

# CRS Report for Congress

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## The Financial Outlook for Social Security and Medicare

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### SUMMARY

Social security's financial condition is assessed annually by its board of trustees, comprised of three members of the President's Cabinet and two representatives of the public. Although their 1993 report raises concerns that the disability part of social security may soon have financial problems, the trustees estimate that *overall* the program's income will exceed its costs until 2025, and that the combined balance of the retirement and disability trust funds by then will have grown to \$5 trillion. However, they project that as the post-World War II baby boomers retire in 2010-20 benefit costs will grow rapidly and the number of taxpayers will not keep pace. As a result, they project that the trust funds' reserves will begin to fall in 2025 and will be exhausted in 2036. At that point the system would be technically insolvent.

Moreover, although the trustees estimate that it would be 43 years before insolvency occurred, they project that social security taxes collected from the public would begin lagging outgo much sooner, in 2015. At that point, the program would have to rely on treasury bonds credited to its trust funds for part of its income, and the Government would have to make good on them. By 2025, \$1 out of every \$6 of the program's outgo would be dependent upon their redemption, an amount equal today to \$55 billion per year. The Government has never defaulted on trust fund bonds, 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 for the medicare program (who dually serve as social security trustees) present a more troublesome picture. The Hospital Insurance (HI) part of medicare is projected to become insolvent in 1999 and to have an average 75-year deficit equal to 64 percent of its costs. This means that its income would have to be increased by 175 percent or, alternatively, its payments cut by 64 percent to restore solvency. While long-range projections are not made for the Supplementary Medical Insurance (SMI) part of medicare (the part that pays for physician services), it will be influenced by many of the same factors affecting HI--e.g., inflation and the rising need for medical care by an aging society. If HI and SMI continue to grow at their current rates, SMI would pay out more than HI in 10 to 12 years, and together the two parts of medicare would cost more than social security sometime between 2010 and 2015.

Considered together, tax receipts of social security and HI are projected to fall below their expenditures in 1995 and to remain lower thereafter. Their costs as a percent of the Nation's payrolls (from which they draw their taxes) would rise from 15 percent today to 24 percent in 2025. SMI's costs--perhaps exceeding HI's at that point--would add to the strain. All told, social security's and medicare's costs as a share of the gross domestic product (GDP) would nearly double, rising from 7 percent today to around 13 or 14 percent in 2025.



## **BACKGROUND**

Social security is the Nation's largest retirement and disability program. It provides cash benefits to 42 million retired and disabled workers and to their dependents and survivors. Medicare provides 35 million of them with health insurance. Social security accounted for an estimated 36 percent of the income of the elderly (as of 1991), and medicare paid for 45 percent of their medical bills (as of 1987). Today, one out of six Americans receives social security and one out of seven receives medicare. The 138 million workers whose taxes support the two programs represent one out of two persons in the population (135 million pay both social security and medicare taxes; 3 million 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 percent on their earnings (6.2 percent for social security and 1.45 percent for HI), which is matched by their employers. The self-employed pay a tax of 15.3 percent (with adjustments that effectively reduce the rate). The social security portion is levied on earnings up to \$57,600 in 1993; the HI portion is levied on the first \$135,000. About \$4 out of every \$5 of these taxes go toward social security; the other \$1 goes toward HI. Taxes comprise 92 percent of social security's income and 86 percent of HI's income. 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; 75 percent of its income comes from general revenues of the Government and 25 percent from premiums paid by enrollees (\$36.60 per month in 1993).

The taxes and premiums people pay flow into the Federal treasury, with each program's share credited to separate trust funds (one for retirement, another for disability, and two others for medicare). The crediting occurs through the posting of interest-bearing Federal securities to them (the interest rate is the same as the average rate prevailing on outstanding Federal bonds with a maturity of 4 years or longer). When the Government receives the money, it records new securities to the appropriate fund; when it makes payments, it writes some off. Since these are Federal securities, they 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." As long as a trust fund has a 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.

## **RECENT SOCIAL SECURITY PROJECTIONS**

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 1968-72 period was followed by higher inflation and leaner economic conditions 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. However, 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 didn't 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. Actually, the funds 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' 1993 "intermediate" forecast (the one cited most often among three contained in their report), surplus income of \$729 billion is projected for the 1992-2001 period, and the trust funds' balances would rise to \$1.1 trillion by the beginning of 2001. This would be equivalent to 190 percent of annual expenditures (or nearly 2 years' worth).

However, although the short-run situation for the program overall is favorable, higher than expected disability enrollments and fewer terminations have soured the outlook for the Disability Insurance (DI) part. The favorable combined outlook comes from the retirement portion of the program, which is projected to be solvent until 2044. Without corrective action--raising DI taxes or curtailing DI expenditures or reallocating part of the taxes that go to the retirement program to DI--the DI trust fund could become insolvent in 2 years (i.e., in 1995).

In the long run, the picture for both parts of the program has been worsening gradually. 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 funds did not represent their condition over the entire period. The funds were not shown to be insolvent at any point, but the program's cost was expected to begin exceeding its 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. However, in recent 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 coming closer) in subsequent reports. The 1993 report shows an average 75-year deficit equal to 10 percent of program costs and projects that the trust funds will become insolvent in 2036.

These long-range projections assume that GDP will rise annually at rates ranging from 1.4 to 2.3 percent, wages will rise at a 5.1-percent rate, and the cost of living will go up at a 4-percent rate; that unemployment will be 6 percent; and that social security benefits will fall in relative terms as the age at which full benefits are payable rises from 65 to 67 over the 2000-22 period. The higher age for full benefits will mean that people retiring at age 67 or younger will get less than under the previous age 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 erodes quickly. By 2025, all the surviving baby boomers will be 65 and older. The number of people 65 and older will have nearly doubled, growing from 33 million today to 61 million then. The number of workers will have grown from 135

million to 162 million, or by only 20 percent. Consequently, the ratio of workers to recipients will have fallen from 3.2 to 1 today to 2.2 to 1 in 2025 and 2 to 1 in 2035.

Under the forecast, the trust funds would be credited with surplus income until 2025, bringing their balances to a level of \$5 trillion. They would decline thereafter and would be depleted by 2036. However, tax receipts begin lagging outgo much sooner, in 2015. At that point, the program would have to rely on treasury bonds credited to its trust funds for part of its income, and the Government would have to make good on them. By 2025, \$1 out of every \$6 of the program's outgo would be dependent upon their redemption. 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 given the large deficits it is running today. 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 today that will dictate or determine what it actually will (or can) do then.

Economists argue that if the surplus taxes projected for the next 22 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 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 resources to pay social security benefits.

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**

Medicare presents a more troublesome picture. The current prognosis is that the HI fund will become insolvent in 1999, just 6 years way. Although major changes have been made in the way HI pays for hospital services, HI's rapid growth is projected to continue indefinitely. This pessimistic outlook reflects the persistent high rate of inflation in the health sector of the economy, growth in the quantity of services provided, an aging population, and the potential impact of the post-World War II baby boomers' retirement early in the next century. Most significant is the assumed rate of increase in inpatient hospital payments. About 87 percent of HI benefits are for hospital services. For more than 20 years, hospital costs have grown faster than inflation. Even in the relatively subdued inflationary period from 1983 to 1990, HI's hospital payments rose by 57 percent, while the Consumer Price Index (CPI) rose by 30 percent. Increases in enrollment of 2 percent a year and heavier use of services by an aging

society contributed to the growth. However, the dominant factors were rising operating costs for hospitals and a shift toward more expensive services.

Under the long-range intermediate forecast in the 1993 trustees' report, hospital wages and other costs would rise at rates ranging from 4.9 to 5.2 percent annually. In contrast, the CPI would grow by 4 percent. In essence, HI's unit costs would rise faster than inflation. Shown as a percent of the Nation's payrolls, HI's costs would rise from 3.21 percent today to 12.43 percent in 2067. On average for the 75-year period, HI income would be 2.9 percent of payroll, HI outgo would be 8 percent, and the deficit would be 5.11 percent (i.e., 64 percent of the program's cost). Said another way, income available to HI would have to be increased by 175 percent or, alternatively, HI's payments cut by 64 percent, for the deficit to be eliminated. Looked at in a historical context, this deficit is 2½ times the size of the social security deficit that Congress tackled in 1983.

Since SMI is financed with premiums and general revenues that are adjusted annually, it does not have an explicit financing problem like HI. However, its costs have been rising even faster than HI's and are projected to grow from .85 percent of GDP in 1992 to 1.72 percent of GDP in 2002. While the trustees have not made projections beyond that point, SMI will likely be influenced by many of the same factors affecting HI--e.g., inflation and the rising need for medical care by an aging society. If SMI and HI were to continue to grow at their current rates, SMI's costs would exceed HI's in 10 to 12 years, and together their costs would overtake those of social security sometime between 2010 and 2015.

#### **THE COMBINED SCENARIO**

Assuming action is taken soon to correct the DI situation, the current projections provide some basis to think that the program overall will generate sufficient tax receipts to cover its commitments during the next two decades. The long-range outlook, however, leaves little to be sanguine about. The program has a growing 75-year average deficit and the point of insolvency moves closer with each new trustees' report. HI's problems are more imminent, as insolvency is projected for 1999. 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 projected tax receipts fall below their outgo in 1995 and remain lower thereafter. Their outgo as a percent of the Nation's payrolls rises from 15 percent today to 24 percent in 2025, a level that contrasts sharply with a combined tax rate that is set now in the law at 15.3 percent. As a percent of GDP their outgo would rise from 6 percent today to 10 percent in 2025; including SMI would raise it from 7 percent to 13 or 14 percent.

These projections are *not* based on pessimistic economic expectations. A modest but sustained rise in GDP and moderate inflation and unemployment are assumed. In large part, the projections hinge 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 or expenditures cut. 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?

**FOR ADDITIONAL READING**

- U.S. Library of Congress. Congressional Research Service. *The social security surplus: a discussion of some of the issues*. CRS Report for Congress No. 88-709 EPW, by David Koitz. Washington, 1988. 48 p. (For shorter discussion, see *Social security tax debate: a fact sheet*. CRS Report for Congress No. 92-894 EPW, by David Koitz and Geoffrey Kollmann. Washington, 1992. 2 p.)
- *Medicare financing*. CRS Report for Congress No. 91-517 EPW, by David Koitz. Washington, 1991. 86 p. (For shorter discussion, see *The financial outlook for medicare*. CRS Report for Congress No. 93-606 EPW, by David Koitz. Washington, 1993. 6 p.)
- U.S. Congress. House. 1993 Annual Reports of the Trustees of the Old-Age, Survivors and Disability Insurance, Hospital Insurance, and Supplementary Medical Insurance Trust Funds. 103d Cong., 1st Sess.: House documents 103-63, 103-64, and 103-65. Washington, U.S. Govt. Print. Off., 1993.