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SOCIAL SECURITY AND MEDICARE FROM A TRUST FUND AND BUDGET PERSPECTIVE

Summary

According to the annual reports of the Social Security and Medicare trustees, the financial outlook for the two programs is not favorable. Under the central forecasts reported for the past 17 years under both Republican and Democratic Administrations, both programs face significant long-range financing problems arising in large measure from the aging of the population and the unrelenting rise in the price of health care.[1] The depth and nearness of those problems vary greatly depending on whether one views the outlook from a trust fund or budgetary perspective. From a trust fund perspective, the programs' deficits are large but are not imminent. From a budget and economic perspective, the problems are larger and are already emerging.

Under the trust fund perspective, Social Security is projected to have reserves that would allow full payment of benefits until 2041, and the average deficit for the next 75 years would equal 14 percent of the program's income. The Hospital Insurance (HI) portion of Medicare would have sufficient reserves to cover all promised benefits until 2020. Its average 75-year deficit would equal 91 percent of its income. Based on this outlook, the combined shortfall for both programs would appear to be fixable by immediately raising the payroll tax rate from 15.3 percent to 20.31 percent (half coming from employees and half coming from employers) or by an equivalent reduction in expenditures. From the trust fund perspective, the Supplementary Medical Insurance (SMI) part of Medicare (which pays for physician services and soon, prescription drugs) presents no problem since the Treasury's general fund finances roughly three fourths of its cost (premiums from enrollee covering the remaining portion) and any shortfalls that should arise for any upcoming year.

Thus, the problem as defined by looking at the outlook from a trust fund perspective is that the earliest any of the programs would become endangered is 2020, and on a combined basis their average shortfall could be remedied by an increase in payroll taxes of 33 percent or a benefit reduction of 22 percent.

While the trust fund perspective does portray a significant future problem, a larger and more imminent problem is shown by looking at the budgetary implications of the two programs. Social Security surplus tax receipts will start to recede in 2009 and by 2017, they would be replaced by deficits that grow larger over time. In constant 2005 dollars, they would grow from $9 billion in 2017 to $256 billion in 2030 and $353 billion in 2040. The HI part of Medicare began running deficits in 2004 that are projected to grow indefinitely, and when one recognizes that only one fourth of SMI's costs are met with enrollee premiums, Medicare as a whole is already running sizeable deficits. With the retirement of the post World War II baby boomers drawing near—the first of whom will be eligible for Social Security benefits in three years, and Medicare, in six—the beginning of the fiscal stress presented by these two major entitlement programs is very close. Today, the two programs absorb 7 percent of the nation's economic production—i.e., its gross domestic product. Under the trustees' projections, by 2030, the figure would grow to 13 percent (or nearly double); and by 2050, it would grow to 15.5 percent. Expenditures of the latter magnitude today

[1] "Significant" being defined here as having an average income shortfall of 5 percent or larger for the following 75 years.

would equal 80 percent of total expenditures of the federal government and consume an amount equal to nearly all of its receipts.

Regardless of how one chooses to view the financial problems of these two vital programs, the looming fiscal strains are large and will not be temporary. Taking action to ameliorate the stress now would be better than waiting as the needed alterations could be implemented gradually giving future recipients time to prepare.

Purpose of Trust Funds

Social Security and Medicare are programs created by federal laws and operated by agencies of the federal government. The taxes and premiums the public pays to support them and the benefits they provide to their recipients flow into and out of the U.S. Treasury.

The U.S. Treasury Department tracks their financial flows through accounts that by law are labeled "trust funds." The label "trust funds" can be confusing in that it may suggest that the money collected for the programs is somehow segregated and managed differently than other receipts. It isn't. When received on a day-to-day basis, any revenue that comes in for Social Security and Medicare is commingled with other federal revenues, and any such revenue in excess of what is needed to pay each day's program costs gets used for whatever other obligations the government has to meet. The excess is not invested outside the government, such as in stocks, corporate bonds, or securities of other nations. At the same time, the appropriate trust fund balance is increased by a corresponding amount by crediting it with U.S. Treasury securities, which is tantamount to the government investing in itself. It is one account of the Treasury giving credit to another—i.e., from the Treasury's general fund to the Social Security or Medicare trust funds.

The purpose of the trust funds is to separately track the income and outgo of the Social Security and Medicare programs. These programs have special taxes, premiums, and other forms of income and governmental contributions intended to finance their expenditures. In contrast, income taxes, which are credited to the Treasury's general fund, are not typically earmarked for any particular activity. Although the trust funds don't cause the programs' revenues to be managed separately, they do have certain operational significance. For instance, as long as the trust funds have a balance of securities posted to them, the Treasury Department is required to pay their benefits. Most general fund programs must have an appropriation from Congress each year before they can spend; in other words, a new law has to be passed. In contrast, the holdings of the trust funds represent a right to spend from the Treasury, up to the balance in each trust fund, without an appropriation from Congress.

In addition, by law, the trust funds earn interest, which the Treasury Department provides in the form of additional federal securities. The interest augments the trust funds' balances. Thus, when excess Social Security or Medicare receipts are collected, the government acknowledges that it is making other use of those funds and rewards the two programs accordingly. For the government, this action is an "accounting" transaction, however, and does not result in immediate additional cash spending by the Treasury.[2] For Social Security and Medicare, this action results in additional spending authority as the "accounting" reward raises the balances of the trust funds.

Measures of Financial Soundness

The trustees of the two programs report annually on the financial status of their various trust funds. Although they use a number of measures, the media and general public typically place emphasis on trust fund exhaustion dates and long-range summary measures of financial status, such as the test of long-range

[2] It has been postulated that excess Social Security and Medicare receipts give the government more money than it otherwise would receive, and as such, they are a substitute for government borrowing from the public. There is, however, no way of tracing the use of those excess receipts. The fact that they are credited to trust funds doesn't isolate them from fiscal policy making, nor does labeling them "off budget." While the excess receipts could cause the government to borrow less from the public, equally likely is that they crowd out other taxes or cause other spending to be higher. The reality is that any discussion about how excess Social Security and Medicare receipts are used is hypothetical.

close actuarial balance. This summary estimate measures whether a trust fund's total income (including governmental contributions) is estimated to exceed its total expenditures or be less than its total expenditures by no more than 5 percent over the following 75 years. If a trust fund meets this test, then the trustees deem the fund to be in *close actuarial balance*, and vice versa if the difference is larger.[3]

Trustees' Projected Trust Fund Deficits (75-year Estimates)[4]

Social Security	Medicare (Hospital Insurance)	Social Security and Hospital Insurance, Combined
Outgo is projected to exceed income by:		
14 percent	91 percent	29 percent

Source: Derived from 2005 reports of the Board of Trustees of the Old Age, Survivors, and Disability Insurance and Medicare Hospital and Supplementary Medical Insurance trust funds, March 23, 2005.

The trustees project income and expenditures for Social Security and the Hospital Insurance (HI) part of Medicare as a percentage of the total earnings and self-employment income in the economy that is subject to Social Security or HI taxation—what is referred to as taxable payroll. In their latest reports issued in March 2005, they estimate that the income of the Social Security trust funds will equal 13.87 percent of taxable payroll for the aggregate 75-year period and that the expenditures will equal 15.79 percent, leaving a gap, or trust fund deficit, of 1.92 percent of taxable payroll. This represents an average gap for the period as a whole of 14 percent of Social Security's recorded income (i.e., 1.92/13.87). The HI trust fund is projected to have income of 3.39 percent of that fund's (higher) taxable payroll,[5] expenditures of 6.48 percent, and an average deficit of 3.09 percent. The combined deficit for the two programs is projected to equal 5.01 percent of taxable payroll, resulting in an average actuarial imbalance of nearly 30 percent of their combined income.

To simplify the trustees' assessment, if the combined Social Security and Medicare tax rate on workers' earnings were raised immediately by 5.01 percentage points—from 15.3 percent to 20.31 percent—and kept at that level for the next 75 years, the combined 75-year trust fund deficits of the two programs would be deemed eliminated—this would amount to a relative increase in payroll taxes of 33 percent.[6] The same would occur if benefits were immediately cut by 22 percent.

Having a reserve credited to the trust funds throughout the period is also necessary in order to assure ample spending authority exists when program income is expected to be less than expenditures. Since the trust fund reserve represents "permission to spend," the point at which no reserve remains and ongoing income is insufficient to pay program benefits is technically when benefits can no longer be paid in full or on time. The latest trustees' reports show that the HI trust fund will exhaust its reserve in 2020, and the Social Security trust funds, in 2041.

The trustees project no financing problems for the Supplementary Medical Insurance (SMI) portion of Medicare, even though premiums paid by enrollees cover only about one-fourth of both parts of that program's costs (i.e., the part that covers physician and related services and the new part that will shortly cover prescription drugs). Current law requires the government to annually cover the remaining costs with credits from the general fund—a practice that effectively precludes exhaustion of the SMI trust fund.

Budget Impact of the Programs

At times, the operations of trust funds are seen as measuring the effect that Social Security and Medicare have on the federal budget and the Treasury. If the trust funds show an excess of income over outgo, some read this to indicate that the programs are having a favorable effect on the budget and vice versa if

[3] The other measures incorporate both shorter and longer valuation periods, but the 75-year average and the exhaustion dates are the ones that garner the greatest attention.
[4] All references here to projections are based on the "intermediate" outlook of the 2005 trustees' reports.
[5] In 2005 taxes are levied on $90,000 in earnings for Social Security and on all earnings for HI.
[6] A "combined" basis is hypothetical since the law requires separate accounting for the various trust funds.

trust fund outgo exceeds trust fund income. The receipts and expenditures of the trust funds, however, do not reflect the actual receipts and expenditures the programs generate for the Treasury. While the trust funds' operations are crucial for evaluating the adequacy of the financing that Congress has established for the programs (i.e., it addresses the question of whether Congress given the programs enough spending authority), they say very little about the impact of these programs on the federal budget and the Treasury. And they say little about where the Treasury will get the resources when the trust fund balances have to be drawn down.

The SMI part of Medicare, for instance, receives a government contribution equal to roughly three-fourths of its costs. The government doesn't receive any money as a result of this transaction; it is paying itself when the general fund of the Treasury credits the SMI trust fund. Similarly, interest paid to the various trust funds represents a credit from the Treasury. Again, nobody pays that interest to the government. The SMI contribution and the interest payments are the two largest forms of governmental transfers to the various trust funds, but there are a variety of others. Counting them as receipts for the budget because they are income to the trust funds can greatly distort the image of how the programs' affect the federal budget and the Treasury.

If governmental transfers are included in an analysis of the impact of Social Security and Medicare on the federal budget, the resulting distortion is large enough to potentially obscure the growing strains the two programs will soon place on the government's finances. Under the trustees' latest projections, the trust funds are estimated to run surpluses through 2015 totaling $2.6 trillion. However, when the governmental transfers to the trust funds are excluded, the federal budget impact of the two programs would be a combined deficit of $2 trillion. A trust fund surplus in a particular year does not necessarily lead to a favorable budget impact in that year.

Comparing Trust Fund and Budget Projections

		Trust Surplus (+)/Deficit (-)	Programs' Impact On Federal Treasury
		($s in trillions)	
Period from 2005-2015:	Social Security	+2.5	+0.8
	Medicare Combined	*	-2.9
	Social Security and Medicare	+2.6	-2.0

*less than $.1 trillion

Source: 2005 trustees' reports, loc.cit.,

Resources Required to Pay for Social Security and Medicare

Trust fund assessments are intended to convey the adequacy of the financing arrangements established for the programs. In other words, the trustees' reports evaluate whether and for how long the programs would be able to pay benefits with the spending authority Congress has given them. But those assessments are not intended to indicate the programs' budgetary and economic implications, nor where the government would get the funds when trust fund balances need to be relied upon.

Moreover, an "average" of 75-years' worth of income and expenditures does not reveal the year by year draw on workers' earnings or the economy that may be required to cover future benefits. It implies that trust fund surpluses occurring early in the period will offset later trust fund deficits. In their report, the trustees project the Social Security and HI trust funds will run surpluses (on a combined basis) for the next twelve years or so—peaking at 1.76 percent of payroll in 2007 and 2008 and declining to 0.04 percent of payroll in 2015. Crediting surpluses to trust funds, however, is simply an "accounting" transaction. In a future year, when trust fund securities are needed to pay benefits, the resources to pay for that future year's program costs will have to be drawn from the economy.

Tax Rates Needed If Current Benefit Rules Remain

	Future Rates Now Scheduled*	Rates Required If Tax Rates Increased Each Year to Match That Year's Projected Current-Law Benefits *		
	(in percent of payroll)			
		2030	2050	2080
Social Security	12.4	16	17	18
Medicare HI	2.9	5	8	13
Rates for Both	15.3	21	25	31

* Combined employee/employer rates. Future rates needed are calculated by subtracting proceeds from the taxation of Social Security benefits from the projected cost rates expressed as percent of taxable payroll (rounded to whole percents).

Source: 2005 trustees' reports, loc. cit.

By the traditional measure of close actuarial balance, the average gap across 75 years would be 5.01 percent of taxable payroll. Immediately increasing the payroll taxes by 5.01 percent would bring excess tax income in the early years, but inadequate income in the later years. The trust funds would build up huge balances in the early years, and rely on drawing down the balances in later years (transfers from the general fund of the Treasury).

However, from the federal budget perspective, the excess income in the early years is not set aside by the Treasury or invested for future use. If the projected spending levels are realized, then the gaps between current law trust fund income and spending would be 7.93 percent of taxable payroll in 2040, 9.98 percent of taxable payroll in 2055, and 15.36 percent of taxable payroll in 2080. Eliminating the gap in 2080 through increased payroll taxes (without lowering benefits) would require a near doubling of the tax rate, bringing it to a level of 31 percent of workers' earnings in 2080 from its now scheduled level of 15.3 percent.[7]

When Trust Funds Become Exhausted and Expenditures Exceed Receipts

	Year of Trust Fund Exhaustion	Year Expenditures Exceed Receipts
Social Security	2041	2017
Medicare Hospital Insurance	2020	Currently

Source: 2005 trustees' reports, loc. cit.

When demographic and economic trends portray ever rising costs and an indefinite stream of deficits, using summary measures for any elongated period may not show important aspects of the financial picture. In effect, using an average by itself may be an inadequate means of drawing a conclusion about the programs' financial status. A better measure, or at least a more explicit and understandable analysis, *is (1) when, (2) by how much (in contemporaneous terms), and (3) for how long is the program's income expected to be out of line with its expenditures.*

While the trust funds are expected to have adequate spending authority for a number of years, the fiscal strains on the government and the economy generated by Social Security and Medicare are not far off. The trustees' project that the Social Security trust funds will have reserves to carry the program until 2041, the HI trust fund will have reserves until 2020, and the SMI trust fund will not be exhausted at any time in the 75-year projection period. However, if the trust fund reserves are recognized from the federal budget perspective as governmental bookkeeping entries, the strains on the government are already emerging.

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[7] Interest is counted in the calculation of the 75-year "actuarial balance" by estimating the trust funds' future income and outgo streams in "present value" terms (i.e., discounting them by an interest rate). Doing so reduces the size of the future deficits relative to those of earlier years and the surpluses that occur at the front end of the projection period. Rather than looking at future deficits contemporaneously (e.g., relative to the taxable payroll or the economy overall in those later years), they are expressed as a single sum of money that if available and invested today would close the long-range gap. The problem with that approach is that neither the Social Security nor Medicare trust funds are true "investment" funds. Consequently, the present value calculation distorts (lowers) the size of the average 75-year deficit by assuming that interest accruing to the trust funds results in real resources to fund future benefits.

Tax and premium receipts for HI are now less than HI's expenditures, and therefore HI is partially funded by general revenue transfers (redemption of its trust fund securities) creating a drag on the federal budget. A similar situation is expected to arise for Social Security, as receipts are projected to fall below the program's expenditures in 2017.

Although Medicare's adverse financial issues are usually discussed only in the context of HI, the taxes and premiums collected for Medicare as a whole are now paying for only 65 percent of its expenditures largely because the premiums paid by enrollees in SMI cover only about one-fourth of SMI's costs. SMI, which covers physician and other related services through Part B, and prescription drugs through Part D, is as much a part of Medicare as HI. The SMI trust fund is automatically in balance because the financing is reset each year to match the expected SMI costs. However, ignoring the financial implications of SMI for the federal budget and the economy fails to recognize the full magnitude of the nation's health care that Medicare is committed to pay.

Assessing the Economic Impacts

From an economic perspective, the gaps between what the government receives and spends for Social Security and Medicare can only be filled by increased borrowing, higher taxes, reduced spending, or some combination thereof. This total gap is composed of two parts. The gap between what a trust fund receives and spends is known as a trust fund deficit. For a trust fund deficit, such as those projected to occur in HI and Social Security, the law would need to be changed to increase the trust fund income or decrease the trust fund spending to eliminate this deficit. The second part of the total gap comes from governmental transfers to the trust funds from the general fund of the Treasury, which are spent on program benefits and have no ear-marked income source. These transfers, such as the transfers to SMI to meet about 75 percent of its costs, increase the federal budget deficit. Expressed as a percentage of the nation's gross domestic product (GDP), spending for Social Security and Medicare under the trustees' projections would rise from 7 percent today to 15.5 percent in 2050, while revenues for the programs would hover around 8 percent. Trust fund accounting does not show the widening gap and thus the growing amount of resources that may have to be drawn from the economy to cover the programs' expenditures.

To put the issue in context, the receipts and expenditures of the entire federal government are today equal to 17 and 20 percent of GDP respectively. The federal budget deficit, thus, is 3 percent of GDP—a large amount, but still less than a fifth of expenditures. If the 2050 shortfall between Social Security's and Medicare's receipts and expenditures (i.e., about 7.5 percent of GDP) existed today and if the Social Security and HI trust funds' deficits were met through transfers from the general fund of the Treasury, for which there is no provision under current law, then the federal deficit would equal more than half of all federal expenditures. If the relative cost of Social Security and Medicare in 2050 (i.e., 15.5 percent of GDP) existed today, the two programs alone would be nearly as larger as all federal revenues.

Draw on the Economy if Current Benefit Rules Remain

	2005	2030	2050	2080
	Percent of Gross Domestic Product			
Social Security	4.3	6.1	6.2	6.4
Medicare	2.7	6.8	9.3	13.8
Both programs	7.0	12.9	15.5	20.1

Source: 2005 trustees' reports, loc.cit.

The looming fiscal strains of these two programs will not be temporary. They reflect a growing imbalance driven by the demand for healthcare, the entitlement rules now prescribed in law, and a long-lasting shift to an older society. Enacting changes to Social Security and Medicare now would be better than waiting for these trends to become established because the revisions could be implemented gradually giving future recipients time to prepare.