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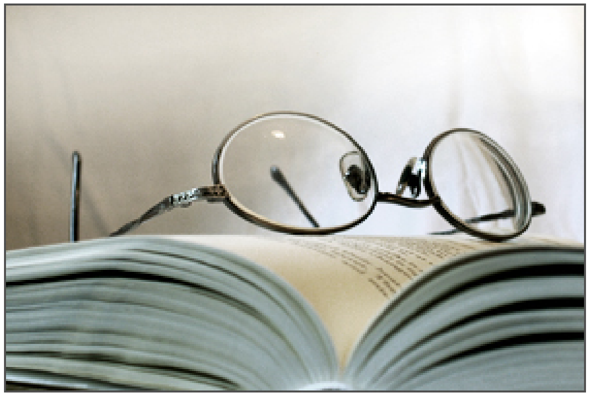

The "Unfunded Liabilities" Ruse

Bernard Wasow, The Century Foundation, 10/25/2004

What is true and what is phony about the alarms that fiscal disaster for Social Security is looming just ahead? Senior fellow Bernard Wasow debunks the myths about the threat of "unfunded liabilities" in this issue brief.

Recently, the mainstream media have been parroting claims that the federal government, particularly the Social Security and Medicare programs, have dozens of trillions of dollars in "unfunded liabilities." For example, USA Today ran a long feature in early October 2004 that proclaimed that "the long-term economic health of the United States is threatened by $53 trillion in government debts and liabilities that start to come due in four years." Many other articles, news reports, and commentary have included comparable numbers that make the fiscal future look not just frightening but entirely unmanageable.

These claims appear aimed at scaring us into making radical changes in our social insurance system for old people. But whatever the motivation, how scared should we be? What is true and what is phony about the alarms that fiscal disaster is looming just ahead?

Here is what is true:

• Medical costs are rising much faster than other costs. If this continues, all future medical bills, including those the government has pledged to pick up, will be frighteningly large.

• In the future, as the population ages, old people will consume a larger share of the income pie, one way or another.

Notice that neither of these facts implies a public sector crisis. The first is a huge challenge confronting the entire society, posed by unmanageable healthcare costs. The second is simply a problem of adjusting our institutions to divide the income pie fairly among people of all ages.

Even the conservative estimates by the Social Security actuaries suggest that, if nothing is changed, the system will be able to meet all of its promised benefits until 2042 and 75 percent thereafter. In fact, the Social Security Trust Funds are bigger today than they have ever been, and these conservative forecasts predict that they will continue to grow for two more decades before beginning to decline (if nothing is done before then).

It is nonsense to suggest that a crisis looms directly before us that requires immediate, profound change to our social insurance system. We do have a serious problem of rising healthcare costs, but these are just as great for private employers and families as for the public sector, just as great for the young as for the old. Against this, Social Security is in good shape; the bill in the future will not threaten the well being of our children or their children. It will be easy to preserve Social Security without any radical "fixes."

Playing Chicken

All of the grotesquely huge unfunded liability numbers spouted by scare mongers depend on forecasts that go out many decades, often hundreds of years. Such forecasts routinely go beyond the point where we could have any firm knowledge of what to expect. Of course, it is technically very easy to trace the implications of assumptions about future productivity, birth and immigration rates, labor force participation levels, and various costs over the next 20, 50, or even 1,000 years. These assumptions have implications for the age structure of the population, the rate of economic growth, and the cost of various government programs. Plugging those assumptions into a spreadsheet can tell us precisely how much Social Security or Medicare will cost us, extrapolated to eternity, if we like.

The problem is that over such long time horizons, small differences in those assumptions compound to huge variations in forecasts. If something (say health care costs) is growing faster than something else (say incomes) and we assume that this continues indefinitely, then eventually, what is growing fast will swamp what is growing slowly. That's arithmetic, not policy analysis.

Over the years, we have responded not to forecasts of what will happen in 50 or 100 years, but to evolving Social Security finances. As it became clear that action was needed, we acted.

The history of Social Security is replete with adjustments to tax rates, benefits, and the retirement age. For example, as funding difficulties approached in 1983, President Reagan appointed a Commission headed by Alan Greenspan that suggested adjustments to keep the system whole. These changes will prevent a funding shortfall for at least another four decades (six decades from the time the Commission's recommendations were adopted).

We Can't Afford It!

The notion of "unfunded liabilities" in certain programs is based on the arbitrary assumption that certain designated revenue sources should pay for certain classes of government expenditures. The story that Social Security and Medicare should be paid for out of payroll taxes and their trust funds is not a recent creation of critics of those systems. It has been around for decades. But why? Revenues and expenditures are "fungible," meaning that a dollar is a dollar is a dollar. In fact, today's Social Security surplus flows right into the pot with other revenues, while a significant portion of Medicare costs already are paid for out of general revenue. The real question is not "will the designated revenues be enough to pay for the designated programs" but "will we have enough income to afford to keep the promises we have made?"

There is no question that the nation's gross domestic product will be sufficient to meet all of our Social Security promises forever, leaving lots of income for increasing the prosperity of the young. In general, the outlook for economic growth is good. Our average income per person in 100 years is likely to be much, much higher than it is today (more than four times as high). Social Security benefits are predicted to rise from about 4.5 percent of our GDP to about 6.6 percent over the next century. Even though such long predictions are very uncertain, this one should leave us sanguine: if incomes in 100 years are only twice their present level, and incomes of the old rise from 4.5 to 6.6 percent of income, that still leaves us with $1.96 for every dollar we have today, after Social Security obligations are taken care of. We can continue to keep our modest Social Security promises, and young families still will be much better off than families are today.

There also is no question that, if health care costs continue to rise as rapidly into the indefinite future as they have in recent years, medical expenditures will soak up a much, much larger share of our overall income than they do now, leaving a smaller and smaller share for other uses. Unlike Social Security, this could indeed become a grave problem.

What's Generational Accounting Got to Do With It?

Although the notion that we are headed for a fiscal train wreck is stated in the language of scientific prediction, there is a moral element as well. Building on the idea of "generational accounting," those who foresee a catastrophe are implicitly using the ethical standard that people should take care of themselves over their lifetimes-not rely on government transfers from others (including from other generations). The idea is that it is unfair for old people as a group to get back more than they paid into the public trough (using appropriate interest rates).

This is a very odd notion. Why is it that young people in general will be better off than their parents? Fundamentally, it is because of the information and technology that earlier generations produced, the engine of modern economic growth. If the older generation levied fees on all the intellectual property they created, that could amount to an enormous claim by older people on their children: "We invented the transistor and financial derivatives, which is what makes you so productive. Pay up."

There is no need to charge rent on the intellectual property the young inherit from earlier generations. Instead, we can use our common sense. If the old are a growing proportion of the population, and the pie we all have to share is much bigger than it was, we should give a larger slice to the elderly.

Don't Worry, Be Happy

Imagine if in 1950, someone had calculated the costs of educating the baby boomers in public institutions through their college years. What an immense, unmanageable burden! And nothing-not a penny-had been set aside by 1950 to cover the costs of public universities in the 1960s and 1970s! Using the logic of unfunded liabilities that has fueled alarmist media stories, public universities should have been closed; education should have been left to the private sector.

Yet nobody ever claimed in the 1950s and 1960s that the education of the Baby Boomers was an excessive burden our society, or that our public institutions could not afford to accept the challenge. When we needed more schools, we built them. Why should the Boomers' retirement be unmanageable? We need to strengthen social insurance for old people, and we will be able to afford it.

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