

THREE QUESTIONS ABOUT SOCIAL SECURITY

This white paper addresses three questions that have arisen from the debate surrounding the President's call to save Social Security:

- *Will Social Security be bankrupt by 2042?*
- *Are projections of future stock returns realistic given the outlook for long-term economic growth?*
- *Will economic growth alone be enough to solve the problem?*

I. Will Social Security be “bankrupt” by 2042?

Yes. Bankrupt means “having insufficient assets to cover ones debts,”¹ which applies to Social Security in 2042, according to the Social Security Trustees most recent report.²

Beginning in 2042, the Social Security Trust Fund will be exhausted. At that point, the resources available to the system (payroll taxes plus some income taxes on Social Security benefits), will be insufficient to cover the liabilities of the system (benefits scheduled for retirees, people with disabilities, and other beneficiaries). If nothing is done to correct this problem, benefit payments would have to be reduced by roughly 27 percent.

A Small Business Analogy:

Consider a small business that has \$750,000 in annual revenue and \$1 million in annual costs, for a \$250,000 annual loss. Obviously, that business would be able to stay open only as long as it has enough money in the bank to cover its losses. Once the money runs out, the business will be bankrupt. The business won't necessarily disappear, but to stay open it would have to restructure so that its revenues at least cover its costs.

Likewise, Social Security will begin to incur annual operating “losses” in 2018, when its outlays first exceed its tax revenues. To cover the shortfall and to “stay open,” Social Security will use up its Trust Fund (or draw down its bank account) from 2018 to 2042. Social Security, like the small business example above, would be better off if it restructured before reaching bankruptcy.

Some argue that Social Security will not be bankrupt until it cannot pay any benefits at all. By that standard, the hypothetical small business wouldn't be bankrupt either, even as the bank forces it to shutter its doors.

¹ www.Dictionary.com

² Social Security Trustees Report, page 3

II. Are projections of future stock returns realistic given the outlook for long-term economic growth?

Yes. The Social Security Actuaries assume that stocks will provide an average real return of 6.5% per year over the next 75 years. Some argue that this is unreasonably high if, as the Social Security Trustees predict, economic growth will average only 1.9% per year in the future. *This argument is incorrect; the stock return and economic growth assumptions are not inconsistent.*

The Actuaries' financial assumptions are consistent with historical experience and other professional estimates.

- The Social Security Trustees estimate future stock returns of 6.5% per year in real terms (i.e., above inflation) based on an independent review of historical data and economic analyses of future stock returns.
- To put this projection into context, it is important to compare it with the Trustees' forecast of returns on long-term government bonds: 3.0% per year in real terms (the average return on long-term bonds in recent decades). The Actuaries are thus assuming that stocks will return 3.5% more per year than government bonds. This premium is consistent with long-run historical experience and is low relative to the experience of the last seventy-five years.
- In its most recent analyses, the non-partisan Congressional Budget Office (CBO) makes similar projections. CBO estimates that the long-run real return on government bonds will be 3.3% per year and the real return on stocks will be 6.8% per year.
- The Actuaries' projection of a 6.5% real stock return is thus consistent both with other professional assessments and with historical investment returns.

The Trustees predict that economic growth will slow primarily because of slower population growth. Slower population growth need not imply lower stock returns.

- The Social Security Trustees project that economic growth will slow in the future, primarily because of slower population and labor force growth. Some observers believe that this growth slowdown will reduce future stock returns.
- Although *short-run* movements in growth can affect stock market returns, there is no necessary connection between stock returns and economic growth in the long run. Long-run economic growth is determined by productivity growth and labor force growth here in the United States, while stock market returns are determined by the overall cost of capital in the global economy and by the return investors require to bear the risk that comes with equity ownership. There is no reason to believe that slowing population growth in the United States would significantly lower the cost of capital, as set by increasingly globalized capital markets, or the premium required by stock investors.

III. Will economic growth alone be enough to save Social Security?

No. While economic growth makes it easier to sustain some government spending programs, this does not apply to Social Security, *because Social Security benefits themselves increase with earnings.*

Some commentators have wondered whether the Social Security Trustees have underestimated future productivity growth and, thereby, future economic growth. If productivity grows faster than expected, the economy will indeed grow more rapidly, as will worker wages. But this won't provide that much help to Social Security. As workers' wages rise, their payments to Social Security go up, providing a short-term benefit to the program. However, their future benefits increase as well. Thus, while there is a short-term benefit to Social Security from economic growth, the long term benefit is relatively small. It is almost like running on a treadmill—getting ahead requires more than is reasonable to expect.

Specifically, the indexation of initial Social Security benefits to wages means that increased benefits offset much of the higher revenue from faster wage growth. Closing the financial imbalance through higher growth of wages and incomes would require that productivity growth remain permanently at a level far above the historical experience. The progressivity of the system and the fact that benefits paid to existing workers are indexed to prices, rather than wages, are the reasons that higher wages help to close the financing gap at all.

The idea that even strong growth of incomes and wages would not be enough to close the financing gap is clear from the 2004 Report of the Social Security Trustees. Simulations in the Report indicate that a 0.5 percentage point increase in real wage growth would improve the 75-year actuarial balance by 0.54 percentage points of taxable payroll. This would mean a 75-year deficit of 1.35 percentage points instead of the currently-projected deficit of 1.89 percent of taxable payroll over 2004-78. The date of Trust Fund exhaustion would be pushed back from 2042 to 2048 in this case.

Under the Trustee's central assumptions, closing the entire 75-year financing gap of 1.89 percent of taxable payroll would require approximately a 1.75 percentage point increase in real wage growth ($1.75 = 0.5 \times 1.89/0.54$). This is approximate because the actual impact of wages on revenues and costs would not be exactly proportional to a single 0.5 percentage point increase in wages. A 1.7 percentage point increase in real wage growth would require an enormous deviation from the Trustees' assumptions; lifting real wage growth from 1.1 percent to 2.85 percent would be nearly a 60 percent increase in real wage growth and nearly a 45 percent increase in nominal wage growth given the assumption of 2.8 percent inflation.

Holding fixed the Trustee's economic assumptions other than wages, the increase in real wages corresponds to long-run GDP growth of 3.5 percent compared to the Trustees' intermediate assumption of 1.8 percent growth, and 3.3 percent long-run productivity growth compared to the Trustees' intermediate assumption of 1.6 percent long-run productivity growth. Such rapid productivity growth would be substantially out of line with the historical experience that productivity growth has tended to revert to the historical experience after

periods of higher performance. The Trustees note: “The annual increase in total productivity averaged 1.5 percent over the last four complete economic cycles (measured from peak to peak), covering the 34-year period from 1966 to 2000.”

The Trustees also report the results of stochastic simulations that quantify the probability that the Trust Fund will be solvent in the event that future changes to underlying economic conditions are similar in magnitude to historical changes. *These simulations indicate that there is less than a 2.5 percent chance that a combination of positive changes in all of the dimensions they model would lead to long-term balance in the present Social Security system.*