

# CRS Report for Congress

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## The Financial Outlook for Social Security and Medicare

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### Summary

The 2004 annual reports of the board of trustees of the Social Security and Medicare trust funds were released on March 23, 2004. While the financial status of the Social Security program is little changed, Medicare's financial difficulties are more severe. Social Security continues to face projected long-range financing problems, with insolvency projected to occur in 2029 for the Disability Insurance (DI) part of Social Security and 2044 for the retirement and survivors part. On a combined basis, the two parts would become insolvent in 2042, the same point projected last year and 13 years later than projected in 1997. Insolvency of the Hospital Insurance (HI) part of Medicare is projected to occur in 2019, 7 years earlier than projected last year. In the long run, the financing gap for Social Security dropped slightly from 1.92% to 1.89% of taxable payroll, an amount equal to about 14% of the program's projected income. The projected long-range funding shortfall for the HI program increased from 2.4% to 3.12% of taxable payroll, an amount equal to about 92% of the program's projected income.

Social Security tax income exceeds program expenditures, however, the system is projected to begin running cash flow deficits in 2018. The HI trust fund is projected to begin running cash flow deficits in 2004, as a result of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and other factors. Total expenditures for Medicare (including the new Part D prescription drug benefit) are projected to increase rapidly as a percentage of Gross Domestic Product (GDP). In 2012, the gap between program outlays and dedicated financing sources is projected to reach 45% of outlays.

### Overview of the Outlook for Both Programs

Social Security's financial condition is assessed annually by its 6-member board of trustees, consisting of the Commissioner of Social Security, three members of the President's Cabinet, and two representatives of the public. The board's reports have projected long-range financing deficits for the system since 1984. Although the trustees' 2004 report continues to show a near-term buildup of trust fund reserves, their "best estimate" for the next 75 years shows that on average Social Security's expenditures will be 14% higher than its income. By 2080, the income shortfall would be 45%. The near-term buildup of reserves would peak at \$6.6 trillion in 2027 (compared to \$7.5 trillion in

last year's report) and then be drawn down as the post-World War II baby boomers retire. The trustees estimate that the disability fund would be exhausted in 2029 and the retirement fund in 2044. On a combined basis, the two funds would be exhausted in 2042 (unchanged from last year). At that point, tax income would be sufficient to pay only 73% of scheduled benefits; by 2078 only 68% would be payable.

Although the estimates imply that Social Security can be kept solvent for 38 years, they also show that the program's taxes would begin lagging expenditures in 2018. At that point, the program would begin relying in part on general revenues in the form of interest payments to the trust funds. By 2028, interest payments and tax revenues would no longer be sufficient to cover the program's expenditures, and the balances of the trust funds would begin to be drawn down. These reserves consist exclusively of Treasury bonds. By 2028, almost \$1 out of every \$5 of the program's outgo would be dependent upon these claims against the general fund. The government has never defaulted on the bonds it records to its trust funds, but the magnitude of future claims has prompted many observers to ask where the government will get the money to cover them.

The picture is more troublesome for Medicare as expenditures are projected to increase at a faster rate than Social Security expenditures. The HI part of the program is projected to become insolvent in 2019, 7 years earlier than reported last year. On average over the next 75 years, HI costs are projected to be 92% higher than its income. By 2080, they would be 282% higher. While Supplementary Medical Insurance (SMI) — both Part B which pays for physician services and the new Part D which provides a prescription drug benefit — does not have the same type of financing problem as HI because it relies heavily on annual general revenue payments and beneficiary premiums, its costs are rising rapidly as well. As a share of GDP, SMI expenditures are projected to increase from 1.19% in 2004 to 8.24% in 2080.

## **Background**

Social Security is the Nation's largest retirement and disability program providing cash benefits to 47 million retired and disabled workers and to their dependents and survivors. Medicare provides 41 million of them with health insurance. Today, one out of six Americans receives Social Security; one out of seven receives Medicare. In 2003, an estimated 154 million workers pay taxes to support Social Security, and an estimated 158 million pay taxes to support Medicare HI.

Workers gain eligibility for Social Security and HI by working in jobs where Social Security and HI taxes are levied. They pay a flat-rate tax of 7.65% on their earnings (6.2% for Social Security and 1.45% for HI), which is matched by their employers. The self-employed pay a tax of 15.3% (with adjustments that effectively reduce the rate). The Social Security portion is levied on earnings up to \$87,900 in 2004; the HI portion is levied on all earnings. In 2003, payroll taxes accounted for 84% of Social Security's total income and 85% of HI's total income. The remainder comes primarily from government credits, the largest of which is for interest on federal securities held by the trust funds. There is no SMI payroll tax. In 2003, 75% of SMI's total income was from general fund revenues, 24% was from premiums paid by enrollees and the rest was interest income.

The taxes and premiums people pay flow into the Treasury, with each program's share credited to separate trust funds (one for retirement and survivors benefits, another

for disability, and two others for Medicare). The government credits the money to the Social Security and Medicare trust funds by recording new interest-bearing federal securities to the appropriate fund (these securities earn interest at the average rate prevailing on outstanding federal bonds with a maturity of four years or longer). When the government makes payments, it writes some off. While these securities are represented as assets for the trust funds, they also represent liabilities for the government. Their primary role is to be reserve “spending authority.” What this means is that as long as a trust fund has a positive balance, the Treasury Department is authorized to make payments for it from the Treasury; however, the funds themselves do not contain the resources to do so.

## The Social Security Picture

For more than three decades after Social Security taxes were first levied in 1937, the system’s income routinely exceeded its outgo, and its trust funds grew. However, the situation changed in the early 1970s. Enactment of major benefit increases in the 1968 to 1972 period was followed by higher inflation and leaner economic growth than had been expected. Prices rose faster than wages, the post-World War II baby boom ended (leading to a large cut in projected birth rates), and Congress adopted faulty benefit rules in 1972 that overcompensated new Social Security retirees for inflation. These factors combined to dampen the outlook for Social Security and it remained poor through the mid-1980s. Before 1971, the balances of the trust funds had never fallen below one year’s worth of outgo. Beginning in 1973, the program’s income lagged its outgo and its trust funds declined rapidly. Congress had to step in five times to keep them from being exhausted. Although major changes enacted in 1977 greatly reduced the program’s long-run deficit, they did not eliminate it, and the short-run changes made by the legislation were not large enough to enable the program to withstand back-to-back recessions in 1980 and 1982. A disability bill in 1980 and temporary fixes in 1980 and 1981 were followed by another major reform package in 1983.

These 1983 changes, along with better economic conditions, helped to alter the picture. Income began to exceed outgo in 1983 and the trust funds grew substantially. Cumulatively, the changes were projected to yield \$96 billion in surplus income by 1990, and to raise the trust funds’ balances to \$123 billion. The funds actually were credited with \$200 billion in surplus income by 1990, and their balances reached \$225 billion by the end of that year. By the end of 2003, the trust funds’ balances had risen to more than \$1.5 trillion. This is equivalent to 306% of estimated expenditures in 2004 (or more than 3 years’ worth).

The long-range picture for Social Security has worsened considerably since 1983. By raising Social Security’s age for full benefits from 65 to 67, subjecting benefits to income taxes, and making federal and nonprofit workers join the system, Congress had attempted in 1983 to eliminate the long-run problem. In fact, projections made then showed that it had, at least on average, for the following 75 years. However, the *average* condition of the two trust funds did not represent their condition over the entire period. The funds were not shown to be insolvent at any point, but their expenditures were expected to exceed their income in 2025 and to remain higher thereafter. Simply stated, 40 years of surpluses were to be followed by an indefinite period of deficits. With each

passing year since 1983, the trustees' 75-year averaging period has picked up one deficit year at the back end and dropped a surplus year from the front end. This, by itself, would cause the average condition to worsen. In subsequent reports, however, birth rate and wage growth assumptions were lowered, and actuarial methods were revised, causing further deterioration in the outlook. A small long-range deficit appeared in the 1984 report and the gap grew larger (with the point of insolvency generally coming closer) in subsequent reports. Projections over the last seven years, however, have shown small improvements, in part due to favorable near-term economic conditions reported in recent years. The 2004 report shows a projected average 75-year deficit equal to 14% of the system's income and that the trust funds would be insolvent in 2042 (same as last year). As a percent of the Nation's payrolls, income would average 13.84%, outgo would average 15.73%, and the deficit would be 1.89% (compared to 1.92% last year). Expressed in dollar terms, the projected long-range actuarial deficit would be \$3.7 trillion (present value basis). This average deficit is slightly less than the deficit tackled by Congress in 1983. An examination of the back end of the projection period, however, shows chronic revenue shortfalls. By 2080, the annual deficit is projected to equal 45% of the system's income.

These long-range projections assume that GDP (adjusted for inflation) will rise annually at rates ranging from 4.4% in 2004 to 1.8% in 2080, wages would rise at an ultimate rate of 3.9% per year, the cost of living would go up at a rate of 2.8%, unemployment would average 5.5%, and that Social Security retirement benefits would fall in relative terms as the age at which unreduced benefits are payable increases from 65 to 67 over the 2000 to 2022 period. These assumptions seem to bode well for the system, however, looming demographic shifts are projected to overtake them. As the baby boomers begin to retire around 2010, the number of beneficiaries relative to the number of covered workers is projected to increase rapidly. By 2025, the number of people age 65 and older is projected to increase from 35.4 million in 2000 to 62.3 million, a 76% increase. In contrast, the number of Social Security-covered workers is projected to increase from 153.7 million to 179.5 million, a 17% increase. As a result, the number of covered workers per beneficiary is projected to decline from 3.3 today to 2.3 in 2025. By 2080, there would be 1.9 workers per beneficiary. These trends are reflected also in projections based on an "infinite horizon" (i.e., beyond the traditional 75-year projection period) that show the system's unfunded obligations would total \$10.4 trillion (present value basis), an amount equal to 3.5% of future taxable payroll.

Under the 2004 forecast, the trust funds (on a combined basis) would be credited with surplus income through 2027 bringing their balances to \$6.6 trillion. Balances would decline starting in 2028, and the trust funds would be depleted by 2042. Tax receipts, however, begin lagging outgo much sooner. Starting in 2018, the program would have to rely on interest credited to the trust funds for part of its income. This interest income would have to be drawn from the General Fund of the Treasury. In 2028, the reserve balance of the trust funds would begin to be drawn down, and almost \$1 out of every \$5 of the program's outgo would be dependent upon general revenues. The government has never defaulted on the securities it posts to federal trust funds, but the magnitude of these potential claims has prompted many observers to ask where the government will find the money to cover them. In the absence of budget surpluses,

policymakers would have three options: raise taxes, curtail spending, or borrow money from the financial markets.

Economists argue that if the surplus taxes projected for the next 14 years were to cause the government to reduce the federal debt held by the public, more money would be available in the financial markets for investment, which could lead to greater economic growth. If this occurred, extracting resources from the economy in the future to honor Social Security claims would not necessarily be so burdensome. Said another way, if one accepts the premise that reductions in the federal debt held by the public today will increase the resources available for investment, then surplus Social Security taxes today could help build a higher economic base from which to draw the needed resources.

However, rolling surplus Social Security taxes into Treasury bonds will not by itself reduce government borrowing from the markets. Reductions in the debt occur when the government runs an overall or unified budget surplus, not when one of its programs generates surplus taxes. Also, if economic growth were enhanced in the coming decades by reductions in government debt, Social Security's problems would not necessarily be resolved. Its costs would grow as the economy grows (since economic growth would likely result in higher wages, which in turn would lead to larger benefit claims). Further, as their numbers increase, the baby boomers and subsequent retirees will raise financial demands on all retirement systems, not only Social Security. The goods and services to be consumed by society cannot be stockpiled in advance, and the economy will have to adjust. The question is whether the adjustment would be mild or severe.

## **The Medicare Picture**

The trustees present a much worsened picture for Medicare in both the short and the longer term. In recent reports, Medicare's financial outlook had improved as a result of major constraints in Medicare payment rates enacted as part of the Balanced Budget Act of 1997 (P.L. 105-33) and improved economic conditions. In the 2003 report, the program was projected to be solvent through 2026, compared to 2001 projected in 1997. The 75-year actuarial deficit was estimated at 2.4% of taxable payroll, compared to 4.32% in 1997. In 2004, the HI trust fund is projected to be insolvent in 2019 and the long-range shortfall is projected to be 3.12% of taxable payroll. As a share of the Nation's payrolls, HI costs are projected to increase from 3.12% in 2004 to 13.4% in 2080. On average, over the next 75 years, HI income is projected to be 3.39% of taxable payroll and HI costs are projected to be 6.51%, for an average funding shortfall equal to 3.12% of taxable payroll. The average gap between HI's projected income and outgo is equal to 92% of program income, compared to a projected gap of 14% for Social Security. The decline in HI's financial outlook is attributed to several factors, including higher projected expenditures for inpatient hospital care; increased expenditures as a result of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA); and lower projected payroll tax income. In addition, the HI outlook reflects persistent high inflation rates in the health sector of the economy, growth in the quantity of services provided and the aging of the population.

Within SMI, Part B pays for physicians' services and other outpatient expenses. A separate account in Part B will pay for the new Part D (enacted under MMA) which pays

for prescription drug coverage. Both Parts B and D are financed with general revenues and beneficiary premiums that are reset annually based on projected program costs. Because SMI is not financed by a fixed rate of payroll taxes, it does not have the same type of financing problem as HI. Projections show, however, that SMI expenditures are projected to increase faster than HI expenditures, from 1.19% of GDP in 2004 to 8.24% in 2080 (HI expenditures would increase from 1.5% to 5.61% of GDP over the period). As a result, the proportion of Medicare costs financed from general revenues is projected to increase from 0.9% of GDP in 2004 to 6.2% in 2078. In addition, premiums and coinsurance amounts paid by SMI beneficiaries are projected to represent, on average, a growing share of beneficiaries' total income (over the projection period, beneficiary premiums are projected to increase from 0.3% to 1.9% of GDP).

## **The Combined Scenario**

Although the trustees' 2004 projections show that Social Security overall will generate sufficient taxes to cover its commitments for the next 14 years, and that the trust funds will have a positive balance until 2042, the long-range outlook is not sanguine. HI's problems are more imminent, with cash flow deficits projected to begin in 2004 and insolvency projected for 2019. Current projections show that total Medicare expenditures will exceed Social Security expenditures in 2024 and increase to a level two times that for Social Security by 2078. Resources could be reallocated from Social Security to HI, however, this would only move Social Security's problems closer. If Social Security and HI are considered together, projected outgo as a percent of the Nation's payrolls would increase from 14.18% in 2004 to 22.43% in 2030 and 32.78% in 2080, levels that contrast sharply with a combined payroll tax rate set by law at 15.3%. As a percent of GDP, projected outgo for Social Security and HI combined would increase from 5.83% in 2004 to 8.94% in 2030 and 12.39% in 2080. In 2003, the combined cost of Social Security and Medicare (HI and SMI) represented about 7% of GDP and two-fifths of federal revenues. The combined cost of these two programs is projected to reach 15% of GDP by 2040 and 20% of GDP by 2078 (by the end of the projection period, total Medicare costs would be 13.8% of GDP while projected tax income would be around 1.4% of GDP). Under current projections, combined program costs would exceed historical levels of total federal revenues relative to GDP (19%) by the end of the period.

Although these projections are based in part on economic assumptions, they are driven by demographic factors — the post-World War II baby boom, the subsequent birth dearth, and the general aging of society. They imply that increases in program income, reductions in spending, or some combination of the two, are required to restore long-range solvency. Beyond possible changes to the programs, important unknowns that can alter the outlook include whether an effective means can be found to control the spiraling cost of medical care and whether future technological advances will propel productivity. Also unknown and little understood is the effect of potential shifts in society's wants and needs: from raising families, buying houses, and educating children to meeting the health and service demands of an older population. Will higher future costs of Social Security and Medicare place large strains on the economy or merely reflect a shift of the Nation's consumption priorities?