2002

Status of the Social Security and Medicare Programs

A SUMMARY OF THE 2002 ANNUAL REPORTS

Social Security and Medicare
Boards of Trustees

Hypertext versions of the Social Security and Medicare Trustees Reports as well as this document are available on the Internet at the following addresses:

Social Security (OASDI):	**http://www.ssa.gov/OACT/TR/TR02/index.html**
Medicare (HI and SMI):	**http://www.hcfa.gov/pubforms/tr/**
Summary:	**http://www.ssa.gov/OACT/TRSUM/trsummary.html**

Other information about Social Security benefits and services is available at **http://www.ssa.gov** or by calling toll-free **1-800-772-1213**.

Other information about Medicare benefits and services is avialable at **http://www.cms.hhs.gov** or by calling toll-free **1-800-663-4227**.

A MESSAGE TO THE PUBLIC:

Each year the Trustees of the Social Security and Medicare trust funds report in detail on the funds' current status and their projected condition over the next 75 years. Here we summarize and synthesize the major findings contained in the 2002 Annual Reports. But first, we highlight the most significant implication of these findings, which is that both Social Security and Medicare need to be reformed and strengthened at the earliest opportunity.

The long-term financing gap for both Social Security and Medicare is slightly larger this year and remains large for both programs. Closing that gap will require innovative solutions that also present opportunities to strengthen each program. While the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon.

- *For Medicare, solutions to its financial problems also provide the opportunity to enhance the quality of medical care by tapping into the tremendous potential for improvements in underlying health care productivity.*
- *For Social Security, the traditional solutions have focused on benefit cuts and tax increases, but could be expanded to include finding ways for workers to benefit from the economy-wide rate of return on private capital.*

With informed public discussion and creative thinking that relates the well-established principles underlying the Social Security and Medicare programs to the economic and demographic realities of the 21st century—and with timely legislative action—these programs can continue to play a critical role in the lives of all Americans. Failure to take action in a timely manner would necessitate larger changes down the road to both Medicare and Social Security.

Medicare

Medicare faces financial difficulties that come sooner—and in many ways are more severe—than those confronting Social Security. While both programs face essentially the same demographic challenge, health care costs per enrollee are projected to rise faster than wages. As a result, the Medi-

care program will eventually place larger demands on the Federal Budget than Social Security.

Specifically, it is important to recognize the financial challenge facing the Medicare program as a whole and the clear need for integrated solutions. To emphasize this point, and to better reflect operational realities, this year the Trustees have combined the separate reports on the Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) Trust Funds into a single report that also provides information on overall Medicare costs and income sources, along with a detailed analysis of each fund.

- *Costs for the two components combined will grow from 2.5 percent of gross domestic product (GDP) today to 4.5 percent in 2030 and 8.6 percent in 2076 based on intermediate economic and demographic assumptions. By comparison, total HI and SMI revenues (excluding interest) will only grow from 2.6 percent of the GDP today to 3.7 percent in 2030 and 5.3 percent in 2076. If the HI financing gap were not addressed, general revenues earmarked for SMI would eventually constitute a larger share of total Medicare income than HI payroll tax revenues.*

- *Medicare spending is ultimately projected to exceed the cost of Social Security. The financing gap for HI is larger than the gap for Social Security, and the HI Trust Fund will become insolvent 11 years sooner than the combined Social Security trust funds.*

Over the long range, the HI Trust Fund financing gap deteriorated slightly this year and the fund continues to fail to meet our test of financial balance by a wide margin. The sooner reforms are made, the smaller and less abrupt they will have to be in order to achieve solvency throughout the full 75-year projection period. The HI Trust Fund is projected to remain solvent until 2030, one year later than projected in last year's report. Even so, projected tax income still falls short of outlays beginning in 2016.

- *The gap between income and costs can best be expressed relative to taxable payroll (the HI Trust Fund's funding base). This year the 75-year actuarial deficit is projected to be 2.02 percent of taxable payroll—an increase from last year's projected deficit of 1.97 percent of taxable payroll.*

- *Bringing HI into actuarial balance over the next 75 years could be achieved by either an immediate increase in payroll tax income of* *almost 70 percent (e.g., by raising the payroll tax rate from 1.45 to 2.46 percent on both employers and employees) or an immediate reduction in program outlays of 38 percent from their currently projected levels, or some combination of the two.*

The SMI Trust Fund, which pays doctors' bills and other outpatient expenses, is projected to remain financed into the indefinite future—but only because current law automatically sets financing each year to meet next year's expected costs. Over time, this automatic financing will require a rapidly growing amount of general revenue, projected to rise from 0.7 percent of GDP today to 2.8 percent in 2076, along with substantial increases in beneficiary premiums.

Social Security

Over the long range, the combined Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Fund continues to fail our test of financial balance by a wide margin. The 75-year projected actuarial deficit in the combined OASDI Trust Fund is 1.87 percent of taxable payroll, virtually the same as last year's deficit of 1.86 percent.

- *Bringing Social Security into actuarial balance over the next 75 years could be achieved by either a permanent 13 percent reduction in benefits or a 15-percent increase in payroll tax income, or some combination of the two.*
- *On a year-by-year basis, cash-flow deficits are projected to rise to levels in excess of 6 percent of taxable payroll by the end of the 75-year period primarily because of the upward shift in the average age of the population.*

The large annual deficits at the end of the 75-year projection period indicate that costs will very likely continue to exceed tax revenues after 2076. As a result, ensuring the sustainability of the system beyond 2076 would require even larger changes than those needed to restore 75-year actuarial balance.

Social Security solvency is essentially unchanged compared to last year's report, although this year the combined OASDI Trust Fund is projected to be financed three years longer than in last year's report—until 2041. Individually, the OASI Trust Fund is projected to be able to pay full benefits on time until 2043, and the DI Trust Fund until 2028. When the baby-boom generation begins to retire in about 2010 and puts increased strains on the Federal Budget, financial pressure on the Social Security trust *funds will rise rapidly and tax income will fall short of outlays beginning in 2017.*

We must take action to address the OASDI financial shortfall in a timely manner. As with Medicare, the sooner adjustments are made, the smaller and less abrupt they will have to be.

By the Trustees:

Paul H. O'Neill,
Secretary of the Treasury,
and Managing Trustee

Elaine L. Chao,
Secretary of Labor,
and Trustee

Tommy G. Thompson,
Secretary of Health
and Human Services,
and Trustee

Jo Anne B. Barnhart,
Commissioner of
Social Security,
and Trustee

John L. Palmer,
Trustee

Thomas R. Saving,
Trustee

A SUMMARY OF THE 2002 ANNUAL SOCIAL SECURITY AND MEDICARE TRUST FUND REPORTS

Who Are the Trustees? There are six Trustees: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, the Commissioner of Social Security and two members appointed by the President and confirmed by the Senate to represent the public. The Public Trustees are John L. Palmer, Dean and Professor of Economics and Public Administration of the Maxwell School of Citizenship and Public Affairs at Syracuse University, and Thomas R. Saving, Director of the Private Enterprise Research Center and Professor of Economics at Texas A & M University.

What Are the Trust Funds? The trust funds are financial accounts in the U.S. Treasury. Social Security and Medicare taxes, premiums and other income are credited to these accounts, and Social Security and Medicare benefits are paid from them. The only purposes for which these trust funds can be used are to pay benefits and program administration costs.

The trust funds hold money not needed in the current year to pay benefits and administrative costs and, by law, invest it in interest bearing securities of the U.S. Government. A market rate of interest is paid to the trust funds on the securities, and when these securities reach maturity or are needed to pay benefits, the Treasury redeems them.

There are four separate trust funds. For Social Security, the Old-Age and Survivors Insurance (OASI) Trust Fund pays retirement and survivors benefits, and the Disability Insurance (DI) Trust Fund pays disability benefits. (The combined trust funds are described as OASDI.)

For Medicare, the Hospital Insurance (HI) Trust Fund pays for inpatient hospital and related care, and the Supplementary Medical Insurance (SMI) Trust Fund pays for physician and outpatient services. Medicare benefits are provided to most people age 65 and over and to most workers who are receiving Social Security disability benefits.

What Were the Trust Fund Results in 2001? In December 2001, 39.0 million people were receiving OASI benefits, 6.9 million were receiving DI benefits, and about 40 million were covered under Medicare. Trust fund operations, in billions of dollars, are shown below (totals may not add due to rounding).

	OASI	DI	HI	SMI
Assets (end of 2000)	$931.0	$118.5	$177.5	$44.0
Income during 2001	518.1	83.9	174.6	98.6
Outgo during 2001	377.5	61.4	143.4	101.4
Net increase in assets	140.6	22.5	31.3	-2.8
Assets (end of 2001)	1,071.5	141.0	208.7	41.3

How Are Social Security and Medicare Paid for? For OASDI and HI, the major source of financing is payroll taxes on earnings that are paid by employees (157 million in 2001) and their employers and by the self employed. People who are self employed are charged the equivalent of the combined employer and employee tax rates. The payroll tax rates are set by law and for OASDI apply to earnings up to an annual amount, which rises as average wages increase (it is $84,900 in 2002). HI taxes are paid on total earnings. The tax rates (in percent) for 2002 and later are:

	OASI	DI	OASDI	HI	Total
Employees	5.30	0.90	6.20	1.45	7.65
Employers	5.30	0.90	6.20	1.45	7.65
Combined total . . .	10.60	1.80	12.40	2.90	15.30

The Supplementary Medical Insurance part of Medicare is financed largely by payments from Federal general revenues supplemented by monthly premiums charged beneficiaries ($54.00 in 2002). Income to each trust fund by source in 2001 is shown in the table below (totals may not add due to rounding).

Source *(in billions)*	OASI	DI	HI	SMI
Payroll Taxes	$441.5	$74.9	$152.0	—
General Revenue	—	—	—	$72.8
Interest Earnings	64.7	8.2	13.2	3.1
Beneficiary Premiums	—	—	1.4	22.8
Taxes on Benefits.	11.9	0.8	7.5	—
Other	—	—	0.5	—
Total	518.1	83.9	174.6	98.6

What Were the Administrative Expenses in 2001? Administrative expenses, as a percentage of total expenditures, were:

	OASI	DI	HI	SMI
Administrative expenses 2001. . .	0.5	2.8	1.5	1.7

How Are Estimates of the Trust Funds' Future Status Made? Short-range (10-year) and long-range (75-year) estimates are reported for all funds. The estimates are based on current law and assumptions about all of the factors that affect the income and outgo of each trust fund. Assumptions include economic growth, wage growth, inflation, unemployment, fertility, immigration, and mortality, as well as factors relating to disability incidence and the cost of hospital and medical services.

Because the future cannot be predicted with certainty, three alternative sets of economic and demographic assumptions are used to show a range of possibilities. The intermediate assumptions (alternative II) reflect the Trustees' best estimate of future experience. The low-cost alternative I is more optimistic for trust fund financing, and the high-cost alternative III is more pessimistic; they show trust fund projections if economic and demographic conditions are more or less favorable for trust fund financing than the best estimate.

The assumptions are reexamined each year in light of recent experience and new information about future trends, and are revised as warranted. In general, greater confidence can be placed in the assumptions and estimates for earlier projection years than for later years. While estimates of income and expenditures usually have been close to actual experience, any estimates for as long as 75 years into the future are inherently uncertain. Nonetheless, careful updating of the assumptions on an annual basis provides the best current indication of the future possibilities.

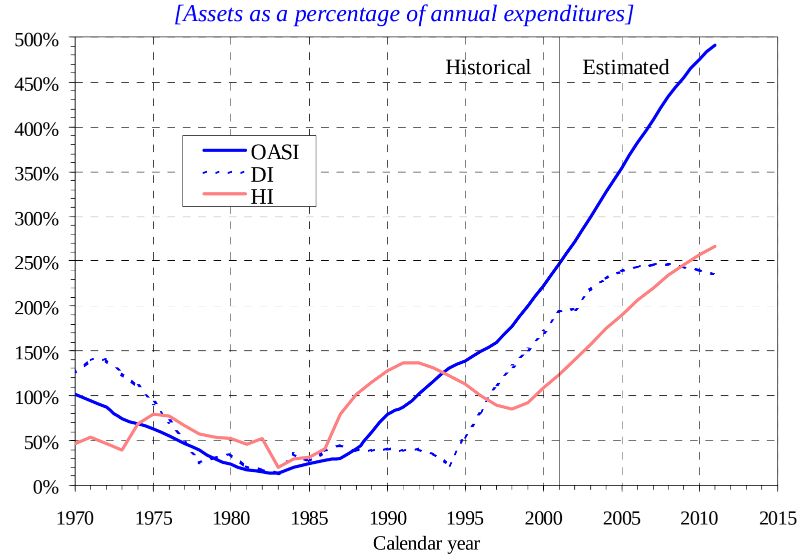
What is the Short-Range Outlook (2002-2011) for the Trust Funds?

For the short range, we measure the adequacy of the OASI, DI, and HI Trust Funds by comparing their assets at the beginning of a year to projected benefit payments for that year (the "trust fund ratio"). A trust fund ratio of 100 percent or more—that is, assets at the beginning of a year at least equal to projected benefit payments for that year—is considered a good indicator of a fund's short-term adequacy. This level of projected assets for any year means that even if expenditures exceed income, the trust fund could pay full benefits for several years, allowing time for legislative action to restore financial adequacy.

By this measure, the OASI, DI, and HI funds are considered financially adequate throughout the short range because the assets of each fund are over the 100 percent level through the year 2011. Chart A shows these trust fund ratios under the intermediate assumptions.

Chart A–OASI, DI, and HI Trust Fund Ratios

[Assets as a percentage of annual expenditures]



For SMI, a less stringent annual "contingency reserve" asset test applies because its financing—provided by beneficiary premiums and Federal general revenue payments—is automatically adjusted each year to meet expected costs. Thus, under current law SMI is fully financed throughout the 75-year projection period.

The table below shows the projected income and outgo, and the change in the balance of each trust fund over the next 10 years.

ESTIMATED OPERATIONS OF TRUST FUNDS
(In billions—totals may not add due to rounding)

	Income				Expenditures				Change in fund			
Year	OASI	DI	HI	SMI	OASI	DI	HI	SMI	OASI	DI	HI	SMI
2002	$537	$87	$181	$104	$394	$71	$149	$108	$144	$16	$32	-$4
2003	572	92	192	113	405	72	153	112	167	21	39	1
2004	608	98	204	117	422	77	160	117	186	21	44	1
2005	648	104	217	125	442	83	170	124	206	21	47	1
2006	690	110	230	134	465	90	180	133	225	20	50	1
2007	735	117	245	144	490	98	190	143	245	19	54	1
2008	781	123	260	156	518	105	203	154	263	18	57	1
2009	829	129	275	168	551	113	216	167	278	16	60	1
2010	878	135	291	182	587	122	230	179	291	14	62	3
2011	932	142	310	196	626	130	245	192	306	12	65	4

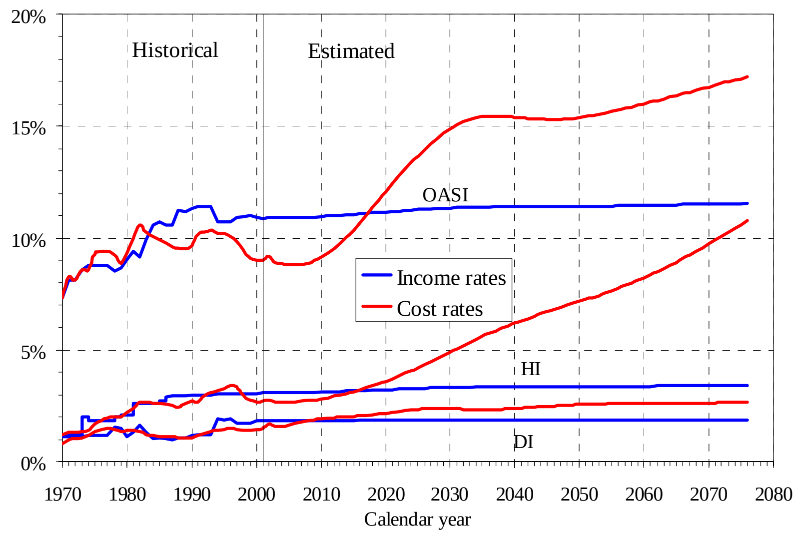
What is the Long-Range (2002-2076) Outlook for the OASI, DI, and HI Trust Funds? By 2018, and thereafter, neither the OASI, the DI nor the HI Trust Fund is projected to have a positive annual cash-flow balance. Chart B compares, under the intermediate assumptions, the income and cost rates of these funds over the next 75 years.

In Chart B the long-range income and cost of OASI, DI, and HI are measured in percentage of taxable payroll rather than in dollars because the value of a dollar changes over time. (Taxable payroll is the amount of total wages and self-employment earnings taxed under the OASDI and HI programs.) Over the 75-year period, the income rates for OASI, DI, and HI remain relatively constant, while the cost rates rise substantially.

For OASI, the income rate is projected to remain above the cost rate for 16 years. Starting in about 2010, however, the OASI cost rate will begin increasing rapidly as the leading edge of the "baby-boom" generation reaches retirement age. In 2018 and later, the cost rate for OASI will exceed the income rate by increasing amounts—by the end of the 75-year projection period the cost rate for OASI will be just over $1^1/_2$ times as large as the income rate.

The income rate for DI is higher than the cost rate only through 2008, after which the annual shortfall of tax income is projected to increase slowly over the remainder of the 75-year period.

Chart B–Income and Cost Rates
[Percentage of taxable payroll]



The cost rate for HI is lower than the income rate through 2015, after which costs exceed income by increasing amounts—by 2076, the HI cost rate is projected to be more than 3 times the HI income rate.

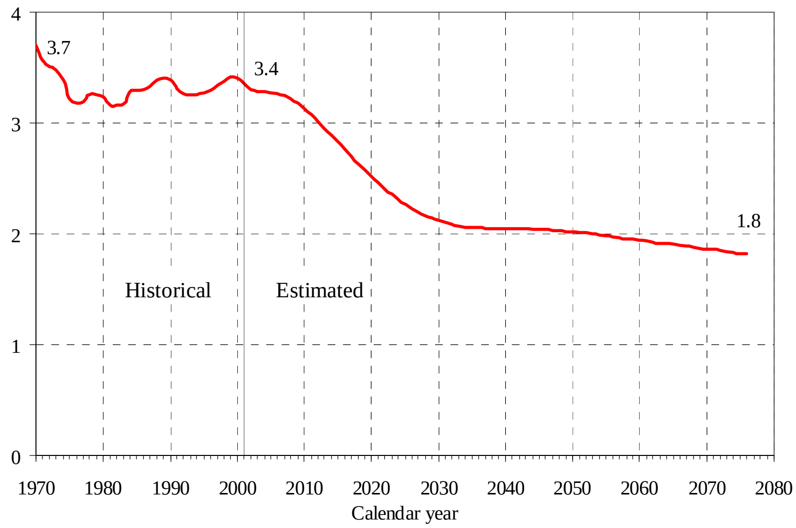
The future income rates for OASI, DI, and HI remain relatively constant in Chart B because the payroll tax rates for the programs are not scheduled to change. Income from taxation of OASDI benefits will rise gradually, primarily because a greater proportion of beneficiaries will become subject to taxation in future years, and this accounts for the slight upward trend in the income lines.

Why Do Costs Rise Faster Than Income? The OASI cost rate increases steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the "baby-boom" generation retires. The OASI cost rate grows more moderately thereafter due primarily to projected increasing life expectancy. The number of workers paying payroll taxes grows slowly in the future because current low fertility rates, relative to historical U.S. experience, are projected to continue.

The HI cost rate increases not only because of growth in the number of beneficiaries per worker, but also because of increases in both the use and cost of health care per person. In particular, continuing development and use of new technology is expected to cause health care expenditures to grow faster than gross domestic product (GDP) in the long term.

Chart C shows the number of workers per OASDI beneficiary through 2076. (The ratio of workers to HI beneficiaries is similar.)

Chart C–Number of Workers per OASDI Beneficiary



What is the Long-Range Actuarial Balance of the OASI, DI, and HI Trust Funds? Another useful way to view the outlook of the payroll-tax-financed trust funds is in terms of their actuarial balances for the 75-year valuation period. The actuarial balance of a fund is essentially the difference between annual income and costs, expressed as a percentage of taxable payroll, summarized over the 75-year projection period.

The OASI, DI, and HI Trust Funds each have an actuarial deficit under the intermediate assumptions, as shown below. Each actuarial deficit can be interpreted as the percentage that could be added to the current law income rate for each of the next 75 years, or subtracted from the cost rate for each year, to bring the funds into actuarial balance. However, such uniform changes, while adequate for this period as a whole, would close just over one-quarter of the gap for 2076 between the annual income and cost rates for OASI and HI as shown in Chart B, and less than one-half of the gap for DI.

ACTUARIAL DEFICIT OF THE OASI, DI, AND HI TRUST FUNDS
(As a percentage of taxable payroll—total does not add due to rounding)

	OASI	DI	OASDI	HI
Actuarial Deficit	1.54	0.34	1.87	2.02

What Are Key Dates in Long-Range OASI, DI, and HI Financing? The projected actuarial deficit for each of the trust funds indicates that at some point in the next 75 years the assets of the fund will be completely used to meet expenses. At that point, however, payroll taxes and other income will continue to flow into the fund. In 2041 when the combined OASI and DI funds are projected to be exhausted, tax income to the combined funds is estimated to be sufficient to pay 73 percent of program costs, but that fraction is projected to decline to 66 percent by 2076 as program costs rise faster than income due to steadily increasing life expectancy and continued relatively low fertility. For HI, tax revenue would cover an estimated 68 percent of costs in 2030 (at the time of asset exhaustion) and would meet only 32 percent of costs in 2076.

Before a trust fund is exhausted, the cash flow of the fund changes in stages. When combined OASDI expenditures exceed current tax income beginning in 2017, in order to pay benefits the program would need to utilize interest earned on invested assets, and beginning in 2027 it would need to redeem a portion of those assets. The comparable dates for HI are 2016 and 2021. These key dates regarding cash flows are shown below.

KEY DATES FOR THE TRUST FUNDS

	OASI	DI	OASDI	HI
First year outgo exceeds income excluding interest	2018	2009	2017	2016
First year outgo exceeds income including interest	2028	2018	2027	2021
Year trust fund assets are exhausted	2043	2028	2041	2030

What Are Trust Fund Exhaustion Dates Under Alternative Assumptions? As noted earlier, the future cannot be predicted with certainty, and three sets of assumptions are used to project the range of possibilities. The year the trust funds are projected to be exhausted varies significantly under the three sets of assumptions. The table below shows this range.

YEAR OF TRUST FUND EXHAUSTION

Set of Assumptions	OASI	DI	OASDI	HI
Alternative I (Low Cost)	(a)	(a)	(a)	(a)
Alternative II (Best Estimate)	2043	2028	2041	2030
Alternative III (High Cost)	2032	2015	2029	2018

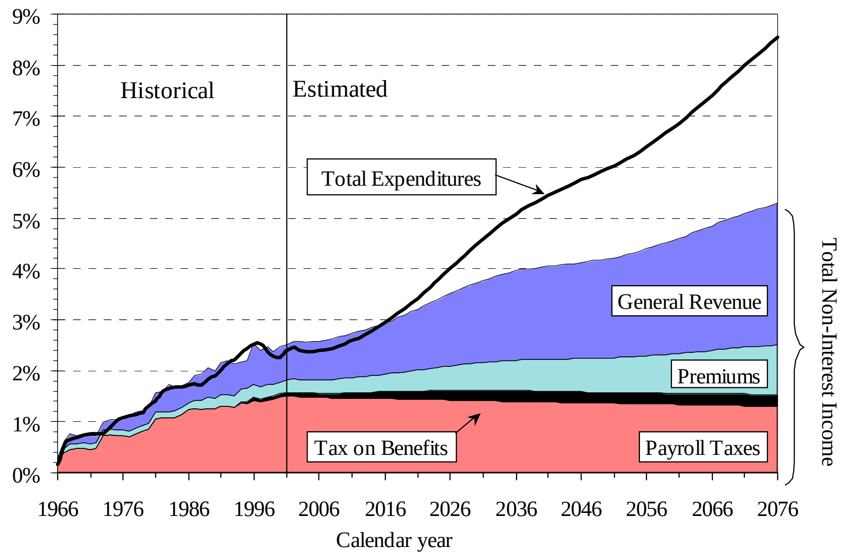
[a] Not exhausted within the 75-year projection period.

How Large Are Total Medicare Expenditures Compared to Revenue?

Even though the HI and SMI programs are financed differently, it is important to recognize the financial challenges facing the Medicare program as a whole. Chart D shows expenditures and current-law non-interest revenue sources for HI and SMI combined as a percentage of GDP.

Medicare costs are projected to grow from 2.5 percent of GDP today to 8.6 percent by 2076. By comparison, combined HI tax revenue, premium income (primarily SMI), and general revenue (primarily SMI) will rise from 2.6 percent of GDP today to 5.3 percent in 2076, resulting in a shortfall of over 3 percent of GDP in that year. The growing difference arises from the projected imbalance between HI tax income and expenditures, since SMI revenues would continue to approximately match SMI expenditures under present law.

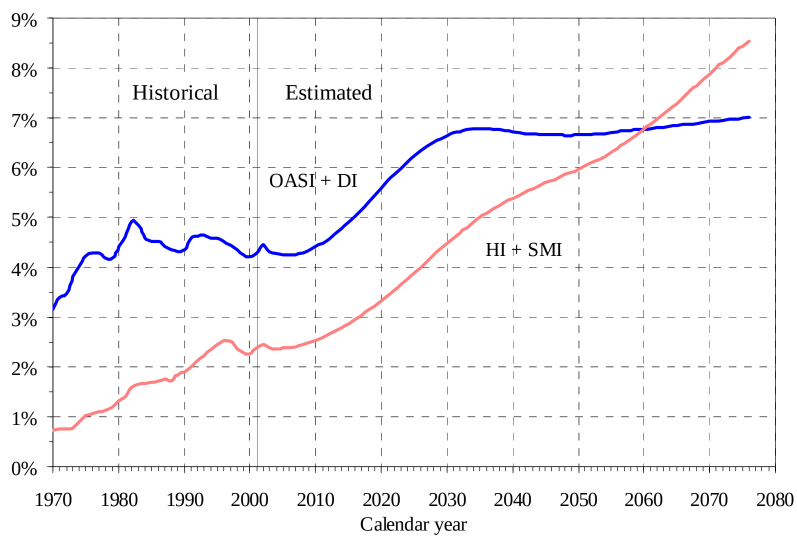
Chart D–Medicare Expenditures and Non-Interest Income by Source as a Percent of GDP



How Large Are Social Security and Medicare Compared to the Whole Economy? It is also useful to view the projected cost of Social Security and Medicare in relation to the economy as a whole. Chart E shows the growth in the outgo as a percentage of GDP. Social Security (OASI plus DI) outgo amounts to 4.5 percent of GDP today and is projected to increase by about 60 percent to 7.0 percent of GDP in 2076. Medicare (HI plus SMI) outgo is smaller today, 2.5 percent of GDP, but is projected to more than triple to 8.6 percent of GDP in 2076.

Moreover, while Social Security costs are projected to virtually level off as a percentage of GDP after 2035, Medicare costs would continue increasing throughout the 75 years—and are projected to exceed Social Security expenditures after 2060.

Chart E–Social Security and Medicare Cost as a Percentage of GDP



A MESSAGE FROM THE PUBLIC TRUSTEES:

These are the second annual Trustees Reports in which we have participated since we began four-year terms as Public Trustees in late 2000. Our goal as Public Trustees is to approach our work in a nonpartisan way to ensure the integrity of the process by which these reports are prepared and the credibility of the information they contain. Despite the inherent uncertainty due to the numerous assumptions that must be made, we believe the projections in these reports are the most reliable picture available of the financial outlook for the Medicare and Social Security programs under current law.

2001 Experience and Outlook

In 2001, non-interest income exceeded outgo in the combined Social Security (OASDI) Trust Fund by $90 billion and in the Medicare Hospital Insurance (HI) Trust Fund by $17 billion. Thus, the large annual surpluses the funds have experienced in the last several years continued in 2001 and are projected in these reports to grow slightly faster over the near term than previously expected. As a result, the year in which OASDI outgo is projected first to exceed non-interest income is delayed from 2016 to 2017, and the year in which all fund assets will be exhausted is pushed back by three years to 2041 for OASDI and by one year to 2030 for HI. This improvement in the financial outlook for the trust funds is due to assumptions of faster growth in productivity and the wages on which payroll taxes are due, higher-than-expected fertility in 2000, and increased estimated revenue from the income taxation of Social Security benefits.

Despite the good news in the near term, the financial outlook for the trust funds over the full 75-year projection period is essentially unchanged from last year. In 2076, the HI fund's income is projected to be just under one-third of its cost, and income to the OASDI combined funds is projected to equal only two-thirds of their cost. This long-range financial imbalance is caused in large part by continuing increases in life expectancy in the U.S., which are assumed to be even faster in this report than in last year's.

Nor are the growing trust fund annual surpluses in the short term any cause for complacency. The retirement of the large baby-boom generation beginning in 2010 will lead to serious Federal Budget challenges in the following decade. These challenges are generally not well understood because of confusion over the interactions between the Medicare and

Social Security trust funds and the Federal Budget. In what follows we attempt to bring some clarity to this issue. Our key point is that trust fund assets can be legitimately characterized in various—and seemingly conflicting—ways depending on one's perspective. The confusion arises when the bonds held by the trust funds are declared to be the "safest investment possible," "worthless IOU's," or something in between, without the speaker explaining his or her viewpoint. Since these bonds can be viewed from basically two distinct vantage points, commentators frequently draw quite different conclusions.

Trust Fund Viewpoint of Assets

While Federal law designates the Social Security and Medicare accounts as "trust funds," the accounts are not "trusts" in the private accounting sense in which funds of one party are held by a second party as a fiduciary. Rather, the Social Security and Medicare trust funds are financial accounts in the U.S. Treasury into which all income to these programs is credited and from which all benefits and administrative costs of the programs are paid. These accounts are established by Social Security and Medicare legislation. This legislation names the Secretary of the Treasury as the "Managing Trustee" with responsibility for overseeing the trust fund accounts. All revenues into the system not required to pay current expenses are used by the U.S. Treasury for general government expenses or to reduce the outstanding publicly held debt. In return, the Social Security and Medicare trust funds are issued special non-marketable U.S. Treasury bonds that by law carry an interest rate equal to the average market yield on all medium and long-term marketable Treasury securities. Interest on these bonds is paid through the issuance to the trust funds of additional special non-marketable U.S. Treasury bonds.

As financial accounts, these Federal trust funds have income, expenditures and assets. The 2002 Social Security Trustees Reports show the Social Security trust funds, for example, as having $1,213 billion in assets at the end of last year, and anticipated Social Security and Medicare surpluses over the next 10-15 years promise to further increase the assets in the trust funds by a substantial amount. These non-marketable U.S. Treasury securities are properly entered under "assets" on the financial accounting balance sheets of the Social Security system, and are available to the system to meet future obligations. It is this availability to meet future program obligations that results in this year's Trustees Reports identifying 2041 as when the Social Security trust funds will be exhausted, *even though under current law Social Security tax revenues are projected to fall short of expenditures beginning in 2017.*

Unified Budget Viewpoint of Trust Fund Surpluses

While the bonds held by the trust funds are assets from the vantage point of the Social Security and Medicare programs, from the viewpoint of the unified budget they are liabilities of the U.S. Treasury. No one doubts the U.S. Government will honor the bonds. But since the U.S. Treasury is the ultimate payer of the programs' benefits and the trust fund assets are also debts of the U.S. Treasury, neither the interest paid on the bonds, nor their redemption, provides any net new income to the U.S. Treasury. When annual revenues from earmarked taxes for Social Security and Medicare begin to fall short of annual expenditures, such shortfalls inevitably must be made up by increased taxation, increased borrowing (i.e., the sale of more U.S. Treasury bonds to the public) and/or a reduction in other government expenditures. This fact is the basis for the view that trust fund assets have no "real" economic value. From a unified budget viewpoint, the trust fund surpluses are a budget accounting device and make no meaningful contribution to funding future Social Security or Medicare expenditures. They simply reflect the fact that in the past, surplus Social Security and Medicare revenues have been used by the U.S. Treasury to fund other government programs or to reduce outstanding Federal debt.

A Shared Concern from Both Viewpoints

As we emphasized in our message last year, the current and projected Social Security and Medicare surpluses can help our society bear the economic burden of higher retirement and health care costs in the decades ahead only if they lead to actual increases in total national (public and private) savings. Higher savings would help generate the increased capital formation, investment in real assets, productivity and economic growth that is needed to increase the total U.S. economic pie from which the retirement costs of a larger aged population will have to be paid. This higher savings could be accomplished through a variety of means, including paying down the Federal debt with the annual net cash flow into the trust funds, individual investment accounts funded by a portion of the Social Security tax, and direct investment of trust fund surpluses in non-Treasury financial assets, such as privately issued stocks and bonds. Each of these alternatives raises other important issues and concerns. But what is critical if they are to have "real" economic value is that the currently *projected surpluses in the Social Security and Medicare trust funds somehow translate into stronger economic growth in the years ahead.*

The Social Security trust funds were excluded by law from the Federal Budget totals starting in the early 1990s to prevent their large positive annual cash flow from "masking" the large annual deficits in the rest of the budget at that time. Social Security and Medicare annual surpluses nevertheless continued to be portrayed as offsetting deficits in the remainder of the budget. In the late 1990s this led to the idea of putting these annual surpluses in a "lock box." The "lock box" concept reflected, in effect, only an informal agreement between the President and the Congress that the Social Security and Medicare annual surpluses would be used to pay down the Federal debt rather than to fund other government expenditures or tax cuts, in the expectation that this would lead to greater national savings. While several factors in the past year have made this agreement moot for now, rapid economic recovery could again offer the possibility of using trust fund surpluses to increase national savings.

Conclusion

While projected assets of the HI and OASDI trust funds result in Medicare and Social Security being adequately financed from the programs' viewpoint for nearly another three and four decades, respectively, such a perspective belies the enormous fiscal challenge these programs pose in both the shorter and longer term. At the time of expected OASDI Trust Fund asset exhaustion in 2041, annual Social Security expenditures are projected to already exceed annual tax income by 37 percent, with this excess growing to 52 percent by the end of the 75-year projection period. Similarly, at the time of HI Trust Fund exhaustion in 2030, annual expenditures are projected to already exceed tax revenues by 47 percent, with this gap growing to over 200 percent by the end of the projection period. While SMI technically has no projected shortfall—because its sources of revenue, premiums from retirees and general revenue transfers from the U.S. Treasury to the SMI Trust Fund, automatically increase in line with costs under current law—its costs nevertheless will require a substantially increasing draw on the Federal Budget. The annual costs of SMI alone are projected to grow from 1 percent to 2.1 percent of GDP over the next 30 years and to exceed 3.5 percent of GDP in 75 years.

From a unified budget perspective, fiscal pressure from Medicare and Social Security will appear early in the next decade, with the beginning of the retirement of the baby-boom population, and mount quickly thereafter, *as SMI continues to grow rapidly and the annual surpluses in OASDI and HI turn to annual deficits. As Public Trustees, we believe that continued national dialogue about the future financing of Medicare and Social Security is imperative. It is important that changes be initiated in these programs sooner rather than later to bring them into long-term fiscal balance. We also believe it is important that the annual surpluses currently projected for the programs over the next 15 years make a positive contribution to national savings, in order to ease the future economic burden imposed by the higher retirement and health care costs of the aging of the baby-boom population.*

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