



The Perilous Path of Social Security?

By Katie Southwick

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Read our related [article](#) on the Medicare and Medicaid trust funds in this week's issue.

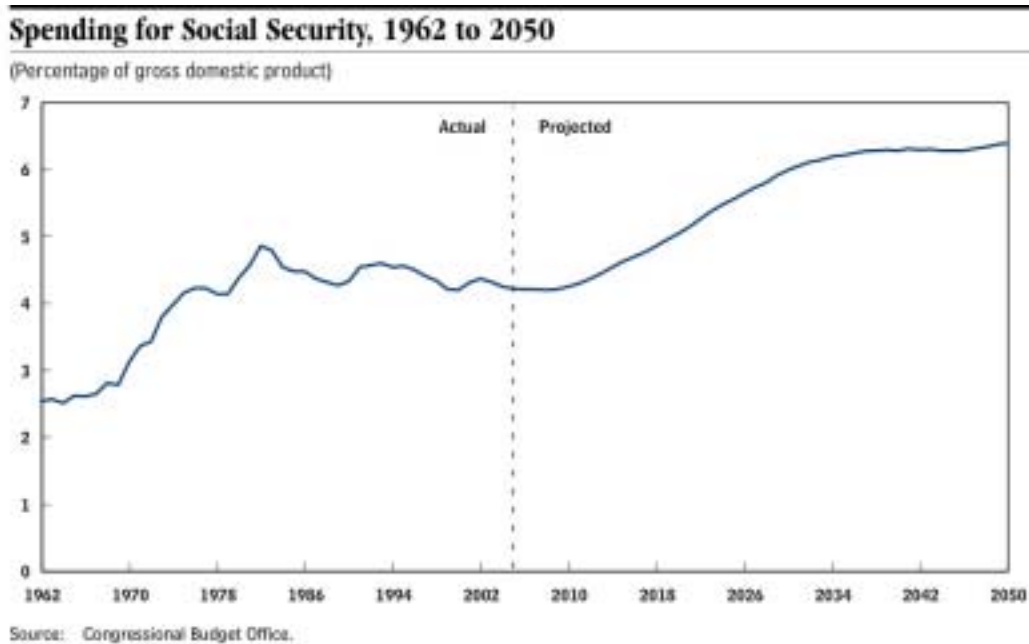
Like Medicare and Medicaid, Social Security is affected by the aging of baby boomers. Since benefits are paid by payroll taxes, Social Security funds are dependent on the size of the current workforce. As the number of retirees grows in relation to the number of current workers, Social Security faces problems.

Some projections remain optimistic. Unlike Medicare and Medicaid, which are predicted to become insolvent by 2012, the [Social Security Board of Trustees](#) believes the program is adequately financed under intermediate assumptions.

Why are these programs on two different trajectories? What drives the difference in projected growth rates for Social Security versus Medicare and Medicaid?

In 2007, almost 50 million Americans were receiving Social Security benefits, costing \$585 billion in total benefits. The cost of Social Security will rise dramatically (see Table 1), says the [Congressional Budget Office](#) (CBO). The size of the Social Security budget is related to the size of the economy, as Social Security benefits tend to grow along with gross domestic product (GDP) and payroll taxes. Social Security is affected primarily by the aging population and its funds are depleted by rising technological or medical costs, as is the case with Medicare and Medicaid.

Table 1: Spending for Social Security, 1962 to 2050



[Source](#)

How Social Security is Funded

Social Security is funded by the Old-Age, Survivors, and Disability Insurance (OASDI) program, which provides retired Americans with monthly income and benefits. The OASDI program consists of two separate funds: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). To measure solvency, the Trustees calculate a trust fund ratio for each program. These ratios are expressed as a percentage of project cost for the upcoming year, and they represent the portion of cost that can be paid with available funds. When applying these tests, the Trustees assume that if the trust fund ratio is at least 100% at the beginning of the ten-year projection period, it must remain at or above 100% throughout the ten years. In addition, if the ratio is less than 100%, it must be projected to reach 100% within 5 years and remain above 100% for the ten-year period. If the funds do not pass these tests, the Trustees believe that they are insolvent.

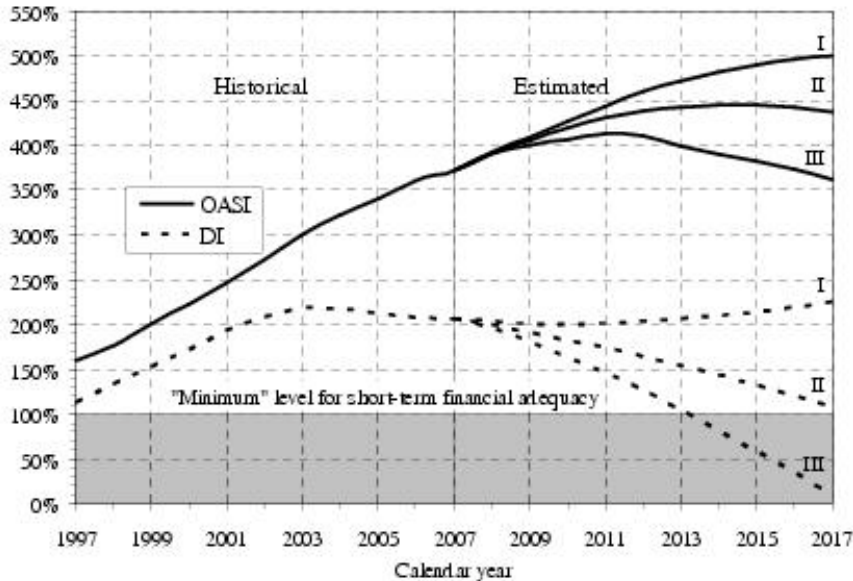
Over the next ten years, the Trustees predict that both employment and average earnings will increase. With these increases, taxable earnings are also estimated to rise significantly. Since these earnings represent a large component of the trust fund's assets, the combined OASDI trust fund is adequately financed. The



combined assets of OASDI trust fund are estimated to increase from \$2,238 billion (359% of annual expenditures) in 2008 to \$4,273 billion (385% of annual expenditures) in 2017.

Like the OASDI trust fund, both the OASI and DI trust funds are in decent financial shape. In December 2007, DI had almost \$2.15 billion in assets, while OASI had over \$2 trillion in assets. According to the Trustees, OASI assets are projected to increase, under high, intermediate and low cost assumptions (see Table 2), and its trust fund ratio will exceed 100% of annual expenditures. Thus, the fund passes the test for solvency by a wide margin. Yet, the DI fund may face some difficulties. Over the next ten years, DI expenditures will rise significantly, as a result of automatic benefit increases and projected increases in monthly earnings. Furthermore, as the baby boomer generation ages, they will experience a higher rate of disability incidence. This will put an additional strain on the DI trust fund. With these changes, the Trustees predict that DI assets may run the risk of exhaustion. In 2008, the DI trust fund ratio represented 199% of annual expenditures. Under intermediate-cost assumptions, assets will exceed expenditures until 2011. By 2017, the DI trust fund ratio will fall to 107%. Similarly, under high-cost assumptions, DI assets will begin to decline in 2008. By 2017, assets will fall below 100% of annual expenditures, as the predicted trust fund ratio is 95% (see Table 2). Thus, under these assumptions, the fund will become depleted. Ultimately, the DI trust fund does not pass the Trustee's short-range test of financial adequacy under intermediate and high-cost assumptions, but it is adequately financed under low-cost assumptions.

Table 2: Short-Range OASI and DI Trust Fund Ratios (Assets as a percentage of annual cost)



I: low-cost

II: intermediate-cost

III: high-cost

[Source](#)

Looking Out to the Next 75 Years

While Social Security is well financed for the next ten years, the OASDI trust fund is predicted to eventually deplete. According to the Trustees, OASDI cost will increase at a faster rate than tax income over the next 75 years. From 2010 to 2030, the majority of the baby boom generation will retire, putting a strain on resources. By 2017, annual cost will exceed tax income. To cover these additional costs, special funds from the Treasury will be redeemed. By 2041, even these redemptions will be exhausted. Furthermore, the OASDI annual cost rate is predicted to increase from 11.20% of the taxable payroll in 2008 to 16.41% in 2030. By 2082, cost rate will increase to 17.50%, which is 4.20% more than the projected income rate. Individually, the Trustees also estimate that the DI trust fund will be exhausted by 2025 and the OASI trust fund will run out by 2042.



Addressing Potential Shortfalls

To address potential shortfalls in Social Security, both presidential candidates have recommended policies. Democratic candidate [Barack Obama](#) hopes to protect and strengthen Social Security by preventing privatization. He proposes a bi-partisan plan that will ask Americans earning over \$250,000 to contribute additional payroll taxes to Social Security. This plan will be implemented ten years from now, to address Social Security's long-term solvency. Furthermore, Obama plans to strengthen retirement savings by eliminating income taxes for seniors making less than \$50,000 and creating automatic workplace pensions for workers. Republican candidate [John McCain](#) believes that we should strengthen Social Security by supplementing it with personal accounts, and he believes that this can be accomplished without raising taxes. He also hopes to modernize Social Security by bringing choice and competition to entitlement programs.

Economists and think-tanks also propose solutions. The [Heritage Foundation](#), a conservative think-tank, believes we must make changes immediately. Four million baby boomers turn 55 each year, placing a strain on the program. With more recipients and increasing costs, they propose three solutions. First, they advocate adjusting benefits based on income. Using "progressive indexing," which indexes initial benefit levels to price inflation, rather than wage growth, additional costs will be eliminated. Next, they believe that individuals should create personal accounts to supplement Social Security. Finally, they propose raising the retirement age by two months per year until it reaches 70, at which point the average life expectancy (or "retirement period") is 17 years.

Like the Heritage Foundation, other groups advocate increasing the retirement age. Last week, the [American Academy of Actuaries](#) issued a statement that proposed raising the early retirement age from 62 to 69. According to their statement, increasing the retirement age would equal a 14% average cut in retirement benefits. Many believe that this change is both unfair and ineffective. According to Bernard Wasow, of the liberal think-tank Century Foundation, increasing the retirement age will hurt low-income workers. Statistics show that poorer people die at an earlier age; thus, they will be affected disproportionately. Instead, [Wasow](#) believes that Social Security is not in crisis, and privatization plans will undermine guaranteed minimum retirement income and increase federal debt.

Challenging the Assumptions in Social Security Projections

Some challenge the assumptions of the Trustee's projections. For example, [John Williams](#), who runs an online newsletter, believes that Social Security payments have been declining in real dollars. [See our [article](#) on Williams' analysis.] According to Williams, inflation is understated by as much as 7% each year, as



Consumer Price Index (CPI) numbers are misreported. This flawed methodology reduces Social Security payments by 50%. Williams claims Social Security checks would be doubled if changes to CPI calculations had not been made. Furthermore, he believes understated rates of inflation affect GDP calculations. While CPI is not used to calculate GDP, there is a relationship between the two values. If calculations employ understated inflation rates, higher inflation-adjusted rate of GDP growth get reported. Thus, growth rates are misrepresented.

Similarly, [Dean Parker](#), co-director of the Center for Economic and Policy Research, believes projections underestimate immigration. According to the US Census Bureau, immigration will rise from 1.3 million per year to more than 2 million by the middle of the century. Yet, the Trustee's projections assume immigration will decrease to a little over 1 million a year by the middle of the century. Ultimately, Parker believes increased immigration will improve Social Security's financial status. If Census reports are correct, around 30% of the projected Social Security shortfall would be eliminated due to immigration, he says.

Ultimately, the Trustees believe changes must be made to maintain Social Security's solvency. With informed discussion and timely legislation, they believe that Social Security can be preserved for future generations. Similarly, Brian Reid, Chief Economist with the Investment Company Institute, believes solvency can be restored. Social Security is better funded than Medicare or Medicaid, he says in a telephone interview. With modest changes, we can restore solvency.

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