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THE ADMINISTRATION'S MISLEADING $600 BILLION ESTIMATE OF THE COST OF WAITING TO ACT ON SOCIAL SECURITY

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Summary

President Bush recently claimed that delaying action on Social Security by "...just one year adds $600 billion to the cost of fixing Social Security."[1] Other Administration officials have used the same figure. But this figure is highly misleading. The American Academy of Actuaries has specifically warned against using such an estimate.

- This figure reflects the reduction in the value of the dollar as time passes and *not* a deterioration in Social Security's finances. A dollar is simply worth less with each passing year. Over time, more dollars are needed to fill the *exact same* shortfall in the Social Security system.[2]

- To be sure, some cost results from waiting to act on Social Security. But it occurs for a different reason and is a small fraction of the Administration's figure.

- The Administration is exaggerating the cost of waiting to act. Moreover, the cost of waiting a few years could be far less than the cost of enacting legislation now that relies on substantial federal borrowing and fails to improve the government's overall fiscal position significantly.

Analysis

The Administration's $600 billion figure is based on the Social Security Trustees' measure of the Social Security shortfall projected over an "infinite horizon" (i.e., into eternity). This shortfall, according to the Trustees, stands at $10.4 trillion in present-value dollars, or 1.2 percent of the projected Gross Domestic Product. The Trustees first introduced this "infinite horizon" measure in their 2003 annual report, producing it in addition to the traditional 75-year shortfall measure.

The new figure is highly controversial. In a letter to the Trustees, the American Academy of Actuaries, the nation's leading professional association of actuaries, warned that the "infinite horizon" measure was highly speculative and likely to mislead the public. In addition,

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[1] George W. Bush, "Radio Address by the President to the Nation," January 15, 2005, available at http://www.whitehouse.gov/news/releases/2005/01/20050115.html.

[2] The present-value measurement is the standard way of presenting financial transactions occurring over long periods of time. One dollar in the future is worth less than one dollar today, and the present-value calculation takes into account this "time value" of money.

American Academy of Actuaries: Figure is Misleading*

The following is from the letter written by the American Academy of Actuaries to the Social Security Trustees.

"For the first time, in their *2003 Annual Report*, the Trustees included OASDI's [Social Security's] unfunded obligations…for an infinite time period…. The Committee [the Social Insurance Committee of the American Academy of Actuaries] believes that the new measures of OASDI's unfunded obligations included in the 2003 report provide little if any useful information about the program's long-range finances and indeed are likely to mislead anyone lacking technical expertise in the demographic, economic and actuarial aspects of the program's finances into believeing that the program is in far worse financial condition than is actually indicated.

"…The infinite-time-horizon unfunded-obligations estimate [in dollar terms] increases each year…. The public, seeing annual large increases in unfunded obligations, is likely to be misled into believing that the program's financial situation is deteriorating and the cost of restoring actuarial balance is increasing, even if this is not the case. If experience matches the Trustees' assumptions, the program's financial situation will remain about the same, and changes to the program that would have restored solvency a year ago would still do so if enacted today, or a year from now, even though estimated unfunded obligations have increased."

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* Letter from the American Academy of Actuaries to the Trustees of the Social Security System, December 19, 2003, available at http://www.actuary.org/pdf/socialsecurity/tech_dec03.pdf.

the Academy specifically cautioned that the measure, when cited in dollar terms, could be used to give the impression that the unfunded obligations of the system are increasing each year *even if this was not the case*. The Administration is currently employing the number in precisely the manner that the Academy of Actuaries criticized as misleading and said should not be done. (See box.)

Each year, the size of the Social Security shortfall, when measured in present-value dollar terms, can appear to grow *simply because it is being expressed in dollars that are less valuable* and not because the size of the shortfall has grown in reality. For instance, a dollar in the 2004 measurement of the Social Security shortfall is worth less than a dollar in the 2003 measurement. As a result, the Social Security gap expressed in 2004 dollars would be a larger number than the same gap expressed in 2003 dollars; the gap, as measured over an "infinite horizon," would be about $600 billion larger even if the gap had not actually changed in dimension.

This is where the Administration gets its $600 billion figure. The increase that the Administration cites is due to the change in the value of the dollar, not to any deterioration in the program's finances.

Stated another way, there is no inherent reason that the size of the Social Security shortfall, measured into eternity, should change from year to year. Unless the Social Security actuaries change their views about future birth and death rates, future growth rates, or other such factors, the shortfall will be the same from year to year. It will only *appear* to increase in dollar terms because of the reduction in the value of the dollar.

The Actual Cost of Waiting to Act

Waiting to act on Social Security does have a cost, but the Administration is misidentifying its source and substantially exaggerating its size. Waiting to act a year means that the same shortfall must be paid down over a slightly shorter period of time. For instance, as of 2003, savings to close the Social Security shortfall could be achieved in all years from 2003 on. But if action did not occur in 2003, the same shortfall would have to be closed over a period that is one year shorter, since 2003 would have passed. To make up for the fact that no savings were achieved in 2003, the annual adjustment necessary to restore solvency to the Social Security system must be slightly larger over the remaining years. This is the true cost of waiting.

- From 2003 to 2004, the size of the policy changes needed to restore full solvency into eternity increased by 0.02 percent of the Gross Domestic Product (the basic measure of the size of the economy) due to the delay of one year. In other words, the cost of closing the shortfall increased by an amount equal to two one-hundredths of one percent of the economy, measured over the period from 2004 into eternity.

- This increase of 0.02 percent of GDP is equivalent to an additional $2 billion per year, relative to today's economy. In other words, the cost of restoring full solvency to Social Security into eternity is about $2 billion higher for each year that we postpone such legislation. But the size of the tax cuts enacted in 2001 and 2003 *just for the top 1 percent of households* equals about $45 billion in 2005, or more than 20 times the cost of a one-year delay in implementing a Social Security fix.

- Over the "infinite horizon," 0.02 percent of GDP is equivalent to a total of $150 billion. (This is the $2 billion per year cost of waiting added up over time and expressed in present-value terms.) Put differently, under the measure of the cost of restoring Social Security solvency into eternity (a measure that the American Academy of Actuaries has strongly criticized as a misleading measure that should not be used in policy debates), an additional $150 billion in total savings would need to be achieved over the period from 2004 on because no action had been taken in 2003. In comparison, the total size of the 2001 and 2003 tax cuts over the infinite horizon is $16.4 *trillion*, or almost 110 times as much.

- Over the more established and widely accepted way of measuring Social Security's solvency — over the coming 75-year period — the cost of deferring action a year is smaller. From 2003 to 2004, the size of the policy changes needed to restore solvency over the 75-year rose by one one-hundredth of one percent of GDP, or close to $80 billion in present value.

A final point should be noted. Social Security must be viewed in the context of the overall federal budget. The federal government today faces large deficits. These deficits have two key effects. They increase future federal interest payments on the debt, and they reduce national saving, thereby reducing long-run economic growth. This means that these deficits will

leave the federal budget and the economy with fewer resources to provide for the retirement and health care of the baby boomers.

Given this, any responsible plan to reform Social Security should have three aims. It should restore solvency in the Social Security system, improve the overall federal budget picture, and increase national saving. Some of the Social Security proposals being discussed by the White House and Congressional leadership, however, would increase deficits for more than 40 years and also would likely fail to produce any significant increase in national saving. These proposals would involve large amounts of new borrowing to finance private account plans; that borrowing could place additional strain on the budget and the economy. The borrowing entailed under a number of the leading plans *dwarfs* the $2 billion per year cost of waiting an additional year to act on Social Security.

This leads to the conclusion that it would be ill-advised to rush to enact unsound Social Security legislation that puts the federal government deeper in the red, even if such legislation might restore Social Security solvency on paper. The cost of waiting a few years could be substantially less than the cost of enacting changes that worsen the federal budget outlook for decades to come.