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# Social Security and Medicare

## Social Security and Medicare Board of Trustees in Its 1996 Reports Find Long-Run Prospect for Both Programs Is Bleak

## Projected Financial Condition of the Trust Funds Indicates the Need for Significant Changes in Eligibility and Benefits

### Introduction

In June, the federal government presented its annual reports on the financial status of the trust funds that finance the government's two largest entitlement programs, Social Security and Medicare.[1] The reports show that both programs suffer serious long-run financial problems. Although the reports do not recommend specific remedies, a careful review of their findings leads one to conclude that only large-scale changes in the benefits they provide can ensure their long-term survivability. The magnitude of the challenges facing Medicare and Social Security has already initiated a national debate about whether their social purposes could be better accomplished through some form of private programs.

Social Security and Medicare both face a short-term problem and a long-term problem. Although the short-term problem differs dramatically between the two programs, they share the same long-term problem; the gradual aging of the workforce. This report briefly reviews the financial problems facing both programs. These problems are the result of economic and demographic factors that are unlikely to reverse themselves.

Currently the Social Security program is financed by a payroll tax with employers and employees each paying 6.2 percent of wages for a total payroll tax of 12.4 percent. Medicare is financed by a combined payroll tax of 2.9 percent. Increases in revenues can temporarily improve the status of the trust funds, but an immediate increase in the payroll tax to over 20 percent would be needed to ensure that the funds remain solvent until 2045. If the goal is to ensure their solvency through 2070, the payroll tax would have to be increased to over 22 percent. Increases of this magnitude are politically and economically infeasible.

Until the 1980s, increases in payroll taxes were used to finance improvements in Social Security and Medicare benefits even though the evidence in previous reports of the Board of Trustees indicated

[1] A series of three reports are issued annually, each dealing with a separate trust fund. The Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund pays all of the costs of Social Security and Disability Insurance. The Federal Hospital Insurance Trust Fund is financed by payroll taxes and pays for Part A of Medicare. Finally, the Federal Supplementary Medical Insurance Trust Fund is financed by beneficiary premiums and pays approximately 33 percent of Medicare Part B. The three funds share the same Board of Trustees. The current members are Robert E. Rubin, Secretary of the Treasury, Robert B. Reich, Secretary of Labor, Donna E. Shalala, Secretary of Health and Human Services, Shirley S. Chater, Commissioner of Social Security, and two independent trustees, Stephen G. Kellison and Marilyn Moon. The fact that three of the six trustees are members of the Cabinet prevents the trustees from making strong recommendations about how to fix the long-term problems they identify.

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a serious long-run solvency problem in the trust funds. In the early years of the Social Security program, the beneficiaries received much more out of the system than they contributed in taxes during their working lives. It was relatively easy for politicians to raise taxes since they could continue to promise improved benefits. As the program matured and the number of workers per beneficiary declined, the rate of return for those paying taxes became smaller. Since the rate of return from participating in the Social Security system (the amount participants receive in benefits compared to the amount they have contributed in taxes) has been declining rapidly over the past two decades, it is no longer politically feasible to increase payroll tax rates. Even if future benefits are reduced somewhat, those now below about 50 years of age are likely to receive a negative return from the program and as the Baby Boom generation retires, the working population will receive increasingly less out of the system than they have paid in taxes. Politically, it is no longer possible to raise Social Security taxes and it may be difficult to sustain the current tax rate of 15.3 percent of wages.

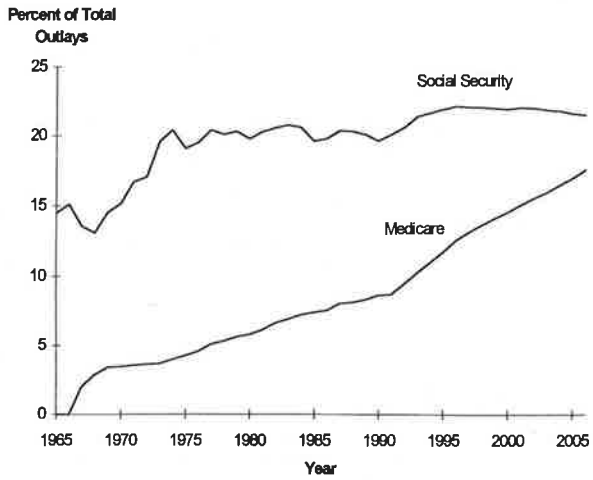
Proposals to raise the Social Security tax rate or increase the amount of wage income subject to the tax make no economic sense. Stronger economic growth and employment growth are critical goals for improving the U.S. standard of living. They are also important to any solution to the financing problem facing the Social Security system. A higher growth rate means higher employment levels and increasing wages on which Social Security taxes are based. Raising taxes produces no additional output in the economy, and if the increased tax revenue is used for consumption by the elderly, the tax increase will retard economic growth. In addition, any increase in the Social Security wage tax above the current level will simply increase the fixed cost of hiring, discourage employment growth, and increase unemployment. Raising taxes is clearly not a feasible option for solving the serious financing problem facing the Social Security system.

Ultimately, significant modifications in benefits will be necessary. The sooner these changes are made, the less severe they will have to be. The most effective changes would be: (1) reductions in the annual cost of living increases; (2) a further increase in the age at which workers qualify for coverage; and (3) the inclusion of a larger portion of Social Security benefits in taxable income. In the long-term, however, greater reliance on private markets for savings and health care may be the only solution to the retirement needs of the generations that come after the Baby Boomers.

**Social Security and Medicare in the Federal Budget**

Chart 1 shows that, as a percentage of total federal spending, outlays for Medicare have grown rapidly. Since the mid-1970s, Social Security expenditures have been about 20 percent of federal expenditures, and will become a slightly higher proportion by the end of the decade. The growing importance of these expenditures is expected to continue for the next decade. Together, the two programs currently account for over 33 percent of all federal outlays, almost 40 percent if one excludes net interest on the national debt. These percentages are expected to rise to 39 and 46 percent, respectively, by 2006.[2] The Medicare trust fund will be insolvent early in the next decade and both programs will consume an ever-increasing share of federal expenditures, making it difficult to balance the federal budget. Attempts to eliminate the federal budget deficit by cutting spending must eventually deal with this growing fraction of the budget. But the rising expenditures shown here are only the beginning of the problem. The most serious problem comes after 2010 when the first of the Baby Boomers begins to retire.

Chart 1
**Outlays for Social Security and Medicare as a Percent of Total Federal Outlays**

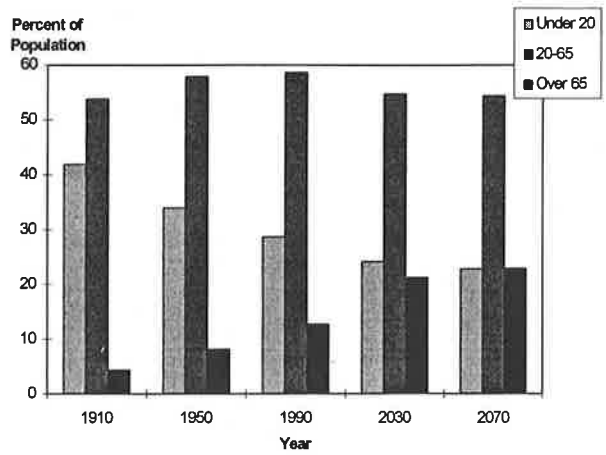



Source: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997-2006,* May 1996

[2] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1997-2006,* May 1996.

Although many factors contribute to the long-term problem facing both programs, the increasing average age of the population is by far the largest. Chart 2 shows how the age distribution of the American population has gradually increased during the past eight decades. This trend, which is expected to continue over the next eight decades, is the result of several changes. Some changes, such as increases in life-expectancy, have undoubtedly been beneficial to society as a whole. Others, such as reduced fertility rates and restrictions on immigration, have had a more neutral impact. None of the relevant population demographics is likely to change enough to significantly alter the trend shown in Chart 2.

Chart 2
**Age Distribution of the U.S. Population: 1910-2070**

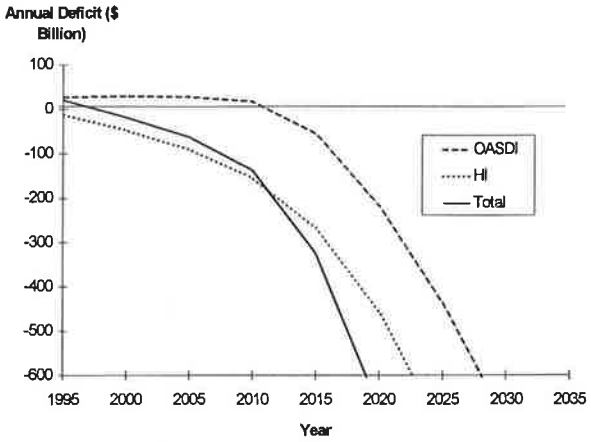



Source: Department of Commerce, Bureau of the Census, Series P-25

The most notable portion of the age distribution are the Baby Boomers, those individuals born between 1946 and 1964. The first of these individuals will reach the age of 65 in 2010 and become eligible for full Social Security and Medicare benefits. As the Baby Boomers age, a much higher proportion of the population will be over 65 years and eligible for Social Security benefits. For example, in 1990 about 13 percent of the population was over 65 and some 59 percent were age 20-65—the prime age of the workforce. By 2030, the over 65 group will represent 21 percent of the population and prime-age workers will have declined to 55 percent. As the Baby Boomers go from paying payroll taxes to collecting benefits, the finances of both Social Security and Medicare will turn highly negative. Within a few years, both programs will begin to run deficits so large that they cannot be continued without significant reductions in benefits.

Chart 3 shows the annual deficits for Social Security and Medicare Hospital Insurance under the Trustees' most likely scenario. The chart omits Part B of Medicare. Even so, the scale of these deficits, and the rate at which they are projected to grow, make it difficult for minor adjustments to do much good. Higher payroll taxes, even if they could be passed, would only temporarily postpone the problem. They would not significantly change the steep slope of the curve. Only spending reductions that have a cumulative effect over time can do that.

Chart 3
**Projected Annual Deficits for Social Security and Medicare**



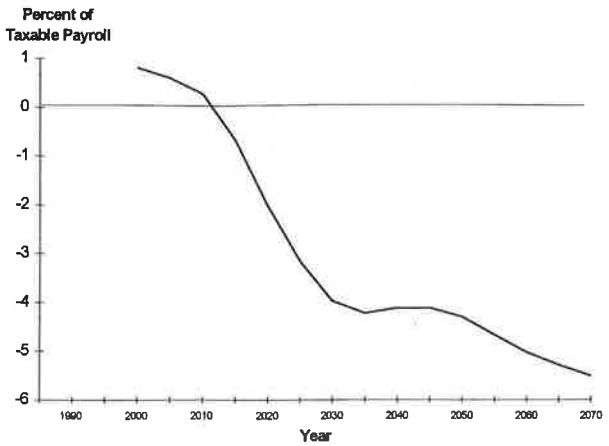

Source: 1996 Annual Report of the Board of Trustees of the Federal Old Age Survivor Insurance (OASI) and Disability Insurance (DI) Trust Funds

## Social Security

Chart 4 (on page 4) shows the Trustees' current projections of the combined Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds over the next several decades. The estimates show that the Funds will be exhausted in 2029, and that their financial position worsens quickly after that. This date should be viewed with skepticism for two reasons. The first is that the Trustees' estimates, which are widely viewed as the most accurate available, have a history of being consistently over-optimistic. Chart 5 (on page 4) shows the steady deterioration in the projected finances since Congress last overhauled Social Security in 1983. Table 1 (on page 4) shows the steady advancement of the date at which the combined Trust Fund is expected to run out of money. The consistently poor performance of the

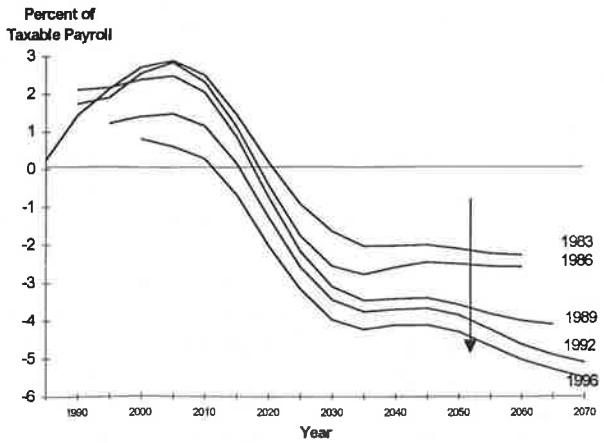
Trustees' reports in estimating the financial strength of the Trust Funds is due primarily to the selection of unreliable estimates of productivity growth which affects the growth of real wages. Unless the Trustees select productivity growth rates more in keeping with historical trends, the actual date of insolvency is likely to continue to creep forward.

Chart 4
**Estimated Balance of the OASDI Trust Funds as a Percent of Taxable Payroll**




Source: 1996 Report of the Board of Trustees for Social Security

Chart 5
**1983-1996 Forecasts of the Estimated Balance of the OASDI Trust Funds as a Percent of Taxable Payroll**




Source: Annual Reports of the Board of Trustees for Social Security

Table 1
**Expected Date of Insolvency of the OASDI Trust Fund 1983-1996**

| Date of Forecast | Date of Insolvency |
|---|---|
| 1983 | N/A |
| 1984 | N/A |
| 1985 | 2049 |
| 1986 | 2051 |
| 1987 | 2051 |
| 1988 | 2048 |
| 1989 | 2046 |
| 1990 | 2043 |
| 1991 | 2041 |
| 1992 | 2036 |
| 1993 | 2036 |
| 1994 | 2029 |
| 1995 | 2030 |
| 1996 | 2029 |

Source: Annual Reports of the Board of Trustees for Social Security

The second reason for skepticism concerns the way in which current surpluses are invested. As Chart 5 shows, Social Security is technically running surpluses, meaning that the payroll taxes dedicated to the OASDI programs are larger than the annual benefits paid out.[3] In 1995 these two programs brought in $64.4 billion more than they spent. These surpluses are expected to grow to $114 billion by 2005. Shortly after that, the amount of surplus will quickly fall until 2012 when Social Security begins running annual deficits. Theoretically, Social Security can then tap into its Trust Fund and spend both past surpluses and the interest earned on them until the Trust Fund is exhausted in 2029.

This is unlikely to happen, however. All government funds are fungible. Only political decisions dictate that the money in the Trust Fund will be used to pay Social Security benefits and nothing else. As long as Social Security taxes exceed benefits, the consensus behind this position seems

[3] The two Trust Funds are technically separate, with OASI being by far the largest. However, since the money is fungible, they are often regarded as one. Regarded separately, the DI Trust Fund is expected to be exhausted by 2015 and the OASI Trust Fund by 2031. As a result the pressure to restrict disability payments is likely to come sooner than the pressure to address retirement payments.

understandable. These surpluses lower the overall deficit and allow the government to avoid the need to sell more debt to the public, raise taxes, or cut spending elsewhere in the budget. But once the program begins running annual deficits, proponents of other federal programs are likely to insist that Social Security share the pain of any future deficit reduction efforts.

The pressure for deficit reduction is likely to be intense because the current surpluses are not being used to build up a store of tangible wealth. Instead, by law, all surpluses are invested in Treasury bonds. From one perspective this investment makes sense. U.S. government bonds are the safest investment in the world. As a result, however, they pay low rates of return. This reduces the growth of the Trust Fund.

Even if Treasury bonds offered higher rates, the Trust Fund would still have difficulty offering retirees protection against political pressure once Social Security begins running annual deficits. There is no doubt that Treasury bonds are highly marketable. However, the Trust Fund is a creature of Congress and under its political control. The Trustees are unlikely to do anything that Congress does not want them to. The Trust Fund could raise money by selling its assets to a third-party in the private sector. This would increase the amount of federal debt held by the private sector and would be recorded as an increase in the federal deficit, however. Even if Congress allowed such a sale, it could direct the Trust Fund to devote the proceeds to government programs other than Social Security. The U.S. Supreme Court long ago ruled that Social Security beneficiaries have no legal right to any payments promised to them.[4]

There is an even deeper problem with investing the Trust Funds in government securities. By investing Social Security surpluses in its own bonds, the government is failing to build up an independent store of wealth that it can tap when the Baby Boomers begin to retire. For the same reason that a person cannot save money by writing a check to himself, the government accomplishes nothing when it creates a Trust Fund composed of its own bonds. Instead of setting aside the surpluses by investing them in independent assets that it could later sell when it needed money, the government is moving the surpluses from one pocket to the other and then using them to pay for other government programs.

At present, the proceeds from current Social Security surpluses are being used to finance current spending on other programs. Since other taxes are insufficient to pay for current spending, the Congress has in effect devoted a significant portion of the payroll tax to other programs. To the extent that these programs are investments, they improve the nation's future by increasing the amount of income it can generate later. But to the extent that other programs merely finance consumption, as most do, they do nothing to enhance our ability to pay for the increased benefits we have promised to later retirees.

The usefulness of Social Security surpluses relieves the political pressure to reduce future benefits. Once these surpluses end, however, Social Security is likely to face the same type of spending restraints facing other programs now. As a result, the relevant deadline for making changes is currently 2012, when the program begins running annual deficits, not 2029, when the Trust Fund is exhausted.

**Medicare**

The problem facing Medicare is even more immediate. Unlike Social Security, Medicare as a whole is currently being financed in large part out of general revenues. The Supplemental Medical Insurance Trust Fund, funded by premiums paid by Medicare beneficiaries, only pays for 33 percent of the total cost of Part B of Medicare. The rest is made up by general revenues. This percentage is expected to fall steadily, reaching 16 percent by 2005. When Medicare was first enacted, beneficiaries were expected to pay for half of the cost of this insurance.

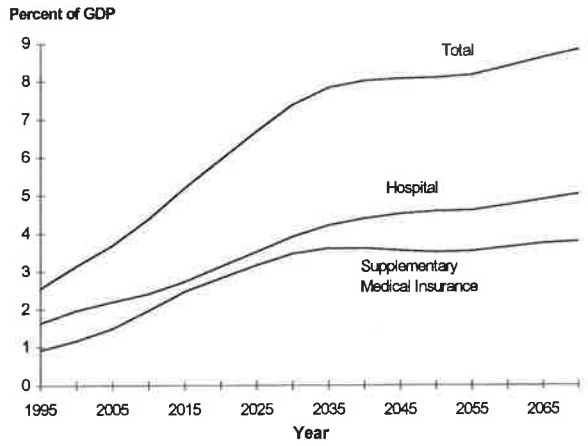
Like Social Security, the Hospital Insurance Trust Fund is financed by payroll taxes. Unlike Social Security, it is currently running a deficit. Although the Trust Fund is not exhausted, it will be by 2002 or sooner. As a result, Part A of Medicare must be pared back just to make it solvent until the Baby Boomers retire. Although there is agreement that something must be done soon, demagoguery and denial still surround the issue. The Republican budget resolution that was vetoed last fall would have slowed the growth in Medicare spending by $270 billion over seven years. These changes were criticized as too harsh by the Administration, which proposes to cut only $103 billion over that time period. Yet even the "harsh" Republican cuts would have kept the program solvent only until 2005, five years before the first Baby Boomer retires. When one remembers that the demographics facing Medicare during the next decade are extremely favorable compared to what it will face when the Baby

[4] *Fleming v. Nestor,* 363 U.S. 603, 611 (1960).

Boomers begin to retire, the current debate over spending cuts takes on the appearance of blowing out candles while the house is burning down.

The problem facing Medicare is even more serious when looked at as a whole. The Trust Fund represents only the Hospital Insurance part of Medicare. The other part, Supplementary Medical Insurance, is also forecast to grow rapidly over the next 30 years. Chart 6 shows the expected size of both Hospital Insurance and Supplementary Medical Insurance as a percent of gross domestic product (GDP). The combined program reaches 7 percent of GDP by the year 2030.

Chart 6
**Forecast Disbursements for Medicare: 1995-2070 as a Percent of Gross Domestic Product**




Source: 1996 Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund

## Conclusion

Given demographic trends, a pay-as-you-go system, in which the current generation of workers finances the benefits of retirees, is unsustainable in the long-run. Yet Social Security and Medicare currently commit the government to the current system, at least for those over the age of 65. The fact that the percentage of beneficiaries will rapidly increase at the same time as the percentage of working individuals falls, makes entitlement reform inevitable.

Most proponents of Social Security and Medicare are strongly committed to its current promise of universal coverage. They argue that future retirees, even those who can afford to pay for their own pensions and health care, were promised benefits in return for their contributions. But because these future retirees were never required to pay a sufficient amount of taxes to fund their benefits, the programs clearly cannot afford to honor all of their promises. These workers are unlikely to see any of the benefits promised to them. This problem is much more immediate for Medicare, but Social Security will eventually face the same problem.

Given that payroll taxes are already over 15 percent, it is inequitable to ask younger low- and middle-income workers to pay more into programs that will be insolvent by the time they retire. Older workers, who still may reasonably expect to receive benefits, could be asked to include Social Security benefits in their taxable income and accept some modification on the timing for receiving benefits by increasing the retirement age for benefit eligibility.

Both Social Security and Medicare have experienced great success in lowering the rate of poverty among the elderly and prolonging life expectancy. But they have not succeeded by raising the national savings rate or improving the efficiency of the delivery of health care. They have succeeded by delivering income and medical care to retirees who otherwise could not have afforded it. In order to preserve these gains, it is necessary to introduce competition into the delivery of health care for seniors and to means-test these services for upper income retirees. Continued universal coverage jeopardizes these gains by contributing to the insolvency of both programs and reducing the ability of younger workers to afford their own savings and health care plans. There are a number of ways in which means-testing could be introduced. The sooner the changes are made, the less drastic the reductions will need to be, and the greater the number of people who can continue to receive coverage.

In the future, the current Social Security system should be gradually transformed into a system which permits younger workers to save for their own retirement. The transition to a partially formalized system will take time and will gradually eliminate the unfunded liability in the current Social Security system. The transition to a new approach to retirement income for the elderly may be difficult, but the alternative of doing nothing to reform the present Social Security system can only lead to a financial disaster for retirees and workers alike.

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