SOCIAL SECURITY AND MEDICARE: A Review of the 1998 Trustees' Reports and Recent Budget Projections

Introduction

Each spring the Boards of Trustees for both Social Security and Medicare issue a report summarizing the history of each program and updating the forecast for the next 75 years. Because the preparation of these reports is supported by the Social Security Administration and the Health Care Financing Administration, respectively, the reports are generally regarded as the best available estimates of the financial health of each program.

Social Security and Medicare already represent the two largest programs in the federal budget, excluding defense and net interest on the national debt. Together they accounted for 36 percent of all federal spending in fiscal year 1997, or 7.1 percent of gross domestic product (GDP). Over the next decade these proportions are expected to rise to 44 percent of the budget and 8 percent of GDP. This growth will accelerate when the first Baby Boomers begin to retire around 2010. By 2030, Social Security and Medicaid are forecast to account for almost 11 percent of GDP and in later decades they are responsible for the federal budget shifting from moderate surpluses to spiraling deficits.

The most recent Trustees' reports were issued April 28, 1998. The reports contain mixed news for those worried about containing entitlement programs. The outlook for Social Security has improved marginally: current payroll taxes are now expected to fund benefits for a longer period of time than previous estimates, although they still fall significantly short over the longer run.

The outlook for Medicare Part A is less optimistic. In 1997 the Trustees predicted that the Hospital Insurance Trust Fund would be exhausted by 2002. Last summer's budget agreement contained changes to the program that lawmakers initially believed would delay the date of insolvency until 2010. It now appears that the date of insolvency will occur two years earlier, in 2008. Recent indications of renewed inflation in health care premiums may advance this date even closer.

1 The Trustees' report for Social Security covers both the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, both of which are funded largely by payroll taxes. Although the two trust funds are technically separate, the Congress and the Administration have occasionally shifted money from one fund to the other. The two funds will therefore be treated as one in this report.

2 The Board of Trustees for Medicare issues separate reports, Medicare Part A and B. Part A covers Hospital Insurance (HI) and pays for hospital, home health, skilled nursing facility, and hospice care. It is financed primarily through payroll taxes. Part B is the Supplementary Medical Insurance (SMI) program and pays for physician, outpatient, home health, and other services for the elderly and disabled. Monthly premiums from beneficiaries pay for approximately 25 percent of the program's cost. Taxpayers pay the other 75 percent.


6 For an earlier review of the financing of both these programs see, Social Security and Medicare, Manufacturers Alliance, LAR-375, August 23, 1996.
The outlook for Medicare Part B, which is funded primarily by general revenues, is little changed. Cost reductions in the Balanced Budget Act were largely offset by other increases, including the transfer of home health care services that had previously been included in Part A. As a result, spending in Part B is still expected to grow rapidly over the next several decades, putting increased strain on the rest of the federal budget.

**Social Security**

The medium-range outlook for Social Security has improved significantly even as the longer range forecast continues to worsen. The balance between the income and outlays of the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance (OASDI) Trust Funds over the next 25 years has improved from an expected deficit of 0.04 percent of taxable payroll to a surplus of 0.18 percent. The 75-year outlook also improved from a deficit of 2.23 percent of taxable payroll to one of 2.19 percent. All of this improvement has occurred in the immediate 25-year period, however. The outlook for the period after 2023, continues to worsen with each year.

**Sources of Long-Run Insolvency: Increasing Life Expectancy and Retirement of Baby Boomers**

Social Security faces two demographic problems. The first is the steady increase in average lifespans. In 1940 the average life expectancy for males was 61.4 years. Those workers who made it to age 65 were expected to live 11.9 more years. In 1997, life expectancy had increased to 72.9 years and a person turning 65 is predicted to live another 15.6 years. These trends are likely to continue (see Chart 1), meaning that a much greater proportion of workers will live long enough to collect retirement benefits and those workers will collect them for a longer period of time. When most workers died before their 62nd birthday, one could have argued that a retirement age of 65 was too high. Now that the average person lives much longer, many people believe it is too low and propose gradually increasing the retirement age to 70 and beyond.

In addition to the increase in average lifespans, a disproportionate number of workers are expected to retire between 2010 and 2030. Fertility rates rose dramatically immediately after World War II and remained high until the mid-1960s (see Chart 2). They then fell rapidly, rebounding only in the last decade. As a result, a large number of Baby Boomers will begin to reach retirement age in 2010. At the same time, the number of workers behind them will remain relatively constant. Right now there are approximately 4.7 workers to support each retiree. By 2035, the burden will have to be spread among only 2.7 workers even though the cost of retirement is expected to be greater than it is today.

**Critical Trust Fund Benchmarks, Emergence of Annual Deficits and Timing of Insolvency**

The finances of Social Security can be summarized in two dates. The first is the date on which Social Security will begin running annual deficits. OASDI payroll taxes currently exceed program outlays by about $30 billion. These surpluses are

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10 Changes made in 1983 already raise the normal retirement age to 67 for those born in 1938 and later years.

expected to continue for several years, improving the balance of the government's overall budget. But eventually, these surpluses end and Social Security's annual outlays begin to exceed its income. At this point the rest of the government must subsidize the program. Last year the Trustees predicted Social Security would run its first annual deficit in 2012. This date has now been pushed back one year to 2013.

Technically, these surpluses are invested in government bonds, earning interest that goes back into the Trust Fund. Thus in 1997 Social Security was credited with $41 billion in interest payments. These interest payments represent only intergovernmental transfers, however. The $41 billion thus had to come from other parts of the federal government. As long as the transfer is only on paper, nothing really changes. But as soon as Social Security's annual outlays begin to exceed its payroll taxes, interest payments will force the government to squeeze other parts of the budget. Lawmakers will have to raise taxes, cut spending, or replace paper borrowing with real borrowing which will require it to pay interest, not to itself, but to others. Either way difficult choices will have to be made.

When the Congress is forced to make difficult choices, it will almost certainly decide to reduce Social Security benefits in order to protect other vital programs. Interest is thus a less certain form of income than payroll taxes. This is important to understand because much of the improved outlook in this year's report comes in the form of higher interest payments from the Congress rather than higher payroll taxes. For instance, in 1997, the Trustees forecast a total surplus of $96 billion for 2015. This consisted of a regular deficit of $65 billion, plus $161 billion in interest payments from the Trust Fund. One year later, the expected surplus has improved to $155 billion. The regular deficit, however, has fallen to only $49 billion. Roughly three-fourths of the improvement is in the form of interest payments that the Congress must still take from other areas of the federal budget. Although higher interest payments improve the financial position of Social Security, they do so at the expense of the rest of the federal budget.

The second date of importance is the estimate of when the OASDI Trust Fund runs out of money. Even assuming that the Congress would decide to repay the Trust Fund interest and principal payments as scheduled rather than to reduce benefits, the Trust Fund would still run out of money less than half way through the Baby Boomers' retirement. After this, income from payroll and other taxes will be sufficient to pay only 75 percent of expected benefits. Last year's report estimated the date of insolvency as 2029. This year, the Trustees pushed the date back to 2032 (see Table 1). The conclusion is that Social Security is in better shape than we believed last year. As Chart 3 on page 4 shows, however, all of the improvement comes in the first few decades. The projected balances for later decades have actually worsened.

### Table 1
**Expected Date of Insolvency of the OASDI Trust Fund, 1983-1998**

<table>
<thead>
<tr>
<th>Year of Forecast</th>
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<td>1997</td>
<td>2029</td>
</tr>
<tr>
<td>1998</td>
<td>2032</td>
</tr>
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</table>

Source: *Annual Reports of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Trust Funds*
The improved short-term outlook is caused mainly by changed assumptions about the economic outlook for the next decade. The Trustees now expect much stronger growth over the next 10 years. With the exception of interest rates, all of the long-term economic assumptions remain unchanged. The path we take over the next decade before settling down into those assumptions looks much more optimistic, however. In the words of the Trustees:

This year’s report assumes lower CPI [Consumer Price Index] increases, lower unemployment rates, higher productivity increases, higher real wage gains, a larger labor force, a higher ratio of wages to total compensation and a smaller decline in average hours, generally through the first ten years of the projection period, than was assumed in last year’s report. These changes combine to produce an increase in the level of employment, productivity, average real wage, and GDP throughout the balance of the long-range projection period.12

However, these assumptions are not guaranteed. They explicitly rule out a recession anytime during the next decade. Yet, problems in Asian markets, the Year 2000 computer bug, or difficulties in integrating European currencies could all cause economic growth to slow or even stop during the next few years. The danger of a recession is moderated by the fact that the Trustees’ forecast is that real GDP will grow by only 1.9 percent to 2.0 percent each year from 1999-2007. This is well below the average of the past six years and it could be that, even with a short recession, the economy would bounce back strong enough to make up any lost ground.

The improved short-term outlook does not remove the need for long-term reform. Significant changes to Social Security are still needed for two reasons. First, over the long-run Social Security taxes are still expected to fall well short of promised benefits. Second, and just as important, reforms that give individual workers more control over their savings can increase their retirement incomes even after the transition costs are taken into account. Enacting these changes as soon as possible would give workers time to adjust their savings patterns and make the transition easier.

**Medicare**

**Hospital Insurance**

**(Part A)**

The Medicare program consists of two parts, each with its own sources of funding. Medicare Part A includes the Hospital Insurance (HI) Trust Fund and pays for hospital, home health, skilled nursing facility, and hospice care for the aged and disabled. It is funded primarily from a payroll tax of 2.9 percent on all wages.

Since 1995, the outlays, including interest, of the Hospital Insurance Trust Fund have exceeded its income. The difference has been made up by payments from other parts of the federal budget. Reflecting these deficits, the Trust Fund’s balance also has fallen in each year. Last year’s report by the program’s Board of Trustees estimated that the Trust Fund would be completely exhausted in 2001.13 The long-term deficit over the next 75 years was put at 4.32 percent of payroll, almost double that of Social Security.

The Balanced Budget Act of 1997 contained significant changes to both parts of Medicare. Between 1998 and 2002, total benefits were reduced by nearly $99 billion and premiums were raised by $13 billion.14 Over the next 10 years, these changes

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Chart 4

**Annual Deficits in the Hospital Insurance Program**


were expected to save $385 billion. Most of the benefit savings come from reductions in payments to providers in Medicare's fee-for-service sector. This and other changes should push more Medicare recipients into fixed payment plans such as health maintenance organizations. The current fee-for-service plans contribute to higher cost growth (estimated at 8.5 percent per year prior to these changes) and encourage fraud by removing the beneficiary's incentive to examine bills.

The most recent Trustees' report reflects these changes. Outlays will still exceed noninterest income, requiring annual payments of roughly $15 billion from other parts of the federal budget. However, the Trust Fund is not expected to be depleted until 2008. The long-term actuarial balance has been cut in half, to 2.1 percent of taxable payroll. Chart 4 shows that, although the HI Trust Fund will run large deficits when the Baby Boomers retire, the recent changes have dramatically reduced the size of the problem.

A significant part of the savings in Part A came from transferring coverage of home health services to Part B. Although this transfer improves the outlook for the HI Trust Fund, it worsens the problems faced by Part B. Beneficiaries will pay 25 percent of these additional costs through higher Part B premiums. Taxpayers will have to make up the difference.

In spite of these changes, total spending on Part A is expected to continue increasing as a percent of GDP (see Chart 5). The Balanced Budget Act also established a National Bipartisan Commission on the Future of Medicare to study longer term changes to the program and make recommendations to the Administration and the Congress next year. It is unclear whether this commission will be successful in overcoming the political and ideological differences that have prevented prior efforts to reform Medicare.

### Supplementary Medical Insurance (Part B)

The Supplementary Medical Insurance (SMI) Program, or Medicare Part B, covers physician, outpatient, home health, and other services for the elderly and disabled. In 1998 the program is expected to provide benefits worth over $2,100 for each senior citizen enrolled in the program. Most of the program's funding comes from taxpayers. Beneficiaries also pay monthly premiums to cover a share of the costs. When the program was originally established, beneficiaries were expected to pay for one-half of the total cost. Because beneficiaries...

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16 Ibid., p. 53.

have frequently pressured the Congress to keep premiums low, even as the cost and scope of services have risen, premiums have paid for a steadily decreasing amount of total program costs. The Balanced Budget Act of 1997 included a provision that would adjust premiums to cover eventually 25 percent of program expenditures. Taxpayers will continue to make up the difference.

Chart 6 shows that the fiscal outlook for Part B has not changed much over the past year. Total spending is still projected to increase rapidly as a percent of national income over the next 30 years. The transfer of home health care services from Medicare Part A and the expansion of benefits to cover certain preventive care practices largely offset the effect of tighter spending controls and higher premiums.

The Medicare program is affected by the same demographic trends as Social Security. The retirement of the Baby Boomers, combined with the increase in expected longevity will raise the ratio of program beneficiaries to workers, placing a larger strain on the latter. In addition, Medicare expenditures also are heavily affected by changes in the price of medical services. In the late 1980s and early 1990s spending on both Medicare and Medicaid rose rapidly in response to double-digit inflation in the cost of health benefits. Since 1992, these cost increases have been under control due partly to the movement toward health maintenance organizations. Within the last year, however, service providers have begun to demand much higher increases in premiums.

The Medicare estimates depend heavily on the Trustees' assumptions that over the next 25 years the rate of increase in the cost of health care services will fall to that of average hourly earnings and remain there. Government programs actually encourage higher inflation, however. The fact that employer-paid premiums for health care are not included in an employee's income encourages workers to consume higher levels of health care. More importantly, the structure of Medicaid gives beneficiaries every incentive to demand high levels of health care without worrying about the cost. The result is high levels of fraud and rapid increases in cost.

This need not be so. If higher costs reflect better care, that is one thing. And middle- and upper-income retirees are more likely to spend extra money on better health than on bigger houses, longer vacations, or larger legacies for their children. But to date, government policy has largely shielded medicine from the competitive pressures faced by other sectors of the economy. Over the last decade manufacturers have learned that lower cost and higher quality are only compatible over the short run. Even within the space of a few years, competition, better management practices, and new technology can allow costs to fall even as quality improves.

The government has made only a few tentative steps toward exposing medicine to these pressures. But without further efforts to place the burden of health care costs on the immediate beneficiaries it is not clear how policymakers will achieve the low rates of inflation assumed by the Trustees. Unless these changes take place, the reports almost certainly underestimate future increases in the cost of health care.

Prospects for Reform

In spite of the short-term improvement in Social Security and Medicare, the level of benefits that has been promised to future retirees is still too high. The major impact of access to more extensive benefits will not really be felt until the Baby Boomers begin to retire around 2010. When they do, Social Security and Medicare will begin to cause the federal government to run significant deficits (see Chart 7). Projected deficits of this size clearly cannot be

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dealt with merely by raising taxes. Entitlement cuts will have to be made. The major questions are whether these cuts will be made soon enough to allow for gradual changes and whether their impact will be distributed fairly across people of different ages and income levels. The sooner policymakers enact these changes, the more flexibility they will have.

The current Administration claims to support entitlement reform, provided the government maintains a large role in running retirement income and health care programs. The political consequences of its support are doubtful, however. The history of both Social Security and Medicare is that significant reform is almost always delayed until the programs are in deep trouble. Moreover, previous efforts such as the 1994 Bipartisan Commission on Entitlement and Tax Reform and the 1994-1996 Advisory Council on Social Security have accomplished little in narrowing the differences between those who want to maintain the government’s control over these programs and those who believe that fundamental changes need to be made.

The Balanced Budget Act of 1997 created yet another commission to recommend changes in Medicare. The likelihood is that this commission will be unable to form a consensus on enough changes to improve significantly Medicare’s financing. Even if a consensus were to emerge, it is not clear that the Congress would pass such legislation within the next five years.

The Administration has taken a more active approach to Social Security. It has begun a series of public events leading up to promised action at the beginning of next year. The Administration’s history on major policy initiatives has been dismal however. The pattern exhibited on previous issues including health care reform, agricultural reauthorization, financial restructuring, energy deregulation, and tobacco legislation is consistent. The Administration’s promised leadership is delayed by prolonged internal struggles about the political ramifications of different options. Eventually guidance is released, usually in the form of general policy principles rather than proposed legislation. This allows the Administration to claim credit for acting and still criticize Republicans as they make the difficult compromises needed to craft legislation that can pass both houses of the Congress. But this tactic fails to provide the leadership that is needed to produce a bipartisan compromise. As a result, on most of the issues listed above the Congress has either been unable to act or Republican leaders have had to work hard to craft legislation capable of passing both houses, with the White House grudgingly coming along at the last moment. There is no sign that the White House is willing to spend significant political capital in order to get Social Security reform next year. As a result, serious reform is extremely unlikely in the near-term.

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