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Trustees’ projections mask Social Security shortfall

By JAGADEESH GOKHALE | 4/30/12 9:54 PM EDT

The Social Security Trustees’ new report reveals serious deterioration in the program’s financial outlook. This decline could have been known much earlier — instead of being gradually revealed to us — if the trustees had used correct projection methods.

Social Security officials have long been misdiagnosing the program’s financial condition. Whether this reflects poor judgment, incompetence or deliberate misdirection seems impossible to determine.

This year’s trustees’ report shows that Social Security’s 75-year actuarial deficit increased from 2.22 percent of payrolls to 2.67 percent — among the largest increases of the past two decades. Out of the total increase of 0.45 percentage points, 0.21 percentage points (or 47 percent) resulted from changes to economic assumptions. Why? It looks as though the program’s actuaries are not particularly good at economics — and don’t adequately build it into their financial projections.
Consider this example in the report:

This year, the trustees changed one of the ultimate economic assumptions — the annual rate of change in average hours worked for the future. Reasons for the change in the ultimate average hours worked include first, the need to establish consistency with the projections of an aging workforce; and second, the belief that increasing productivity is likely to result in workers’ desire to enjoy productivity gains in the form of more leisure (2012 Annual Report of the Social Security Trustees, Chapter IV.B7).
The first reason is something that I have argued for. It’s now finally being implemented but in a piecemeal manner.

The second reason — the trustees' newfound belief that workers would enjoy more leisure in the future — is stunning. Did new information since last year convince the trustees of the need for such a major change? It suggests that Social Security's financial projections are not informed by any disciplined application of proper projection methods. Though there has been progress in updating the trustees' projection methods, the pace of this progress remains glacial. The trustees have not explained why they shied away from using all available information in making their demographic projections. And all the key demographic changes are still not incorporated into deriving their economic assumptions.

Crucially, just projecting historical trends of economic variables into the future is insufficient to capture the full economic implications of projected demographic changes. This is a key methodological shortcoming that the recent report of Social Security's Technical Panel on Assumptions and Methods overlooked.
The term "demographic change" of course includes the continuing retirement of the large baby boomer cohort. However, there are many other important, if less visible, demographic changes likely to persist and influence our economy's evolution in terms of labor-force participation, earnings, inequality, productivity growth, payroll taxes and Social Security benefits.

The most important of these are overall changes in family structures, marital trends, fertility, economic dependency relationships, educational attainment and workforce composition. All are evolving steadily but differently among different population groups. These important "micro" demographic changes, however, are ones that Social Security's officials have ignored when making the program's financial projections. It's no wonder that the largest of the "technical adjustments" to the projections are now emerging among their economic components.

Had the Social Security officials used appropriate assumptions and methods in building financial projections, we might have seen more than mere lip service by lawmakers of both parties regarding program reforms. This has created big problems, because analysis of the relatively simple mechanics of the program's finances reveals that the longer we delay implementing reforms, the costlier they will be.

The program's total unfunded obligations — $20.5 trillion according to the report — grow at an interest rate that is larger, on average, than the productivity-plus-population-growth formula that determines growth of the payroll tax base. Calculations based on micro-data sources of demographics and economic behavior suggest that the program's long-term financial shortfall is about 50 percent larger than the trustees are letting on.

However, this difference will be revealed only gradually as official projections play catch-up with actual realizations. That can only mean costly delays to urgently needed Social Security reforms.

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