National Center for Policy Analysis

BRIEF ANALYSIS
No. 257
For immediate release:
Friday, February 13, 1998

Can Social Security and Medicare Be Saved?

President Clinton wants to use any possible budget surplus to save Social Security. Republican leaders in Congress want to use any money from a possible tobacco settlement to save Medicare. But neither approach will work unless we replace our chain-letter approach to elderly entitlements with fully funded systems, under which each generation finances its own retirement and health care expenses.

How Pay-As-You-Go Finance Works. Under the current system, every dollar collected in (FICA) payroll taxes is spent — the very minute, the very hour, the very day it comes in the door. Payroll tax revenues are mainly spent on Social Security benefits and Medicare expenses. If anything is left over, the funds are spent on something else. But nothing is saved. No money is stashed away in bank vaults. No investments are made in real assets.

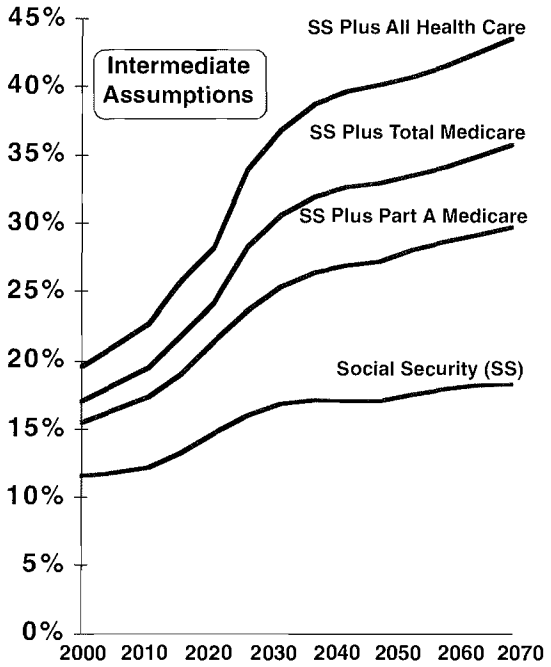
Pay-as-you-go finance means that taxes taken from today's workers pay for the benefits government provides to today's retirees. When today's workers reach the retirement age, their benefits will be paid only if higher taxes are collected from the next generation of workers. How high will future taxes have to be?

Crisis Created by Baby Boomers' Retirement. As Figure I shows, the tax rate needed to pay benefits to retirees is expected to grow continuously — as far into the future as we care to look. Today the payroll tax that funds Social Security and Medicare Part A (mainly hospital bills) is 15.3 percent. But when today's baby boomers begin early retirement in 2010, the government will need 17 percent of workers' wages to pay these benefits. To also pay the government's share of Medicare Part B (mainly physicians' fees), the tax burden will be equivalent to 19 percent. And to cover elderly health care expenses through Medicaid and other programs, the total bill will be 23 percent — more than a fifth of workers' incomes that year.

By 2030, when all boomers will be beyond age 65, the needed tax revenue will be much higher. For example, the payroll tax for Social Security and Medicare Part A will have to be 25 percent. And to pay for Medicare Part B and other health care commitments, the tax burden will have to be 37 percent. *That's more than one-third of workers' incomes just to pay benefits already promised under current law.*

FIGURE I

Elderly Entitlement Spending As a Percent of Taxable Payroll



Source: National Center for Policy Analysis and *1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

These projections are based on the Social Security Trustees "intermediate" projections. If pessimistic assumptions are used, the future looks much worse. By 2010, the government will need 27 percent of payroll, and by 2030, it will need 55 percent — *or more than one-half of the income workers will earn that year.*

Prospects for Young People Entering the Labor Market. Based on the Social Security Trustees' own projections, there is a good reason why more young people believe in UFOs than believe they will get promised Social Security benefits. The taxes needed to pay those benefits are higher than government is likely to be able to collect from future workers — most of whom are not yet born.

As Figure II shows, by the time today's 20-year-olds are eligible for Social Security, we will need almost one-third of workers' incomes to pay Social Security and both parts of Medicare on the intermediate forecast. Under the pessimistic forecast, almost 53 percent of the entire taxable payroll will be required just to fund Social Security and Medicare benefits already promised the elderly under current law.

When other government spending on health care for the elderly is included, government will need from 40 percent of workers' incomes (intermediate forecast) to more than two-thirds (pessimistic forecast).

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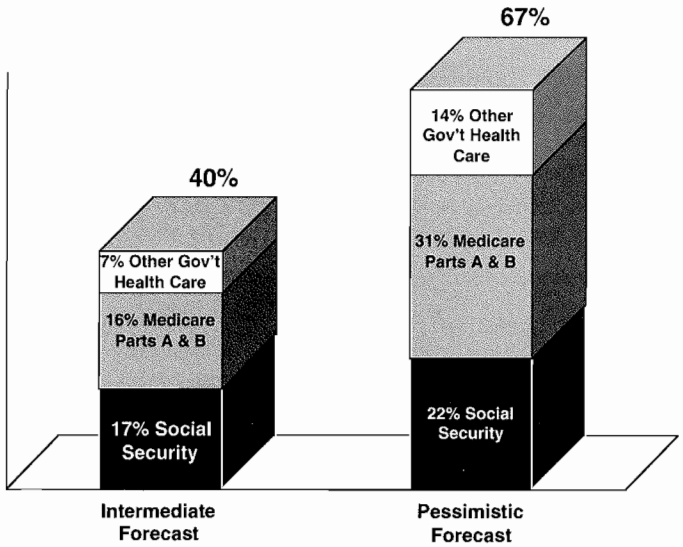
Why the Trust Funds Don't Matter. Payroll tax collections currently exceed benefit payments. The surplus is credited to Social Security and Medicare trust funds and is then borrowed by the federal government in exchange for special, nonnegotiable Treasury bonds. The bonds are nothing more than IOUs the government writes to itself.

On paper, the Social Security trust funds have enough IOUs to "pay" Social Security benefits for about 17 months on any given day; the Medicare trust fund can "pay" benefits for about one year. In reality, they cannot pay anything. Every asset of the trust funds is a liability of the Treasury. Summing accounts over both agencies of government, the balance is zero. For the Treasury to write a check, it must first tax or borrow.

If the trust funds were simply abolished, real economic activity would be unaffected. No private bondholders would suffer. The government would not be relieved of any of its existing obligations or commitments. Liberal economist Robert Eisner has suggested that we could abolish the trust funds or, with the stroke of a pen, double or triple the number of IOUs they hold. Either option would allow us to dispense with artificial crises and address the real problem: how the Treasury is going to pay the government's bills.

FIGURE II

Tax Burden in 2045



Source: National Center for Policy Analysis and *1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Other Countries Have Systems That Work. The alternative to a pay-as-you-go system is to fund benefits by saving. Let each generation save for its own retirement benefits and pay its own way. Some countries have already taken this step. For example:

- Britain allows employers and workers to opt out of the second tier of the state pension system by setting up private pension plans with benefits at least as generous as those promised under the government system.
- Australia requires workers to contribute to privately managed retirement savings plans.
- Chile requires workers to save for their own retirement by making regular deposits to private pension accounts, similar to American Individual Retirement Accounts (IRAs).

These systems are fully funded, and each generation provides for its own retirement. This averts the long-term financial crisis inherent in a chain-letter approach. It also encourages saving, which in turn generates higher economic growth.

Why Budget Surpluses Can Help Make the Transition. How do we get from here to there? All serious proposals made to date have involved giving individuals tax deductions or tax credits for deposits to private investment accounts. In return for the right to make such deposits, individuals would give up the right to draw a dollar in benefits for each dollar deposited in their private accounts. After a number of years, the private account balances would grow to a point at which the account holders' claims against government programs would be zero. Through such a mechanism, individuals could opt out of Medicare, Social Security and the survivors and disability system as well.

But if payroll taxes were lower, how would we fund retiree benefits? Clearly, government must find other sources of revenue. That's where budget surpluses and tobacco settlement moneys come into play. They can smooth the transition to a fully funded retirement system, under which each generation pays its own way.

This Brief Analysis was prepared by NCPA President John C. Goodman and NCPA Senior Scholar Dorman E. Cordell.