THE REAL FISCAL DANGER

> The current system is financially unsustainable. Without reform, the promise of Social Security to future retirees cannot be met without eventual resort to benefit cuts, tax increases, or massive borrowing. The time to act is now.
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> Interim Report of the President's Commission to Strengthen Social Security
> August, 2001
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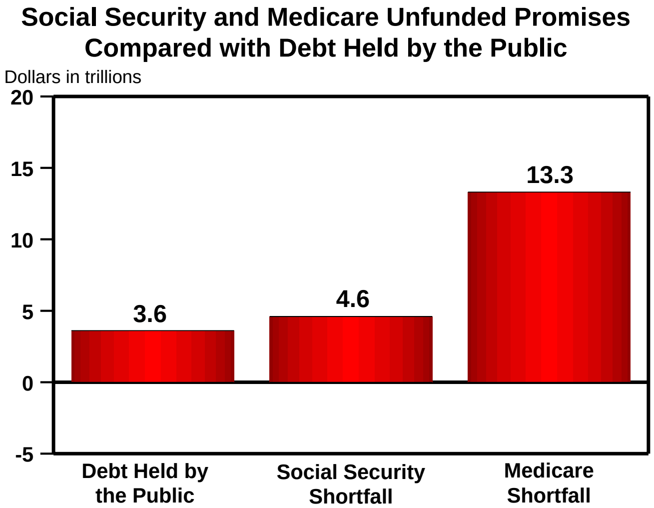
> *Without meaningful reform, the long-term financial outlook for Medicare is bleak...When viewed from the perspective of the entire budget and the economy, the growth in Medicare spending will become progressively unsustainable over the longer term.*
>
> David Walker, Comptroller General of the United States
> April 7, 2002

As noted frequently in this document, the federal government appears likely to spend more than it takes in for at least the next few years. Although the resulting deficits are manageable by any reasonable standard, they are cause for legitimate concern and attention. But whatever judgment one reaches about the deficit of this year or even the next several years combined, these deficits are tiny compared to the far larger built-in deficits that will be generated by structural problems in our largest entitlement programs. Social Security and Medicare combine to provide financial support to 39 million seniors—14 percent of our population—and account for one-third of total federal spending. As our population ages and health care costs continue to escalate, the costs of these programs will grow enormously, in fact, so rapidly that they will threaten to overwhelm the rest of the budget.

Americans have often heard that Social Security and Medicare are in deep trouble financially, and the simple reason is that the benefits promised under these programs will soon far outstrip their dedicated revenues. Over the long term, the actuaries of the Social Security Administration project that the cost of all benefits paid to current beneficiaries and promised to future retirees exceed Social Security revenues by almost $5 trillion. The Medicare shortfall is even worse at more than $13 trillion.

Citizens and policymakers rightly monitor and debate the size of the national debt, which stands at $3.5 trillion in public hands, with another $2.7 trillion credited to various government trust funds. But in 2002 the combined shortfall in Social Security and Medicare of nearly $18 trillion was about five times as large as today's publicly held national debt. In other words, it would take an additional $18 trillion in today's dollars to pay for the obligations of these systems as they are now constituted. This is roughly the equivalent of the total income Americans will earn over the next year and a half. Expressed yet another way, the combined shortfall in Social Security and Medicare was eight times the amount of total government spending in 2002.



The figures on Social Security and Medicare's unfunded promises are subject to some variation depending on the underlying assumptions made. (The analysis is presented in much greater detail in the Stewardship chapter in the *Analytical Perspectives* volume.) However, no conceivable combination of reasonable assumptions can erase the problems in Social Security or Medicare. The Social Security and Medicare shortfalls compel change. They must not be left hanging over the heads of our children and grandchildren. The longer the delay in enacting reforms, the greater the danger, and the more drastic the remedies will have to be. The Administration is committed to making these two programs financially sustainable so they can continue to serve our seniors now and in the future without jeopardizing the financial security of generations to come.

Entitlements on the Brink

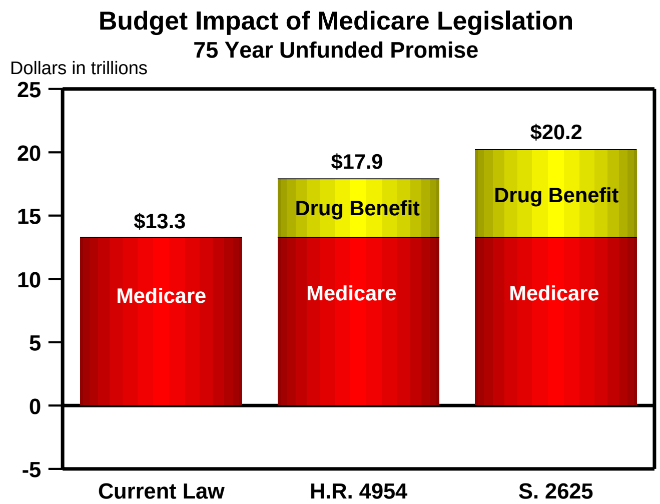
Social Security and Medicare represent an enormous financial burden for America's workers through the payroll tax. The Social Security portion of the tax is 12.4 percent of a worker's wages up to a total tax take of $10,528 in 2002, while Medicare's tax is 2.9 percent of wages and there is no cap on the tax. For the great majority of households, the amount paid in payroll taxes each year (counting both the employer and employee share) exceeds that paid in federal income taxes. The true burden is even heavier; to pay Medicare's bills a massive subsidy ($78 billion in 2002) must be funded out of other government taxes.

Despite the enormous revenue flows into Social Security and Medicare, totaling $729 billion in 2002, these programs are going to spiral out of control. Social Security's dedicated receipts, which include both payroll taxes and income taxes levied on Social Security benefits, did exceed Social Security spending by $82 billion in 2002. But by 2017 this surplus is projected to become a deficit and Social Security as presently designed would never return to balance.

Medicare is in even worse shape. Its payroll taxes do not even come close to covering its costs, and the gap is projected to get steadily worse absent reform of the system. Medicare's problems are so much worse simply because its promised benefits grow with the increase in health care costs, which are widely projected to grow much faster than inflation. So Medicare and Social Security must each be refashioned to address the fact that there are more and more beneficiaries per worker paying taxes into these systems, but Medicare must also be reformed to account for rapidly rising health care costs.

Given the financial challenges faced by Medicare in the future, the Congress must be extremely careful that legislative changes not add to long-term unfunded promises. As a case in point, the bills that advanced furthest in the last Congress would have increased the Medicare long term unfunded promise by an estimated $4.6 trillion and $6.9 trillion, respectively.

These high and perpetual deficits make it obvious that Social Security and Medicare are in deep trouble. But it can still be difficult to grasp the true magnitude of the problems they pose for future workers. These are highly complex programs extending over many generations. For the same reasons, it is inadequate to assess the long-run financial consequences of a proposed change in these programs over a one-, five-, or even a 10-year horizon. What a proposed reform is estimated to cost over its first five or 10 years is less important than whether it reduces or worsens the unfunded (and unfundable) liabilities of the system. Hence the importance of taking a longer time horizon, for example, as is reflected in the 75-year estimates.



What Does $18 Trillion Mean to You?

While the analysis may be unfamiliar to many Americans, the meaning of the results is straightforward. Total household wealth in the United States was $40.2 trillion in 2002. The combined Social Security and Medicare shortfall is nearly $18 trillion. This means that the federal government would have to confiscate almost half of all household wealth to have the resources necessary to close both these programs' future financing gaps.

Of course, it is not necessary to pre-fund promised Social Security and Medicare benefits immediately. In theory, the Congress could enact a 7.1 percent permanent increase in the payroll tax to close the combined shortfalls over time. This would mean a permanent payroll tax increase to a rate of 22.4 percent, amounting to about $3,000 in additional taxes every year for an average family. A tax increase of this magnitude is unthinkable. It would devastate the economy, job growth, and family finances, but it does serve to indicate the magnitude of the problem we would be leaving to future generations if we fail to act.

Today's seniors and near retirees are counting on Social Security and Medicare to provide retirement income and health insurance. They should never doubt that promises made will be promises kept. But it is also true that these programs cannot continue as they are structured today. We must make a different kind of promise to the retirees of tomorrow. We must not delay in enacting reforms to make these programs financially sustainable. Delay erodes the confidence of today's workers that Social Security and Medicare will be there for them when they retire. And delay increases the financial threat that we leave to our children and grandchildren.