WebMemo
Published by The Heritage Foundation

No. 1867
March 25, 2008

Medicare and Social Security: The Challenge of Giant Entitlement Costs

David C. John and Robert E. Moffit, Ph.D.

Social Security and Medicare have promised $42.9 trillion more in benefits to senior and disabled workers than they will be able to pay, according to a new report. The 2008 annual report of the trustees of the Social Security and Medicare trust funds concludes that both programs will require progressively larger transfers from general revenues to maintain projected levels of spending. The burden from Social Security and Medicare will fall directly on younger generations, and this report affirms the need for Congress to begin a serious overhaul of both of these vital programs.

Medicare Funding Warning. Congressional inaction on entitlements imposes huge costs on current and future taxpayers. Under the Medicare Modernization Act of 2003 (PL 108-173), Medicare's trustees are required to issue a "funding warning" if, two years in a row, they determine that general tax revenues would be required to cover more than 45 percent of Medicare's total costs within a seven-year period.

The "funding warning" was issued last year and required the President to propose remedial legislation to bring the funding back into balance. The President's legislation (H.R. 5480), which proposes medical malpractice reforms and higher premiums for drug coverage among upper-income seniors, is not expected to receive serious consideration by Congress.[1]

The 2008 Trustees Report issues the "Medicare funding warning" once again: "The difference between Medicare's total outlays and its 'dedicated financing sources' is estimated to reach 45 percent of outlays in fiscal year 2014, the seventh year of the projection."[2] This is the third such consecutive finding. Congress has no legitimate excuse for refusing to act.

Medicare's Financial Crisis. Of the two programs, Medicare presents the greater challenge to Congress and taxpayers. The first wave of the 77-million-strong baby boomer generation will start to retire under Medicare in 2011, stimulating a higher utilization of new and more expensive medical technologies. There is no substantive improvement in the outlook for the Hospital Insurance Trust Fund, which is still projected to be exhausted by 2019. The rapidly rising cost of the Supplemental Medical Insurance (SMI) program, which is mostly funded through general revenues, is the source of the largest portion of Medicare's unfunded obligations.

According to the Trustees, "Within the next 5 years, general revenue transfers are expected to constitute the largest single source of income to the Medicare program as a whole—and would add significantly to the Federal Budget pressures."[3] Medicare's total unfunded obligations, based on the Trustees' 75-year actuarial projection, is estimated to be $36.3 trillion.[4]

This paper, in its entirety, can be found at:
www.heritage.org/Research/Budget/wm1867.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Current and future taxpayers will be faced with enormous burdens in trying to sustain the Medicare program as it is today. Few expect Congress to raise beneficiaries' premiums to a level sufficient to cover Medicare's shortfalls. Likewise, few expect Congress to cut off Medicare benefits to seniors, at least in any explicit fashion. Realistically, if Congress refuses to address rapidly rising Medicare spending, then it would perforce require Americans to pay taxes at a level far exceeding anything Americans have paid before.

Tax increases could come in the form of increased federal income taxes or payroll taxes. An independent estimate by Professor Thomas Saving of Texas A&M University, a former trustee of the Medicare and Social Security trust funds, models a payroll tax required to pay for current and projected Medicare deficits. While holding the non-entitlement expenditure share of the gross domestic product constant, Saving estimates that today's Medicare payroll tax of 2.9 percent would jump to 5.7 percent in 2020 and 9.3 percent in 2030.[5]

The only responsible policy option for Congress and the Administration is to embark quickly on serious reform of the Medicare program, changing it from an open-ended entitlement to a defined-contribution program, adjusting government contributions to seniors for age, health costs, and income.

Social Security's Growing Deficits. In present value terms, Social Security owes $6.5 trillion more in benefits than it will receive in taxes. That number includes $2.2 trillion, in net present value terms, to repay the bonds in Social Security's trust fund and $4.3 trillion to pay benefits after the trust fund is exhausted in 2041. While this is a decrease of $0.3 trillion from last year's report, almost all of that change results from a technical change in the methodology used to make the estimate. If last year's methodology had been used, the total deficit would have been $7.3 trillion.

Net present value measures the amount of money that would have to be invested today in order to have enough money on hand to pay future obligations. In other words, Congress would have to invest $6.5 trillion today in order to have enough money to pay all of Social Security's promised benefits between 2017 and 2082. These funds exclude what Social Security receives during those years from payroll taxes.

Social Security will continue to collect more in taxes each year than it will spend on benefits until 2017, the same year as in the 2007 report. The trust fund will run out of money in 2041, also the same year that was reported in last year's report.

This year's report makes a major change in the way that legal and illegal immigrants are counted that greatly increases estimates of the numbers of illegal immigrants who are paying payroll taxes. Most of these workers are estimated to have left the country by the time that they retire, so the report also reduces its estimate of the number of immigrants who eventually end up receiving benefits. These changes offset projected increases in Social Security's deficits caused by changes in lifespan and other factors.

What most reports will miss is that Congress will have to start to deal with reduced surplus Social Security tax collections much faster than it or the

1. For a brief discussion of President Bush's Medicare proposals to meet the legal requirements of the Medicare "trigger" law, see Robert E. Moffit, Ph.D., "The President's Medicare Budget: A First Step Towards Entitlement Reform," Heritage Foundation *WebMemo* No. 1797, February 5, 2008, at *www.heritage.org/research/healthcare/wm1797.cfm.*
2. *2008 Annual Report of The Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, March 25, 2008, pp. 2–3.
3. *Ibid.*, p. 13.
4. *Ibid.*, p. 197.
5. Thomas Saving, Ph.D., "Medicare's Future Burden: CBO versus Trustees Estimates," Texas A&M University, Private Enterprise Research Center, 2008, Slide No. 2. Under Professor Saving's estimates, the CBO and Trustees' data for required payroll increases would be the same for 2020 and 2030 but, because of different assumptions, would start to diverge by 2040, with CBO data yielding a 13.1 percent Medicare payroll tax as opposed to a 12.3 percent Medicare payroll tax based on the Trustees' data.

public expects. Starting in 2010, the roughly $80 billion in annual Social Security surpluses that Congress has been borrowing and spending on other programs will begin to shrink. From that point on, Congress will have to either find other sources to replace the borrowed money or reduce spending. The surpluses will end completely in 2017, the year when Social Security begins to spend more than it collects.

In 2020, a little more than 12 years from now, today's $80 billion annual Social Security surplus will turn into a $75 billion annual deficit—a $150 billion change. From 2017 on, Social Security will require large and growing amounts of general revenue money in order to pay all of its promised benefits. Even though this money will technically come from cashing in the special-issue bonds in the trust fund, the money to repay them will come from other tax collections or borrowing. Moreover, the billions that go to Social Security each year will make it harder to find money for other government programs.

Conclusion. The 2008 Medicare and Social Security Trustees Report shows that the two entitlement programs cannot remain in their current forms. It is irresponsible to saddle our children and grandchildren with the trillions in additional taxes that will be needed to pay full benefits into the future. Making matters worse, this cost continues to grow every year.

Unless Congress begins to work now to fix this country's most important programs for senior citizens, our children will face the choice of paying for programs for their parents or paying for education for their children. The first baby boomer has already retired under Social Security. Delay will only make that dilemma worse.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies, and Robert E. Moffit, Ph.D., is Director of the Center for Health Policy Studies, at The Heritage Foundation.