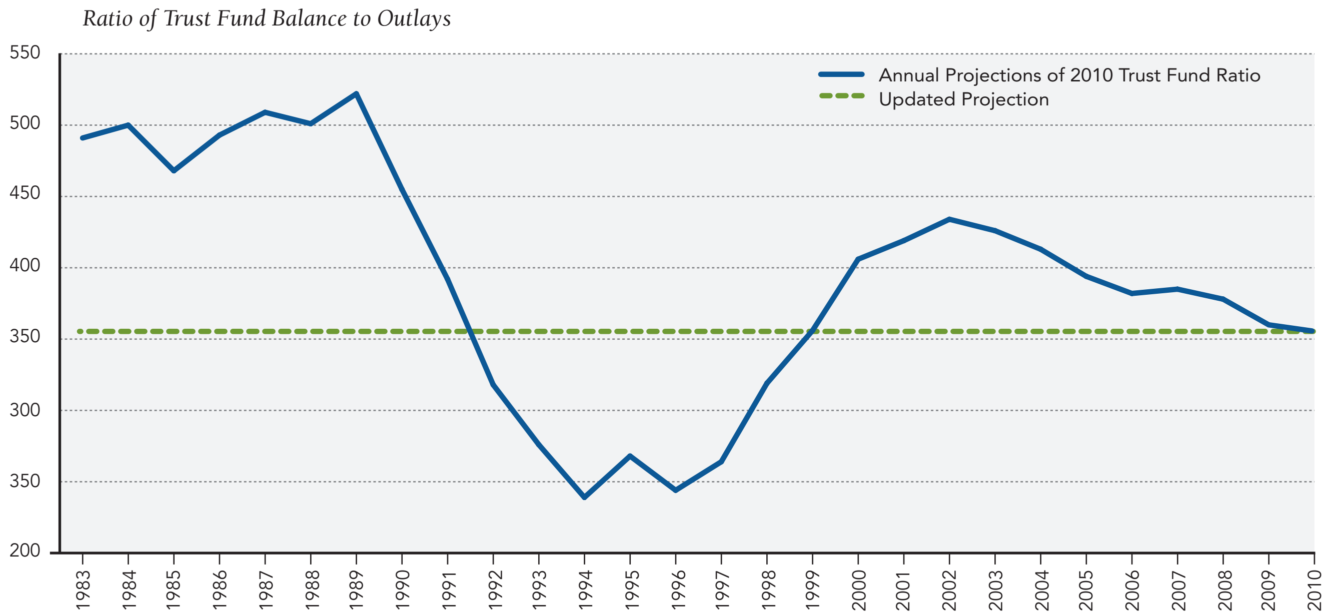
An accurate evaluation of the trustees' overall projection record is difficult, since the current recession is depressing Social Security finances relative to most previous forecasts, including the trustees'. Even prior to the recession, however, the data did not support the claim that the trustees had been persistently too pessimistic (or optimistic). Figure 7 shows the evolution of the trustees' annual projections for the 2010 trust fund ratio—the ratio of the trust fund balance to annual outlays—a figure that captures predictions for program operations in 2010 and the accumulated value of all program surpluses since the 1983 reforms. The trustees have generally achieved qualitative accuracy, with fluctuations on both sides on the line.

Figure 6 The Trustees Assume that Real Wage Growth Will Resemble Its Historical Average



Source: 2010 Annual Report of the Social Security Trustees

Figure 7 The Trustees Are Neither Consistently Too Optimistic Nor Too Pessimistic About the Program's Finances



Source: Annual Social Security and Medicare Trustees' Reports
Note: The trust fund ratio is defined as the assets at the beginning of a year expressed as a percentage of the cost during the year.

Several recent developments lend further credibility to the trustees' projections. Over time, the trustees' estimates and those of CBO have moved closer together. The transparency of the trustees' projection process has also steadily increased through such means as public reviews conducted by technical panels of the Social Security Advisory Board, as well as the publication of details of the Social Security actuaries' projection methodology.

5 Social Security and the Long-Run Budget Challenge

Social Security currently is the federal government's largest domestic program. Its payroll taxes constitute about one-fourth of all federal revenues, and its spending accounts for about one-fifth of total outlays. While the federal government tracks Social Security's income, outgo and assets in a separate trust fund and policy makers from both parties have historically attached great importance to maintaining the program's self-financing integrity, it is also important to view Social Security as part of the nation's broader budgetary challenges.

When examining the overall federal budget, it is common to express spending and revenues in relation to total economic output, or gross domestic product (GDP), rather than as a share of the Social Security taxable payroll (which accounts for slightly over one-third of GDP). This is because GDP provides the economic base to finance *all* federal spending, encompassing many different federal programs and activities that—unlike Social Security—do not necessarily have an earmarked revenue source. Such projections are available from CBO.[5]

Social Security expenditures will grow rapidly over the next two decades with the aging of the baby boomer population but then level off as demographic shifts stabilize. CBO projects that Social Security costs will rise from 4.8 percent of GDP now to 6.2 percent of GDP in the mid-2030s before subsiding slightly to 5.9 percent in 2050 and rising very slowly thereafter.[6]

In contrast, CBO expects that federal expenditures for the major health-care programs—chiefly Medicare and Medicaid—will more than double over the same period, rising from 5 percent of the economy today to about 10 percent in the mid-2030s and to almost 13 percent in 2050, and continuing to rise afterward.[7] While the aging of the population contributes to higher Medicaid and Medicare spending levels—especially as the baby boomers join the ranks of the "oldest old," who tend to incur the heaviest medical bills—the bulk of the long-term growth in these programs stems from rising per-person health costs. Collectively, Social Security and the health-care programs now cost 10 percent of GDP; by 2050, CBO estimates they will cost more than 18 percent of GDP. (See Figure 8.)

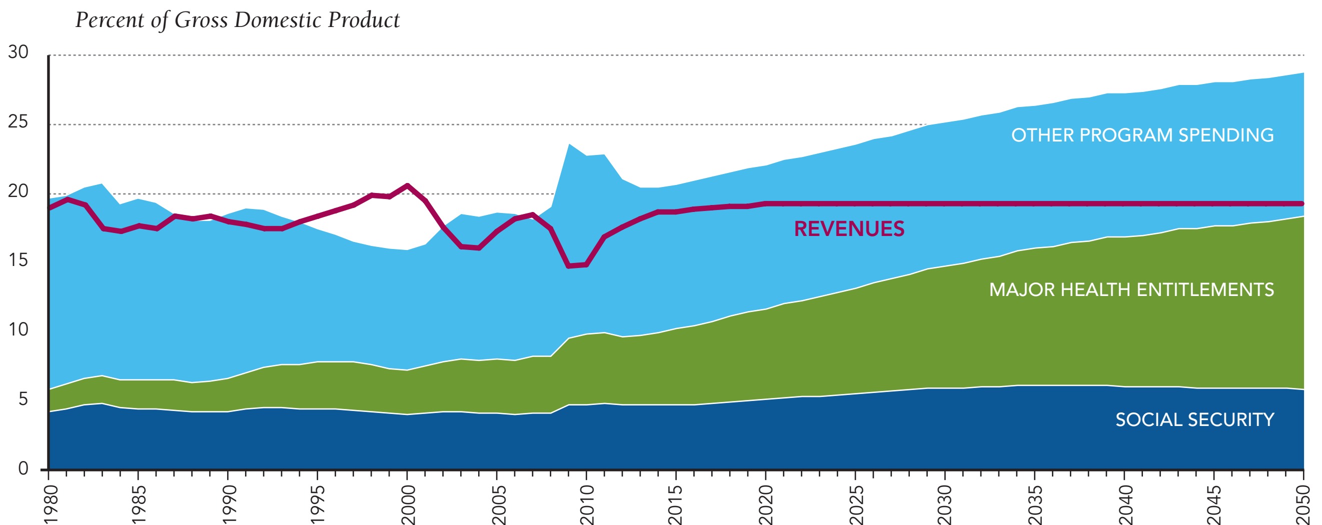
Total spending for all other programs, in CBO's extrapolation, will remain steady at just over 10 percent of GDP once the short-term bulge in expenditures from the economic downturn and from recovery legislation fades. This category includes all entitlement programs other than Social Security and the major health-care programs, as well as defense spending and non-defense discretionary spending. *All* federal spending should receive careful scrutiny, but these other programs collectively are not contributing to the widening of the long-term gap between federal spending and revenues.

If we continue current policies, deficits and debt are headed for dangerously high levels. The federal debt held by the public is projected to skyrocket from 53 percent of GDP at the end of 2009 to nearly 350 percent of GDP in 2050. That would be over three times the existing record (set when the debt reached nearly 110 percent of GDP at the end of World War II) and would threaten significant harm to the economy. In addition, under current policies, the annual budget deficit is projected to exceed 25 percent of GDP by 2050—including over 16 percent of GDP for interest costs alone.

It would be next to impossible, both technically and (equally important) politically, to put the budget on a sound course without tackling all of its major components—health-care spending, Social Security, other spending and revenues. And projections show that over the long term, rising health-care costs are the largest factor. But projections also show that when Social Security's trust funds become depleted, the gap between the program's revenues and outgo will equal about 1.3 percent of GDP—about one-fifth of the federal government's total projected gap between revenues and (non-interest) spending at that point. Regardless of whether one views this as a large or a modest contribution to the overall fiscal problem, there are sound reasons for policy makers to take action on Social Security soon.

It is important to note that CBO's long-run budget projections, like those of Social Security's trustees, assume that scheduled Social Security benefits will continue to be paid in full after the program's trust funds are depleted in 2037. In fact, Social Security has no legal authority to borrow, and trust fund depletion would trigger deep cuts in benefits. However, an across-the-board cut in all benefits (which would be required under current law when the trust funds ran out) is generally agreed to be unacceptable. Showing the long-run implications of currently scheduled taxes and benefits—as both CBO and the trustees do—gives policy makers a ready gauge of how much they will need to trim the benefit formula or increase revenues to keep the program solvent for the long run.

Figure 8 Gap Between Federal Expenditures and Revenues Will Widen in Coming Decades



Source: Congressional Budget Office, The Long-Term Budget Outlook, June 2010 (revised August 2010), Alternative Fiscal Scenario
Note: "Major health entitlements" include Medicare, Medicaid, the Children's Health Insurance Program and the exchange subsidies under the new health-care reform law. Medicare premiums and certain Medicare-related receipts from states are netted against health spending. "Other program spending" excludes interest.

6 Advantages of Acting Soon

The *reality* of the Social Security challenge is well documented. And possible *solutions* also are well known. Various organizations and individuals have drawn on the actuaries' and CBO's estimates to compile menus of options—including both tax increases and benefit modifications—that, when judiciously combined, would put the program on a sound footing for many decades.[8]

Although the trustees project that Social Security will remain solvent through 2037, it would be desirable to act to improve the program's finances well before then, even if the changes are not fully phased in for some time. The "no-action" scenario—in which many beneficiaries face the stark prospect of losing over a fifth of their monthly income in 2037—is clearly undesirable. Taking prompt action offers several advantages.

Reductions in scheduled benefits and/or tax increases can be phased in gradually. The longer a solution is postponed, the more difficult it will be to restore solvency without imposing large, sudden reductions in benefits or increases in taxes. For example, if action is delayed until 2037, Social Security taxes would have to be increased by more than one quarter, or benefits would have to be reduced by more than one-fifth for both current and new beneficiaries, or some combination of tax increases and benefit cuts would have to be adopted to bring the program into financial balance. If changes were begun earlier, the eventual changes required would be nearly as large in the aggregate, but they could be implemented in a series of small steps.

More options will be available. Delaying action forecloses some options for restoring solvency and can produce less attractive distributional outcomes. For example, if Social Security tax increases were phased in soon, some or all current workers could contribute to restoring solvency. But if payroll tax increases are not implemented until 2037, the additional tax burden will fall entirely on younger workers still in the labor force after that date. Similarly, if reductions in scheduled benefit growth were begun soon and phased in gradually, those who are already receiving benefits, are nearing retirement or have low earnings could be protected from any changes. By the time Social Security is on the verge of insolvency, in contrast, it will be difficult to achieve significant savings from benefit reductions unless they apply to current beneficiaries as well as those who are not yet eligible.

Beneficiaries and taxpayers will have more advance notice of changes and will be able to adjust their work, saving and retirement plans accordingly. Social Security is critically important to its recipients. About 90 percent of the aged receive Social Security and on average it accounts for 65 percent of their income.[9] It provides an inflation-adjusted benefit on which Americans can depend throughout their retirement. It is not intended to be the sole source of retirement income,

however, and is designed to be complemented by private pensions and personal savings. If scheduled Social Security benefits are to be reduced, people should receive ample warning so they can compensate by saving more or delaying their planned retirement.

Confidence in Social Security will be strengthened. The projected insolvency of Social Security saps public confidence in the system. Even though benefit payments are secure for some time (since trust fund insolvency is still far off), and Congress has always stepped in when needed to keep the program financially sound, many Americans do not believe that Social Security will be there for them or their children when they retire. If people do not believe that they can count on Social Security, the program will not be fully effective in serving as a basis for their retirement planning. Putting Social Security on a sound long-run financial footing will help restore public confidence in the system and help it perform its intended purpose.

Strengthening Social Security's finances could provide a modest first step toward closing the federal government's long-run fiscal gap. Many options are available to improve Social Security finances, such as increasing Social Security revenues, reducing scheduled benefits or a combination of the two. Such changes would not only improve the program's finances but also reduce the federal government's projected long-run budget deficits. Even if the changes were not scheduled to be fully effective for many years, their enactment would cause an immediate improvement in the long-run budget outlook. Taking prompt action to strengthen Social Security's finances would provide evidence of America's intention to solve its long-run fiscal problem.

7 Conclusion

Social Security faces a significant shortfall, which policy makers would be better off addressing sooner rather than later. Prompt action would reduce the risks of sudden future changes in the benefit structure, better inform current workers' retirement planning and increase public confidence in Social Security.

All projections regarding the program's finances contain an element of uncertainty, but this is not a reason to adopt a "wait-and-see" attitude. Under the overwhelming majority of possible scenarios, and allowing for variance in a wide range of critical variables, Social Security's future shortfall will be substantial. It is also much more likely that the shortfall will be significantly *larger* than now projected than that it will vanish altogether. All of these factors argue for acting soon.

Reasonable and well-intentioned people will have differences over the best way to resolve the Social Security shortfall. We share a common interest, however, in taking action to do so at the earliest practicable time.

Notes

[1] Unless otherwise noted, all data for figures, tables and text in this paper come from the *2010 Annual Report of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (informally known as the trustees' report) and the online supplemental tables, available at http://www.ssa.gov/OACT/TR/2010/index.html.

[2] Social Security encompasses the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, whose operations are tracked separately. This paper focuses on the combined operations of the Old-Age, Survivors and Disability Insurance (OASDI) trust funds, the most commonly-cited definition of "Social Security" as a whole.

[3] Effects of immigration on program finances are somewhat complex, depending on the wage profile of the immigrant population, the fiscal metric employed and other factors.

[4] Congressional Budget Office (CBO), *The Long-Term Budget Outlook* (June 2010). The 2037 insolvency date is from CBO's "alternative fiscal scenario," which assumes (among other things) that the bulk of the 2001 and 2003 tax cuts will be extended. In CBO's "extended baseline" scenario, which assumes that the tax cuts will expire on schedule, higher income taxes on benefits would stave off trust fund exhaustion until 2039.

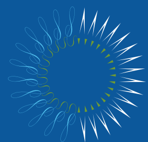
[5] Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010). These are "current-policy" projections that assume that Social Security and Medicare Hospital Insurance benefits will be paid even after those programs' trust funds are exhausted. Estimates are from CBO's "alternative fiscal scenario;" see note 4, above.

[6] This is very close to the trustees' projection, which is also 5.9 percent of gross domestic product in 2050.

[7] This category includes Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and the new program of health insurance subsidies that will be provided through the exchanges established by the recently enacted health reform law. It is dominated by Medicare and Medicaid. In its long-run projections, CBO includes Medicare premiums and certain Medicare-related receipts from the states—which rise from 0.4 percent of GDP in 2010 to over 1 percent of GDP in the 2030s and beyond—as an offset against "other spending"; we have instead subtracted them from health-care spending.

[8] Congressional Budget Office, *Social Security Policy Options*, July 2010, and the solvency options estimated by the Social Security Administration's Office of the Chief Actuary at http://www.ssa.gov/OACT/solvency/provisions/index.html.

[9] Social Security Administration, *Income of the Population 55 or Older, 2008*, Tables 2.A1 and 9.A1.



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