

# CRS Report for Congress

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## The Financial Outlook for Social Security and Medicare

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### Summary

The 1998 annual reports of the board of trustees of the Social Security and Medicare trust funds were released on April 28, 1998. Both programs are shown to have long-range financing problems. Insolvency for the Disability Insurance (DI) part of Social Security is projected to occur in 2019, and for the retirement and survivors part, in 2034. On a combined basis, the two parts of Social Security would become insolvent in 2032, three year later than projected in last year's trustees' report. Insolvency of the Hospital Insurance (HI) part of Medicare is projected to occur in 2008, 7 years later than projected last year. Both the Social Security and Medicare programs have benefitted from an improved economic outlook in the near term. However, more pronounced for Medicare is a reduction in the long-range HI deficit attributed to constraints in reimbursement of Medicare providers as well as other changes enacted last summer as part of the Balanced Budget Act of 1997 (P.L. 105-33). The trustees project that these recent changes will cut the average (75-year) HI deficit in half.

The combined expenditures of Social Security and Medicare are now higher than the taxes and premiums collected to support them, and even with this recent improvement in the two programs' condition, their expenditures are projected to remain higher than their receipts indefinitely. While their income is projected to hover around 7% of the gross domestic product (GDP) well into the future, their cost would rise from 7% today to 12% in 2025.

### Overview of the Outlook for Both Programs

Social Security's financial condition is assessed annually by its 6-member board of trustees, comprised of the Commissioner of Social Security, three members of the President's Cabinet, and two representatives of the public. For a number of years, the board's reports have projected long-range financing problems for the cash benefit system. Although the trustee's 1998 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 16% more than its income. The buildup would peak at

\$3.8 trillion in 2020, 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 2019 and the retirement fund in 2034. On a combined basis the two trust funds would be exhausted in 2032.

<b>Projected Points of Insolvency</b>	
<i><b>Social Security—</b></i>	
Disability . . . . .	2019
Retirement & survivors . . . . .	2034
Disability & retirement combined	2032
<i><b>Medicare—</b></i>	
Hospital insurance . . . . .	2008

Although these estimates imply that Social Security can be kept solvent for 34 years, the trustees project that the program’s taxes would begin lagging its expenditures in 2013. At that point, the program would begin relying in part on general revenues in the form of interest payments to the trust funds. By 2021, interest payments would no longer be sufficient to supplement the revenues, and the balances of the trust funds would begin to be drawn down. These reserves consists exclusively of treasury bonds. By 2025, \$1 out of every \$5 of the program’s outgo would be dependent upon these claims against the general fund. Expressed as an equivalent portion of today’s annual expenditures, these claims would amount to \$85 billion. The government has never defaulted on the bonds it records to its trust funds, but the magnitude of these future claims has prompted many observers to ask where the government will get the money to cover them.

The trustees present a more troublesome picture for Medicare. The HI part of the program is projected to become insolvent in 2008, and on average over the next 75-years, its costs would be about 65% higher than its income. While Supplementary Medical Insurance (SMI), the part of Medicare that pays for physician care, is smaller and does not have HI’s financing problems (it relies heavily on annual general revenue payments, not a fixed tax rate), inflation and the rising demand for medical care as society ages are causing its costs to rise rapidly. By 2015 SMI’s costs as a percent of GDP will more than double and at that point SMI will be larger than HI.

**Background**

Social Security is the Nation’s largest retirement and disability program. It provides cash benefits to 44 million retired and disabled workers and to their dependents and survivors. Medicare provides 38 million of them with health insurance. Social Security accounted for an estimated 42% of the income of the elderly (in 1994), and Medicare provided more than 95% of the elderly with basic health insurance coverage. Today, one out of six Americans receives Social Security and one out of seven receives Medicare. The 151.9 million workers whose taxes will support the two programs in 1998 represent one out of two persons in the population (148.5 million will pay both Social Security and Medicare taxes; 3.4 million will pay the Medicare, or HI, part only).

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 \$68,400 in 1998; the HI portion is levied on all earnings. About 78% of these taxes go toward Social Security; the rest goes toward HI. In 1997, payroll taxes comprise 89% of Social Security’s income and 88% of HI’s. The rest comes mostly from government credits, the largest of which is for interest

on federal securities held by their trust funds. There is no SMI tax; 76% of its estimated 1997 income came from general revenues of the government and 24% from premiums paid by enrollees (\$43.80 per month in 1998).

The taxes and premiums people pay flow into the federal 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).. When the government receives the money, it records new interest-bearing federal securities to the appropriate fund (these securities earn interest at the same as the average rate prevailing on outstanding federal bonds with a maturity of 4 years or longer); when it makes payments, it writes some off. These securities represent obligations that the government has issued to itself. In effect, they are not assets for the government, but claims against it. 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; the fund itself does 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 1968-1972 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 precipitously (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 sour 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 1 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. Under the trustees' 1998 "intermediate" forecast (the one cited as their "best estimate"), surplus income of \$753 billion is projected for the 1991-2000 period, and the trust funds' balances would rise to \$978 billion by the beginning of 2001. This would be equivalent to 226% of annual expenditures (or 2 1/4 years' worth).

Generally, the long-range picture for Social Security (viewing the retirement and disability parts of the program as if they were one) has been worsening gradually since 1983. (This year's report shows some minor improvement over the 1997 report largely

because of improvement in near-term economic conditions.) 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 1 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. However, in subsequent reports assumptions about birth rates, economic growth, and wages have been lowered, causing further deterioration in the outlook. A small long-range deficit appeared in the 1984 report and the gap has grown larger (with the point of insolvency generally coming closer) in subsequent reports. The 1998 report showed an average 75-year deficit equal to 16% of the program's income and projects that the trust funds on a combined basis would become insolvent in 2032 (it was 2029 in the 1997 report). As a percent of the Nation's payrolls, their income would average 13.45%, their outgo, 15.64%, and the deficit would be 2.19% (2.23% in the 1997 report.)

These long-range projections assume that GDP (adjusted for inflation) will rise annually at rates ranging from 2.5% in 1998 to 1.3% in 2050, wages would rise at an ultimate rate of 4.4% per year, the cost of living would go up at a 3.5% rate, unemployment would average 6%, and that Social Security benefits would fall in relative terms as the age at which full benefits are payable rises from 65 to 67 over the 2000-2022 period. The higher age for full benefits will mean that people retiring at age 67 or younger will get less than under the previous rules. These assumptions by themselves would seem to bode well for the system; however, looming demographic shifts are projected to overwhelm them. During the next two decades, the baby boomers will be in their prime productive years, and the baby-trough generation of the 1930s will be in retirement. Together these factors will lead to a stable ratio of workers to recipients. However, as the baby boomers begin retiring around 2010, this ratio will erode quickly. By 2025, most of the surviving baby boomers will be 65 and older. The number of people 65 and older will have risen by 75%, growing from 35 million today to 61 million then. The number of workers will have grown from 148 million to 166 million, or by only 12%. Consequently, the ratio of workers to recipients will have fallen from 3.4 to 1 today to 2.2 to 1 in 2025 and 2 to 1 in 2030.

Under this forecast, the trust funds (on a combined basis) would be credited with surplus income until 2020, bringing their balances to a level of \$3.8 trillion. They would decline thereafter and would be depleted by 2032. However, tax receipts begin lagging outgo much sooner, in 2013. At that point, the program would have to rely on the interest credited to its trust funds for part of its income, which would have to be funded from general revenue. In 2021, the reserve balance of the trust funds would begin to be drawn down. By 2025, \$1 out of every \$5 of the program's outgo would be dependent upon general fund expenditures for interest payments and the redemption of the government bonds in the trust funds. The government has never defaulted on the securities it posts

to its 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. Basically, the government will have three options: raise other taxes, curtail other spending, or borrow money from the financial markets. There is nothing in the law that will dictate or determine what it actually will (or can) do then.

Economists argue that if the surplus taxes projected for the next 15 years were to cause the government to borrow less from financial markets, more money would be available for investment, which could lead to greater economic growth. If this happened, 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 federal borrowing today will increase the amount of resources available for investment, then surplus Social Security taxes today could help build a higher economic base in the future 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 borrowing occur when the government reduces its overall deficit, not when one of its programs generates surplus taxes. But even if economic growth were enhanced in the coming decades by less government borrowing, 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 swell, 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. Whether this adjustment would be mild or severe is mostly conjecture.

## **The Medicare Picture**

The trustees presented a more troublesome picture for Medicare. Although major constraints in Medicare payment rates were enacted last summer as part of the Balanced Budget Act of 1997 (P.L. 105-33), HI's rapid growth is projected to continue indefinitely. The changes extended the HI trust funds' projected insolvency point by 7 years, from 2001 to 2008, and cut the average 75-year deficit in half; however, the remaining deficit is large. On average, HI's costs would be about 65% higher than its income. By 2072, its costs would be 2 1/4 times as large as its income. This pessimistic outlook reflects a generally aging population, the impact of the post-World War II baby boomers' retirement early in the next century, the persistent high rate of inflation in the health sector of the economy, and growth in the quantity of services provided. Most significant are the looming demographic shifts. Where there were 3.9 workers per HI beneficiary in 1997, there will be an estimated 2.3 workers per beneficiary in 2030.

Shown as a percent of the Nation's payrolls, HI's costs would rise from 3.4% today to 5.93% in 2030 and 7.79% in 2070. On average for the 75-year period, HI income would be 3.26% of payroll, HI outgo would be 5.37%, and the deficit would be 2.10%. To put this figure in context, the long-range HI deficit is now about the same size as that of Social Security, but in terms of the size of each program, the HI problem is larger. The average gap between HI's income and outgo is equal 39% of the program's cost in

contrast to a gap of 14% for Social Security. Looked at in a historical context, the deficit for each of these programs is about the same as the Social Security deficit that Congress tackled in 1983.

Since SMI is financed with general revenues and premiums that are determined and reset annually, it does not have an explicit financing problem like HI. However, inflation and the rising demand for medical care as society ages are causing its expenditures to rise even faster than HI's. The trustees projected that its expenditures would grow from .97% of GDP in 1998 to 2.14% in 2015. At that point SMI would be larger than HI. Over the 1998 to 2070 period, the combined costs of HI and SMI are projected to rise from 2.65% of GDP to 6.71%.

### **The Combined Scenario**

The trustees' 1998 projections provide some basis to think that Social Security overall will generate sufficient taxes to cover its commitments for the next 15 years. The long-range outlook, however, leaves little to be sanguine about; the program faces a sizeable 75-year funding gap. HI's problems are more imminent, as insolvency is projected for 2008. Resources could be reallocated to HI from Social Security; however, this would only move Social Security's problems closer. If Social Security and HI are considered together, their outgo as a percent of the Nation's payrolls would rise from 14.6% today to 22% in 2025, a level that contrasts sharply with a combined tax rate that is set now in the law at 15.3%. As a percent of GDP Social Security's and HI's outgo would rise from about 6.25% today to 9% in 2025; including SMI would raise it from 7% to 12%. In contrast, the taxes and premiums collected to support them are projected to hover in the 7% range throughout the period.

These projections are *not* based on pessimistic economic assumptions. A modest but sustained rise in GDP and moderate inflation and unemployment are assumed. Moreover, they hinge in large part on demographic factors that are in place today — the post-World War II baby boom, the subsequent birth dearth, and the general aging of society. They suggest that to restore long-run solvency, income needs to be raised, expenditures cut, or some combination thereof. Beyond possible changes to the programs themselves, important unknowns that can alter the outlook include: whether an effective means can be found to rein in the spiraling cost of medical care generally 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 the higher future costs of Social Security and Medicare place a large strain on the economy or merely reflect a shift of the Nation's consumption priorities?