JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

SENATOR SAM BROWNBACK, SENIOR REPUBLICAN SENATOR

May 8, 2007

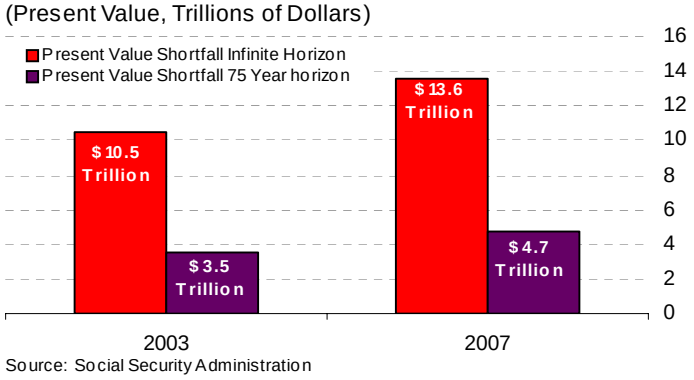
PRICE TAG FOR PERMANENT SOCIAL SECURITY SOLVENCY UP $3.1 TRILLION SINCE 2003

The price tag for permanent Social Security solvency has grown by $3.1 trillion in present value terms since 2003. And the present value price tag for 75 year solvency has grown by $1.2 trillion in the past four years (see Figure 1). The harsh reality is that the longer Congress waits to address Social Security's systemic insolvency, the greater the cost will be for both taxpayers and citizens who depend on the program.

In its annual report, issued on April 23, 2007, the Board of Trustees of the Social Security system wrote: *"We are increasingly concerned about inaction on the financial challenges facing the Social Security and Medicare programs. The longer we wait to address these challenges, the more limited will be the options available, the greater will be the required adjustments, and the more severe the potential detrimental economic impact on our nation."*

Cost of Permanent Solvency Increases $3.1 Trillion in Four Years Fig 1

(Present Value, Trillions of Dollars)



Source: Social Security Administration

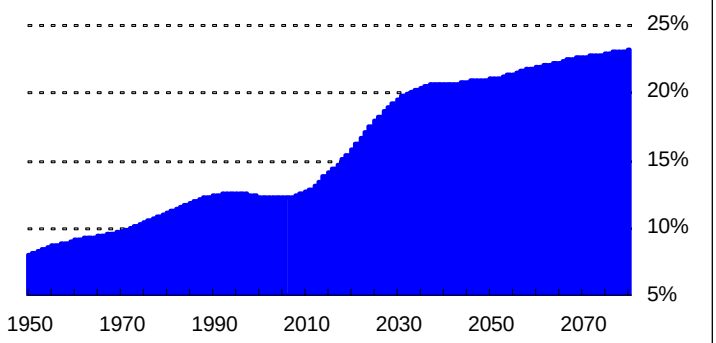
The Trustees' report emphasizes the magnitude of the shortfall facing the system under current law and the need for bipartisan action to put the system on sound financial footing and to provide for a secure retirement for future generations of retirees.

While the magnitude and severity of the Social Security system's insolvency is often the subject of emotional debate, there is no denying the demographic "tidal wave" that is about to strike the system and the nation. The numbers are well known but bear repeating:

- In the next twenty years the percentage of Americans age 65 and older will grow by more than half from 12.3% to 18.6%. And the percentage will nearly double to over 23% by 2080 (see Figure 2).

Americans are Getting Older Fig 2

(Percentage of Americans ages 65 and older)

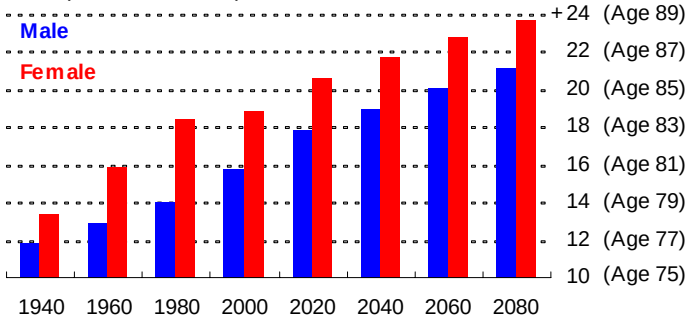


Source: Social Security Administration

- In addition to the rising percentage of Americans over 65, life expectancy at age 65 is projected to increase by nearly five years between now and 2080 (see Figure 3).

Seniors are Living Longer Fig 3

(Additional life expectancy for those who reach age 65, by year in which person turns 65)



Source: Social Security Administration

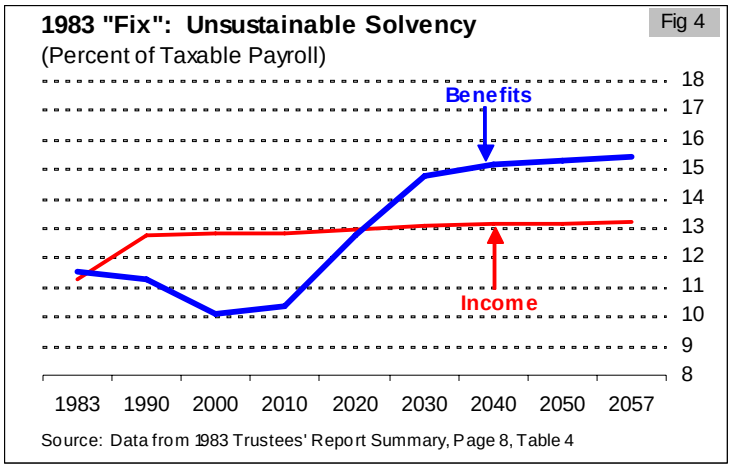
- The percentage of Americans surviving from age 21 to age 65 has increased dramatically since 1940 when only 54% of males and 61% of females reached age 65. By 1990 more than 72% of males and 84% of females survived to age 65.
- In 1950, there were 16.5 workers per retiree. Today, there are 3.3. By 2080, there will be only 1.9 workers supporting each retiree.

It is a demographic reality that the present system is simply

unsustainable absent significant changes.

The problems highlighted in the 2007 report are not new - the basic structural misalignment of benefit promises and revenues remain. Sadly, the long range inability of the system to meet scheduled benefits has been known for a long time. The problem that exists today existed prior to and after the 1983 reforms.

A misconception exists that the 1983 reforms enacted by Congress following the Greenspan Commission's recommendations solved the Social Security system's problems. Following the 1983 "fix," the system may have become solvent over the 75-year term, but the "fix" did not achieve sustainable solvency. In fact, the 1983 Trustee's report issued shortly after passage of the 1983 "fix" made clear that the system's condition would be worsening, not improving, at the end of the 75-year period (see Figure 4).



Benefit Formula Causes Inflation Adjusted Benefits To Grow Beyond What Revenues Can Support

Social Security benefits are indexed annually to account for price inflation. However, a retiree's initial benefit is calculated by indexing past earnings, not for price inflation, but for changes in wage levels within the economy.

The primary insurance amount (PIA) is the benefit that a worker would receive upon retirement at the worker's normal retirement age. Retirement prior to the worker's normal retirement age means benefit reductions relative to the PIA. Retirement after the worker's normal retirement age means benefit increases relative to the PIA.

The PIA depends on an amount, called the average index of monthly earnings (AIME), which is computed by taking a worker's past wages, indexing those wages to present dollar values, and finding a monthly average. In particular, the AIME for a worker is computed by:

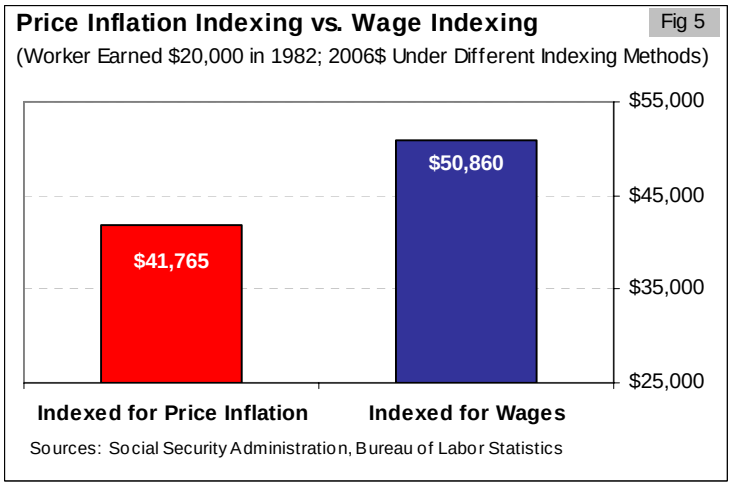
- Adjusting, or "wage-indexing," the worker's past earnings to reflect changes in general wage levels that occurred between when the earnings were realized and the present.
- Adding the highest 35 years of indexed earnings to arrive at an indexed total.
- Determining the average index of monthly earnings by dividing the indexed total by 420, the number of months in 35 years.

Once a worker's AIME is calculated, the PIA is arrived at by adding three separate percentages (90%, 32%, and 15%) of portions of the worker's AIME. These portions, to which separate percentages apply, change over time—they are indexed to wages and consequently grow through time as wages grow.

The measure of average wages used by the Social Security Administration to determine the wage indexation factors is called the average wage index. That index is calculated from Internal Revenue Service records of payroll taxes, which are used in principle to fund Social Security benefits.

Wage indexation of past earnings, used to determine a worker's AIME and PIA, is different from price indexation. Wage-indexed earnings tend to be larger than price-indexed earnings because wages typically grow faster than prices. Wages tend to grow faster than prices because of advances in productivity - the amount of goods and services a worker producers per hour of work. Productivity advances lead to increases in standards of living over time. Indexing a worker's past wages to wage growth that occurred over the worker's lifetime effectively credits the worker with past gains in productivity and living standards that occurred after the worker produced and earned wages and salaries.

For example, if a worker earned $20,000 in 1982 and you indexed those earnings for price inflation, the worker would have earned approximately $42,765 in 2006. On the other hand, if you indexed those earnings as Social Security does to wages, the worker would have made roughly $50,860 in 2006 (see Figure 5). It is because of this methodology that initial benefits will continue to increase in inflation adjusted terms. It was relatively easy in the past to give credit to retiring



workers for advances in productivity that occurred after they recorded their earnings because of favorable demographics. With a relatively large number of payroll-tax-paying workers per Social Security recipient, Social Security system receipts have generally been more than sufficient to finance benefit payments on a pay-as-you-go basis.

With the large wave of baby boomers soon to enter retirement years, however, there will be fewer and fewer payroll-tax-paying workers per Social Security benefit recipient. As a result, it will become increasingly difficult to continue to credit retiring workers with past gains in productivity and living standards, as is done with wage indexation of the AIME and PIA, without significant increases in payroll taxes levied on workers.

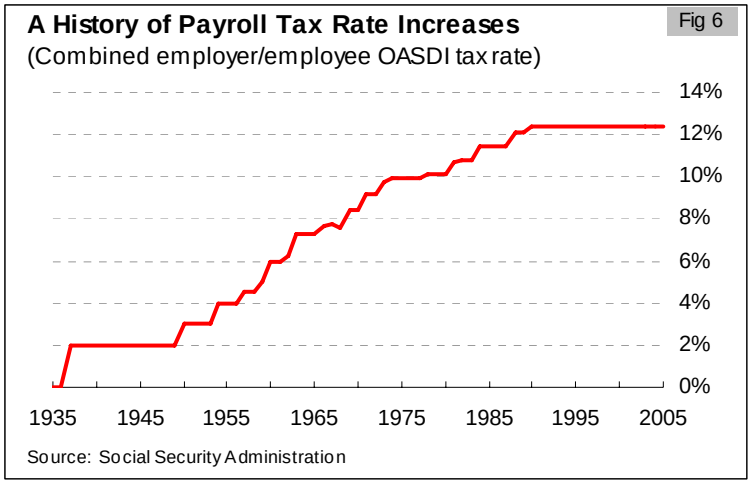
Temptation to Raise Taxes Should be Avoided

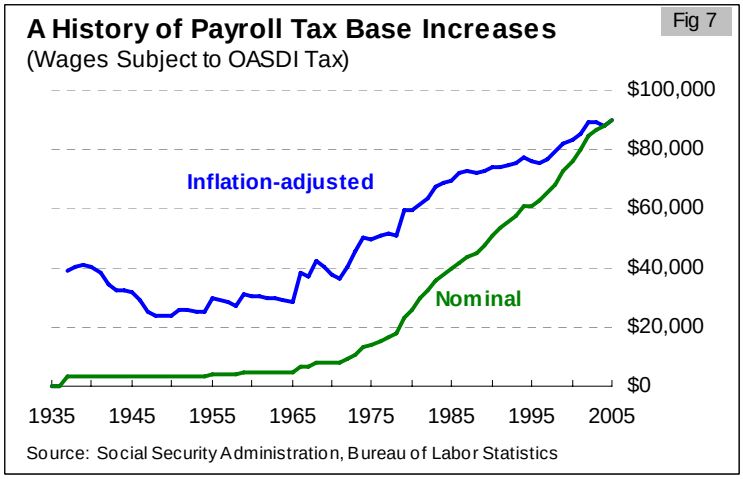
The 2007 Trustees' report projects the system's 75-year actuarial deficit to be 1.95% of taxable payroll. This leads some to assume incorrectly that the Social Security can be fixed permanently by increasing payroll taxes on both workers and employers by roughly 1% each.

Unfortunately, those who advocate tax increases fail to acknowledge that raising taxes and reducing promised benefits are equivalent, except that raising taxes increases barriers to economic growth and job creation.

The Social Security payroll tax has been raised repeatedly throughout the system's history. When Social Security was first enacted in 1935, the government undertook the massive effort to educate citizens about the new system. A 1937 government pamphlet providing details about Social Security contained the following statement about the level of taxation that the new system would entail: *"… beginning in 1949, twelve years from now, you and your employer will each pay 3 cents on each dollar you earn, up to $3,000 a year. That is the most you will ever pay."*

Obviously, history has demonstrated the fallacy of that statement. Not only has the rate paid by workers and their employers more than doubled (see Figure 6), but the maximum earnings subject to the tax has increased at a rate greater than inflation (see Figure 7).

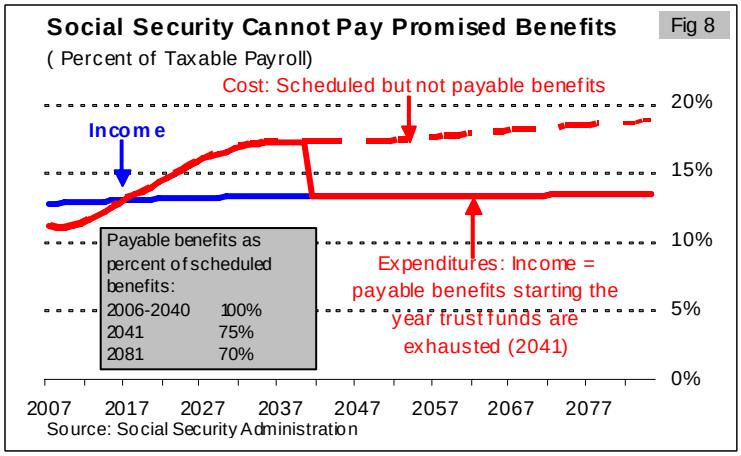




Highlights of the Trustees' Report

The numbers in the Trustees' report change slightly from year to year, but the systemic problems remain due to continued inaction by Congress. Some of the key numbers from the most recent report include:

- Costs begin to rise sharply next year - 2008 - when the first of the baby boomers turn 62 and begin to collect Social Security benefits. The annual cost of Social Security benefits represented 4.2 percent of Gross Domestic Product (GDP) in 2006, is projected to increase to 6.2 percent of GDP in 2030, and then rise slowly to 6.3 percent of GDP in 2081.
- The cost of providing Social Security benefits will exceed the system's revenue by 2017.
- By 2041, the system will be insolvent. Annual income will only be sufficient to pay 75% of benefits promised under current law and 70% by 2081 (see Figure 8).



- As early as 2035, the cost of paying full scheduled benefits will require more than 17% of worker wages.

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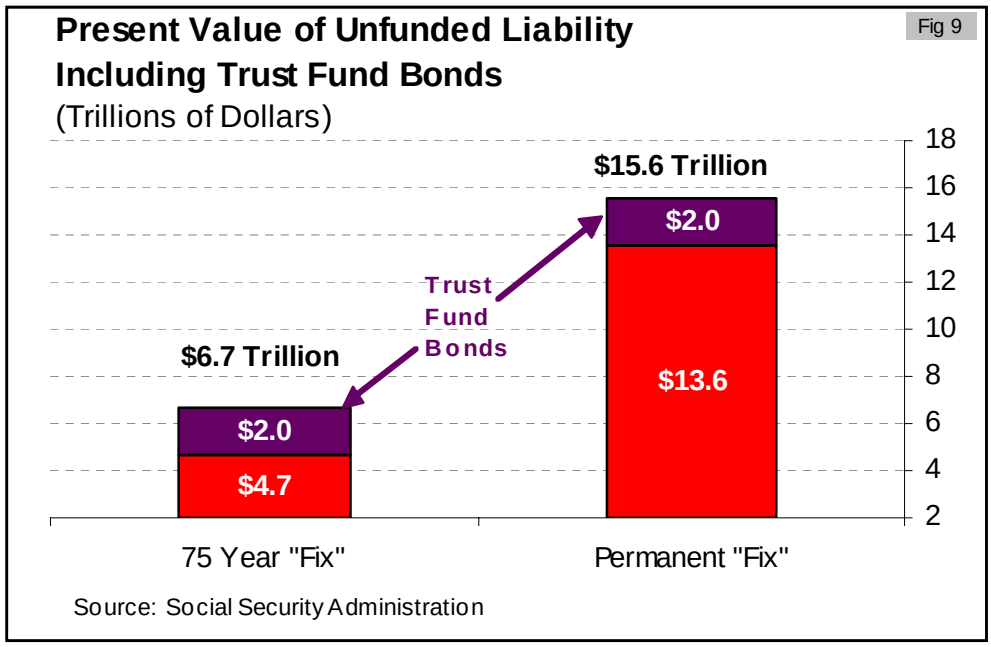
- There is a 95% probability that Social Security will begin to experience **permanent** cash shortfalls sometime between 2013 and 2022.

Opponents of fundamental Social Security reform often argue that the Trustees assumptions are overly pessimistic and that any problem will fix itself, but the projected date of Social Security's first cash deficits has varied little over the years. Since 1993, the year of the first Trustee's report issued under the Clinton administration, the date at which cash deficits begin has stayed within the range of 2012 to 2018. This year's report projects 2017 as the first year of cash deficits.

How Big is the Problem?

The Trustee's report details the "cost" of "fixing" the Social Security system by quantifying the shortfall in a number of different ways. Historically, the primary measure of the system's solvency has been the actuarial balance over a 75-year period expressed as a percentage of taxable payroll. More recently, attention has been paid to the infinite horizon actuarial balance or unfunded liability expressed in present value dollars. This represents the amount of cash you would need to pay into the system today to cover all expected future shortfalls.



The system shortfall over the 75-year period is $4.7 trillion. This does not "count" the roughly $2 trillion in trust fund bonds that must be "paid off" when cash deficits in the program begin. In other words, the government will need to generate $6.7 trillion to cover the costs of the program over the next 75 years.

While discussion of reforming Social Security focuses most often on achieving an actuarial balance over the next 75 years, the focus on the 75 year period estimates tends to mask the true magnitude of the problem facing the Social Security system. This leads to a false sense of security and fails to recognize the more real and significant problem of a system that is in permanent deficit.

It was this focus on the narrower time frame in 1983 that led Congress to restore solvency for the 75-year period, while failing to address the long-term systemic issues than rendered the system unsustainable.

Since 2003, annual Trustees' reports have also measured the actuarial deficit over an infinite time horizon.

According to this year's report, the present value unfunded liability of the Social Security system over an infinite time horizon is $13.6 trillion. In 2003, the total present value unfunded liability was $10.5 trillion. In just four years, inaction has added $3.1 trillion or 30% to the price tag of permanently fixing the Social Security system.

As with the 75-year time horizon, the $13.6 trillion does not include the $2 trillion in trust fund bonds that will need to be redeemed over the next 35 years. With those needed funds included, the present value of the actuarial deficit rises to $15.6 trillion.

To put this in some perspective, Gross Domestic Product was $13.2 trillion in 2006.

In other words, the permanent shortfall in Social Security is larger than the size of the entire United States economy.

Conclusion

With an unfunded liability in present value terms that exceeds the size of the entire US economy, there can be no further delay in addressing Social Security's structural problems.

As the trustees noted, the longer we postpone action, "*the more limited will be the options available, the greater will be the required adjustments, and the more severe the potential detrimental economic impact on our nation.*"

Action should not be limited to the traditional raise taxes or cut benefits approaches. Congress should start by asking itself how it would design Social Security if starting anew.

The time to act is now, not after the cost has increased another $3.1 trillion.