COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET
U.S. Budget Watch

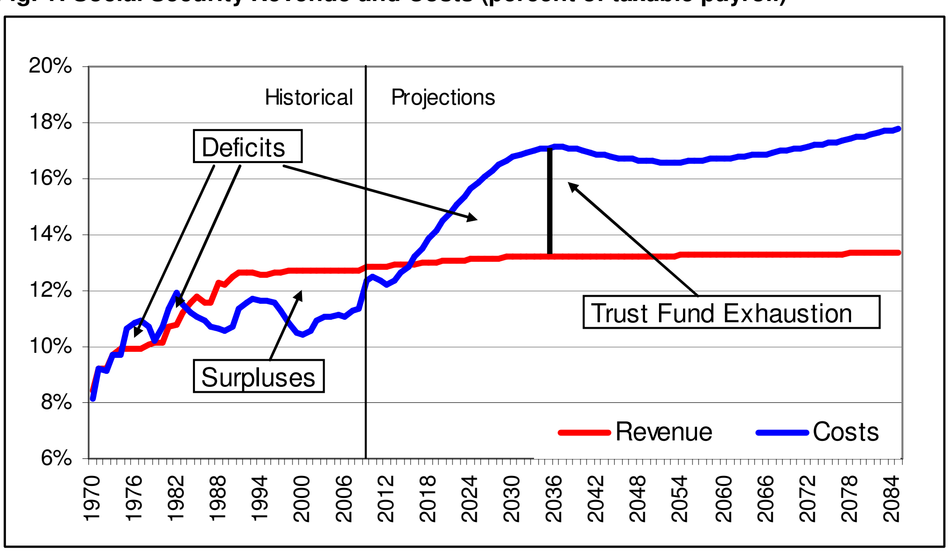
Social Security Trustees Report
May 14, 2009

This week, the Social Security and Medicare Trustees released their annual reports, describing the financial status of the programs. Mainly due to an aging population combined with health care cost growth, both programs are on an unsustainable path and require attention by policymakers. The economic crisis has significantly worsened the condition of both programs, particularly over the next decade.

Of the two programs, Medicare is in far worse shape, and is a greater threat to overall fiscal stability. CRFB will address Medicare in future reports; this analysis focuses on the Old Age, Survivors, and Disability Insurance (OASDI) programs, commonly known as Social Security.

According to the 2009 Trustees Report, Social Security is not solvent over the long-term. The Trustees project that the program will begin running annual deficits in 2016 as costs grow faster than revenue. By 2037, these rising deficits are projected to deplete the trust fund, leaving it unable to pay full benefits. The recession has moved up these dates: last year's report projected deficits in 2017 and depletion in 2041. Over the 75-year actuarial period, the system will face an average shortfall of 2 percent of taxable payroll – up from last year's estimate of 1.7 percent.

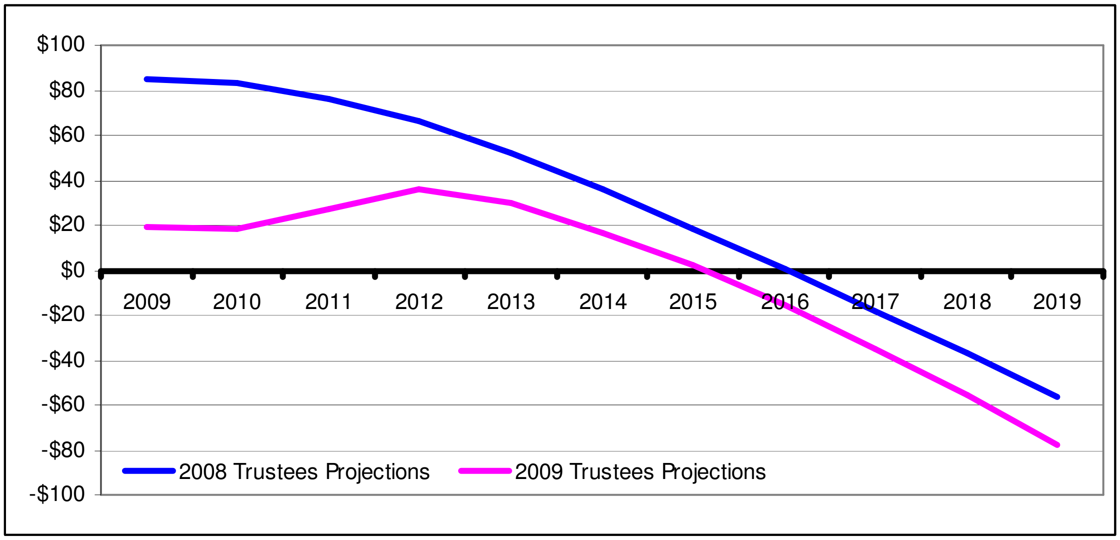
Fig. 1: Social Security Revenue and Costs (percent of taxable payroll)



Changes from Last Year

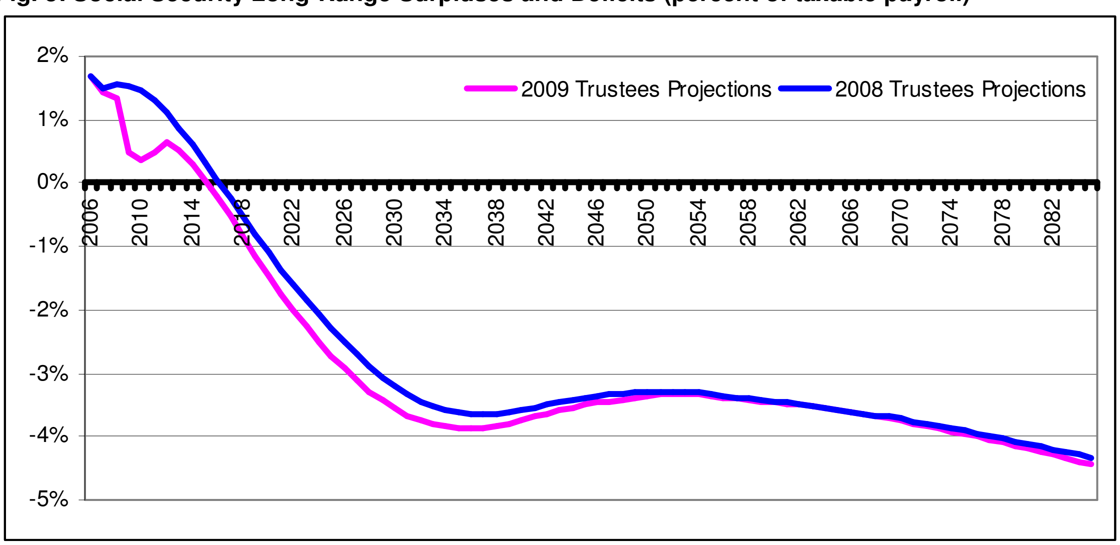
Last year's report projected that Social Security would have large but declining surpluses over the next few years – $87 billion in 2009 and $510 billion over ten years – and would begin running cash-flow deficits in 2017. The new projections estimate that, because of declining revenue as a result of the shrinking economy, the 2009 surplus will be only $19 billion and the ten year surplus just $25 billion (although this is partially a factor of the passage of time), with deficits beginning in 2016.

Fig. 2: Social Security Short-Range Surpluses and Deficits (billions of 2009 dollars)



Although short-term projections incur the most significant changes, expected shortfalls continue to exceed last year's estimates through much of the 2050s. This is largely due to projections of a permanently smaller economy and increasing population longevity.

Fig. 3: Social Security Long-Range Surpluses and Deficits (percent of taxable payroll)



Closing Social Security's Shortfall

All told, Social Security faces a 75-year shortfall of 2 percent of taxable payroll. This equals roughly $5.3 trillion in present value terms, or almost three quarters of a percent of GDP over the 75 year period. This average shortfall is somewhat misleading, however, because of the nature of the program's growth. As the baby boomers retire and the population ages, program costs are projected to increase from 12.35 percent of taxable payroll this year to 14.5 percent in 2020, almost 17 percent in 2040, and 17.75 percent by 2085. At the end of the 75-year valuation period – in 2085 – the program is projected to face a shortfall of about 4.4 percent of payroll, or 1.5 percent of GDP.

These shortfalls are problematic for at least two reasons. First, they draw down the Social Security trust funds. Once these funds are depleted (around 2037), with no legislative changes, benefit checks would have to be delayed; this would result in a large, precipitous drop in annual benefit across the board. At the same time, since the trust fund is invested in government bonds, general revenues essentially finance trust fund withdrawals. As the shortfall grows, therefore, they crowd out other government spending, require higher taxes, and/or necessitate increased government borrowing.

Closing the system's gap will require increasing revenues, lowering benefits, or both. Benefits could be altered by increasing the retirement age, modifying the calculation of initial benefits, or changing the way in which benefits are adjusted each year. To increase revenue, policymakers could raise the payroll tax rate, increase the amount of income subject to the payroll tax, or dedicate outside sources of revenue to the program. Measures to improve the economic or demographic situation can also help somewhat, but cannot alone close the shortfall under any reasonable set of assumptions.

Although none of these options are painless, they are well-known and relatively easy to administer. During the campaign, the Obama administration proposed a "payroll surtax" of between 2 and 4 percent for income above $250,000. While this can be part of the solution, it would only close a small portion of the program's shortfall (See figure 4).

We recommend that the Administration work with Congress to find a comprehensive and bipartisan fix for Social Security. The ultimate composition of the reform should be decided in negotiation, with all options put on the table.

Although its problems are not as large as Medicare's, Social Security still represents the single largest government program – and projections show its costs are growing faster than its revenues. Addressing Social Security now leaves more time to phase-in changes, making it easier for workers to adjust. Acting on Social Security now will also signal to markets and lenders that we are dedicated to controlling our debt, and will signal to the American public that our political system still works, and is capable of making hard choices.

Fig. 4: Options to Reform Social Security

Policy	Percent of 75-year gap closed	Percent deficit closed in 75th year	Description
Immediately cut all future benefits of non-retirees by 3%	18%	11%	Social Security benefits are calculated by averaging past earnings and then multiplying the first $8,928 by 90%, the next $44,868 by 32%, and remaining earnings by 15%. Social Security benefits could be reduced by cutting any or all of these replacement rates.
Immediately cut all future benefits of non-retirees by 5%	30%	19%	
Gradually cut all future benefits by 23% by 2040	73%	71%	
Immediately raise payroll tax rate from 12.4% to 14.2%	89%	41%	The Social Security payroll tax rate of 12.4% could be increased to help cover expanding benefits.
Gradually raise payroll to 14% in 2021 and 15.6% in 2051	85%	73%	
Reduce COLAs by 1%	72%	46%	Social Security benefits are updated every year through a Cost of Living Adjustment (COLA) based on the Consumer Price Index (CPI). Some experts believe the CPI that is used overstates inflation.
Reduce COLAs by 0.5%	38%	24%	
Use chained-CPI to calculate COLA	23%	15%	
Calculate benefits based on 40 years of work instead of 35	25%	17%	Benefits are calculated based on a worker's top 35 years of earnings. Increasing this number would have the effect of reducing benefits, since lower-earning and zero-earning years would be averaged in.
Index benefits by prices instead of wages	115%	164%	Benefits are calculated by inflating past wages to reflect growth in average wages. The benefit formula could be changed so that initial benefits would grow with inflation, rather than wage growth. Some proposals would apply this price indexing to wealthier recipients, while wage-indexing the benefits of those at the bottom and offering other retirees a hybrid of wage and price indexing (progressive price indexing).
Progressive price indexing (maintain benefits for bottom 30%)	68%	94%	
Progressive price indexing (maintain benefits for bottom 60%)	34%	38%	
Index benefits to life expectancy	24%	39%	Social Security benefits could be indexed downward to life expectancy.
Shorten the hiatus in the normal retirement age increase	5%	0%	Under current law, the normal retirement age is scheduled to increase to 66 by 2009, and from 66 to 67 between 2021 and 2026. To increase revenues and reduce benefits, the retirement age could be raised to 67 more quickly and/or raised further after that.
Gradually raise normal retirement age to 68	18%	17%	
Gradually raise normal retirement age to 70	26%	33%	

<table>
<tr><th>Policy</th><th>Percent of 75-year gap closed</th><th>Deficit closed in 75th year</th><th>Description</th></tr>
<tr><td>Eliminate taxable maximum – without offering new benefits</td><td>110%</td><td>61%</td><td rowspan="5">Payroll taxes are applied to only the first $106,800 of wages (indexed for wage growth.) Raising or eliminating this “taxable maximum” would bring new revenues into the system. Additional benefits could be offered in conjunction with the new tax, or not. Instead of raising the maximum, some proposals would charge a smaller “surtax” for higher earners.</td></tr>
<tr><td>Eliminate taxable maximum – while offering new benefits</td><td>92%</td><td>45%</td></tr>
<tr><td>Raise taxable maximum to cover 90% of earned income – without offering new benefits</td><td>47%</td><td>31%</td></tr>
<tr><td>Raise taxable maximum to cover 90% of earned income – while offering new benefits</td><td>42%</td><td>21%</td></tr>
<tr><td>Impose a 4% surtax on earnings above $250,000 a year</td><td>14%</td><td>8%</td></tr>
<tr><td>Invest 40% of the trust funds in equities (Assumes 5.4% annual growth. Overall effects of the policy vary greatly depending on other changes to the program.)</td><td>26%</td><td>0%</td><td>Currently, Social Security surpluses are invested in special-issue Treasury bonds. Instead, this revenue could be invested in stocks and/or non-federal bonds.</td></tr>
<tr><td>Limit spousal benefits for wealthy retirees</td><td>10%</td><td>7%</td><td rowspan="2">Although most proposals focus on Social Security’s retirement program, a number of proposals exist for reforming disability and dependents benefits. One would reduce dependent benefits for wealthy households. Another would switch disabled workers into the old-age system at the early retirement age, rather than normal retirement age, resulting in lower benefits upon reaching old age.</td></tr>
<tr><td>Require disability insurance recipients to convert to old-age benefits at early retirement age</td><td>19%</td><td>18%</td></tr>
<tr><td>Tax Social Security benefits like private pensions</td><td>14%</td><td>4%</td><td>Retirees making over $34,000 a year are taxed on 85% of their Social Security income. Some proposals would tax a higher portion of this income, or reduce the threshold to qualify for this tax.</td></tr>
<tr><td>Cover all new state and local government employees</td><td>11%</td><td>0%</td><td>Some state and local government employees are exempt from the Social Security system. Some proposals would require newly-hired workers to pay into the system, and subsequently receive benefits.</td></tr>
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Source: *CRFB Calculations from Office of the Chief Actuary, Social Security Administration; Social Security Trustees; Andrew Biggs, American Enterprise Institute*