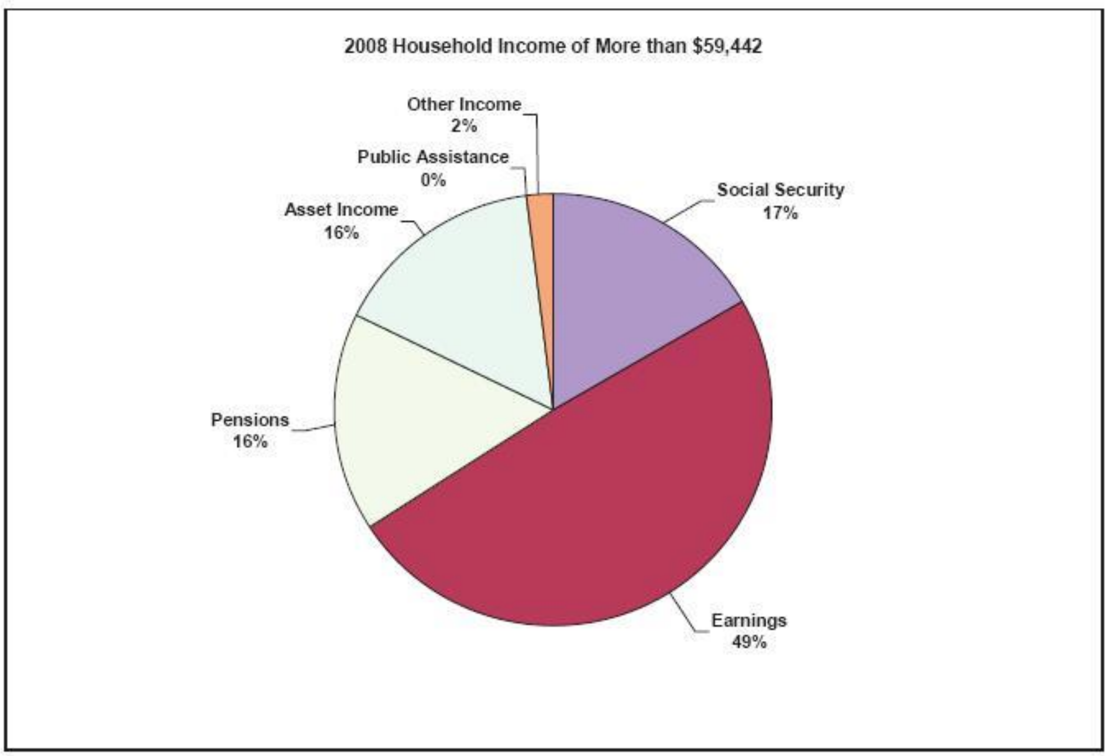
Mitchell's Musings 2-28-11: Grandma's Unfunded Liability

Currently, about 38 million individuals age 65 and over receive payments from the Social Security program. About 59 million individuals of all ages in total receive payments, including those retired early, disabled, or under other related components of Social Security. There will be about 80 million people in the U.S. over age 65 in 2050, according to Census projections. The proportion of the population in that age bracket will be a little over one fifth of the total as the baby boom bulge peaks in 2040-2050. At present, the figure is about 13%.

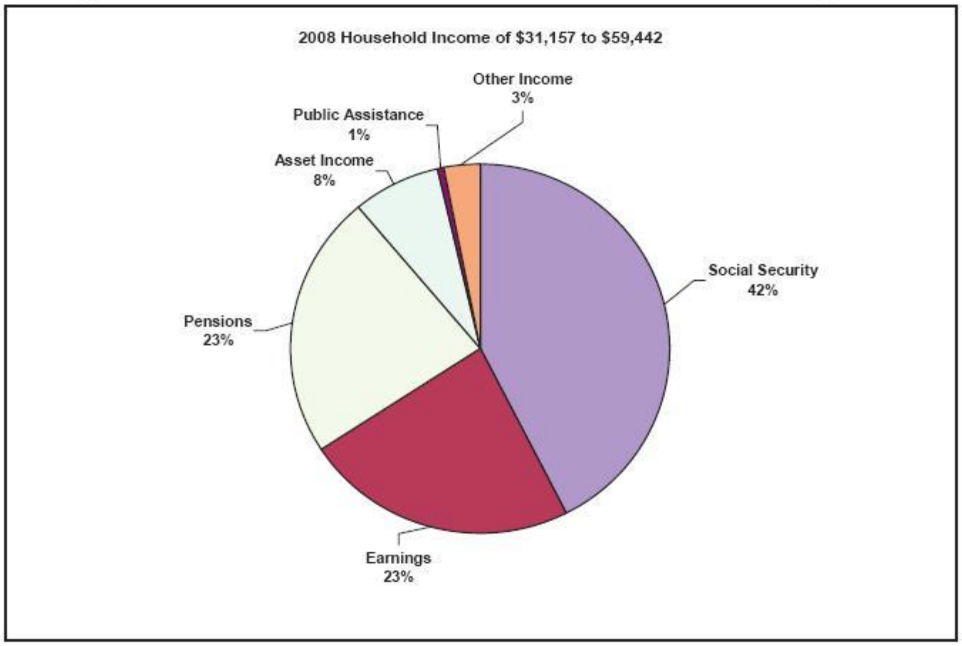
Social Security income is an important resource for households with a head or spouse of head age 65 or older. Below are four charts (numbered 5-8) from a Congressional Research Service report breaking down the share of Social Security income by household income quartile from top to bottom. (The source is http://assets.opencrs.com/rpts/RL32697_20091002.pdf) In the top quartile, Social Security accounts for about one sixth of income, a small but not negligible share, and the about half of income comes from employment.

Figure 5. Sources of Household Income in 2008, Top Quartile, Age 65+



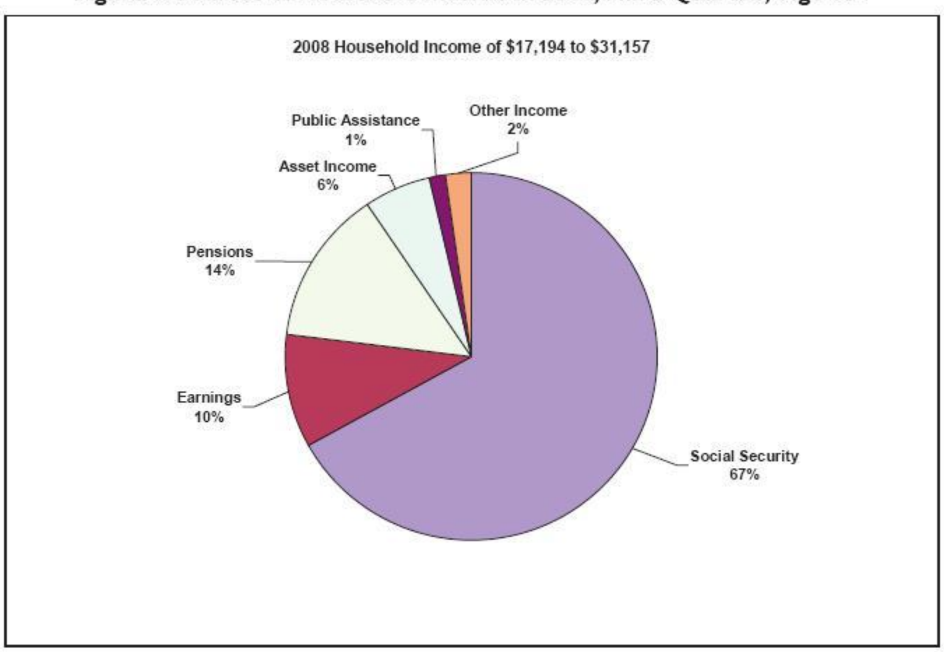
In the next lowest quartile – shown on the next page - the share of Social Security rises to 42% while the employment share drops below one fourth.

Figure 6. Sources of Household Income in 2008, Second Quartile, Age 65+



In the third quartile from the top, Social Security accounts for two-thirds of income and employment drops to a tenth.

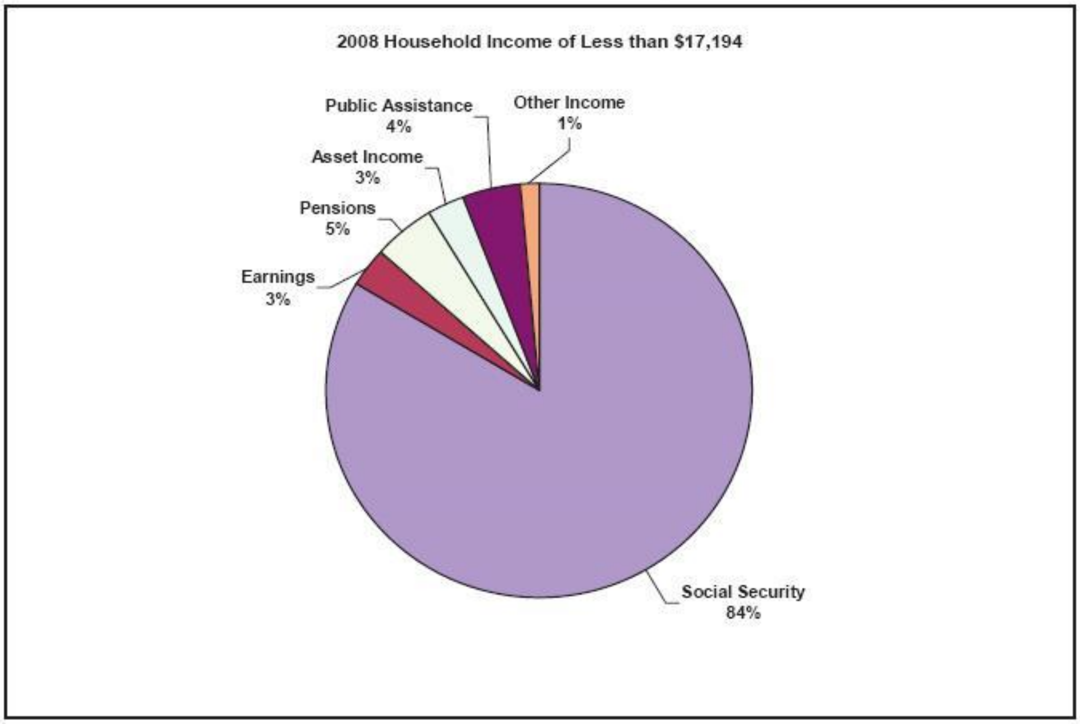
Figure 7. Sources of Household Income in 2008, Third Quartile, Age 65+



Finally, in the bottom quartile (next page), 84% of household income comes from Social Security and the employment share is negligible. Note that in none of these pie charts do private pensions of any type (defined benefit, defined contribution, IRAs, etc.) make up a substantial share of retirement income.

Particularly for the bottom half of the household income distribution, pension income is drawfed by Social Security.

Figure 8. Sources of Household Income in 2008, Bottom Quartile, Age 65+



The lesson from the information above is that Social Security is THE retirement program for the U.S. Sometimes, in political discussions, Social Security has been described as a "third rail" for any elected officials who propose to trim it. Actually, what the data show is that careless fiddling with the program in any substantial way could expose those covered by Social Security (most of the U.S. population) to a third rail.

As is well known, the Social Security system has an unfunded liability. Normally, the projections made for Social Security go out 75 years. That is a long time. In my undergraduate class this quarter, someone asked about the length of the projections. I pointed out that unless an elixir of youth is discovered, most of the folks in the class – obviously including yours truly – would be dead by the end of that period. A sobering thought! Undaunted by that thought, however, the trustees of the system actually make a projection of the unfunded liability for forever. Forever is a very long period; indeed, everyone who is alive today *or will ever be alive* will be dead by the time forever ends. Nonetheless, on a forever basis, the unfunded liability was put at about $16 trillion. (You can find this figure at http://www.ssa.gov/OACT/TR/2010/IV_LRest.html#267528 on Table IV.B7.)

How shall we think of that number? We might compare it with other unfunded liabilities. Although Social Security has a dedicated revenue stream of payroll taxes, the Defense Department does not. It is funded out of the general budget. Since the president is constitutionally required to provide for the national defense, if we take his latest defense request of $670.9 billion (http://comptroller.defense.gov/defbudget/fy2012/FY2012_Budget_Request_Overview_Book.pdf) and assume we will continue at that level in real (inflation-adjusted) terms forever, the unfunded liability of the Pentagon would be about $27 trillion. (I used a real interest rate of 2.5% in that calculation as the discount factor.)

More seriously, we can simply ask to what extent the liability for Social Security would go away if we somehow obliterated the system. There would still be aging baby boomers. For that matter, the generations beyond the boomers would also still be aging. At some point in their old age, they would be claiming a share of GDP. In the period before Social Security was created, elderly support was provided in various ways. A few people saved enough to retire comfortably. Others worked until they dropped. Extended families took care of elderly relatives. Or there were poor houses and similar charitable arrangements. To the extent that the elderly could not support themselves through work or savings, there was an implicit societal unfunded liability that could have been calculated. Of course, no one made such calculations back in the day, because there was no official system created to take over much of these responsibilities.

The bottom line from these musings is that much of the unfunded liability which we now explicitly calculate for Social Security would be there without the system. Unless each generation truly saves enough to provide for its own retirement – and we are far from that situation – there will always be an intergenerational unfunded liability that no clever scheme can erase. The immediate political task before us is to determine how much of the GDP of, say, 2040 can reasonably go to the aged boomers. In reciprocal terms, that question comes down to how much income sharing the active workers of 2040 will be willing to provide. We can have that conversation in terms of modifications to Social Security so long as we understand the underlying demographic basis of the issue, essentially the boomer bulge in the population. The demographics tell us that, in the main, we can shuffle the liability around, but we cannot make it go away. Grandma will be here, no matter what we do.