



AMERICAN ACADEMY of ACTUARIES

December 19, 2003

Trustees of the Social Security System
6401 Security Blvd.
Baltimore, MD 21235-0001

Social Security Advisory Board
400 Virginia Avenue, S.W.
Suite 625
Washington, DC 20024

Dear Trustees and Advisory Board Members:

I am writing on behalf of the American Academy of Actuaries¹ Social Insurance Committee. In October, the 2003 Technical Panel on Assumptions and Methods issued its *Report to the Social Security Advisory Board*. The Committee appreciates the high quality work the Technical Panel has performed in preparing its report. We particularly appreciate that the Advisory Board has recognized the importance of an actuarial viewpoint in evaluating the methods and assumptions the Trustees use in their annual valuations of the OASDI program by including two actuaries among the eight Panel members.

The Social Insurance Committee, however, is concerned about the Technical Panel's Recommendation M-6, regarding summary measures of the OASDI program's unfunded obligations. Before 2003, the annual Trustees Reports showed OASDI's actuarial deficit and, more recently, its unfunded obligations only on an open-group basis over the statutory 75-year valuation period. For the first time, in their *2003 Annual Report*, the Trustees included OASDI's unfunded obligations on a closed-group basis and its actuarial deficit and unfunded obligations on an open-group basis for an infinite time period. In Recommendation M-6, the Technical Panel commends these additions to the report as improvements in the presentation of the financial status of the OASDI program and, further, recommends that the infinite-horizon actuarial deficit be presented more prominently in future reports.

The Social Insurance Committee disagrees with Recommendation M-6. Rather, the Committee 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 believing that the program is in far worse financial condition than is actually indicated. Thus, we believe that including these values in the Trustees Report is unnecessary and is, on balance, a detriment to the Trustees' charge to provide a meaningful and balanced presentation of the financial status of the program.

With regard to the infinite-time-period estimates, the Committee begins its analysis by noting that the results of the 75-year statutory valuation are themselves subject to extreme uncertainty. Consider the situation of actuaries or economists in the year 1928 attempting to project demographic and economic parameters 75 years into the future - to 2003. They likely would have missed the Great Depression, World War II, the baby boom, the influx of women into the labor force, etc. Nobody, no matter how intelligent or educated, could have anticipated these very significant events.

Although methods of demographic, economic and actuarial analysis have improved greatly over the years, the sources of error in past valuations of OASDI have been unforeseen — and really unforeseeable — large-scale changes in the U.S. society and economy. We see no reason to believe that similar, unforeseeable large-scale changes will not occur in the future. Given the uncertainty of projections 75 years into the future, extending the projections into the infinite future can

¹ The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

only increase the uncertainty, rendering the results of limited value to policymakers, unless an infinite projection is used exclusively to identify an ultimate reversal of an apparent trend demonstrated in the 75-year projection.

Anomalies and incongruities inevitably arise from extending any set of long-range actuarial assumptions to infinity. In Recommendation A-6, the Panel recommends eliminating from the intermediate assumptions a modest assumed increase in future labor-force participation rates in response to increases in life expectancy. This recommendation stems from the observation — an incorrect observation, incidentally — that data show no such increase in labor-force participation rates even though life expectancy has risen steadily over the past century. Extending this analysis to infinity leads ultimately to a situation where the typical worker is expected to receive benefits for a period longer than he or she pays into the system. It is not surprising that, at the current payroll-tax rate, the OASDI program cannot sustain itself in this situation. However, it seems unreasonable to argue that workers would not extend their working years to some degree in this case based on extended years of ability to work, and the need to save more beyond Social Security benefits for the lengthened period of retirement.

Another assumption that has a major impact on Social Security's projected financial status and that presents great difficulties when making long-range projections is rates of mortality. Demographers have reached no consensus, despite years of debate, on whether the rate of mortality improvement observed in the last century is sustainable for the very long-term future. The Technical Panel sidesteps this serious problem by simply assuming that mortality rates stop declining at some point in the future, although no evidence supports such an assumption. It seems strange the Technical Panel should give such heavy weight to actual retirement patterns in its recommendation for projecting labor-force participation rates into the indefinite future, but give no weight at all to actual mortality improvement in its recommendation for projecting mortality rates. The Social Insurance Committee is not attempting to duplicate the work of the Technical Panel and make its own recommendations with respect to either of these two assumptions. We simply note that inconsistencies among interdependent assumptions are inevitable when they are taken to infinity.

We also note that the infinite-time-horizon unfunded-obligations estimate increases each year with interest even if actual future experience matches the assumptions in all respects. In contrast, the long-range actuarial balance for the infinite-future period does not change materially under those circumstances, because the unfunded obligations and the present value of future payroll tax income both increase by approximately the same interest factor. Because the estimate of unfunded obligations — \$10.5 trillion — is so huge, annual interest is itself a large number. 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 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 the estimated unfunded obligations have increased.

With regard to the closed-group figures, the panel states, "...the measure is not directly related to OASDI as it was designed or is currently run." We agree with this statement because the closed group figures are appropriate only if the intention is to substantially fund benefits in advance. Under the actual financing system, benefits of retired workers and beneficiaries are funded primarily by contributions on behalf of contemporaneous workers, and no recent proposal has been made to change this. The panel goes on to say, "Given the wide ranging debate over the future path of the system, additional measures, even a theoretical one that excludes future participants, can only serve to better inform analysts and policy makers." The Social Insurance Committee frankly does not understand this reasoning. A huge complex system like OASDI can spawn an enormous variety of measures of its financial condition. It stands to reason that measures directly related to OASDI as it was designed and currently run are more valuable than other measures. Due to the importance of this report, speculative measures should be avoided in order to focus on the status of the program that is currently in effect.

The Social Insurance Committee appreciates the opportunity to provide these comments and would be very happy to meet with the Trustees, the Advisory Board and/or their staffs to discuss these issues at greater depth. If you have any questions about our comments or would like clarification of any of the points discussed, you may contact Heather Jerbi, the Academy's pension policy analyst (202-785-7869; Jerbi@actuary.org) or me at (216) 875-9019.

Very truly yours,

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American Academy of Actuaries