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The Nightmare in Our Future – 2001 Update

By Matt Moore

Social Security and Medicare are in trouble. By 2016, both programs will begin paying out more in benefits than they receive in payroll taxes. And the government will no longer be able to maintain full benefit payments to retirees at current tax rates. These programs will consume an ever-increasing portion of workers' incomes if the government is to keep its promises.

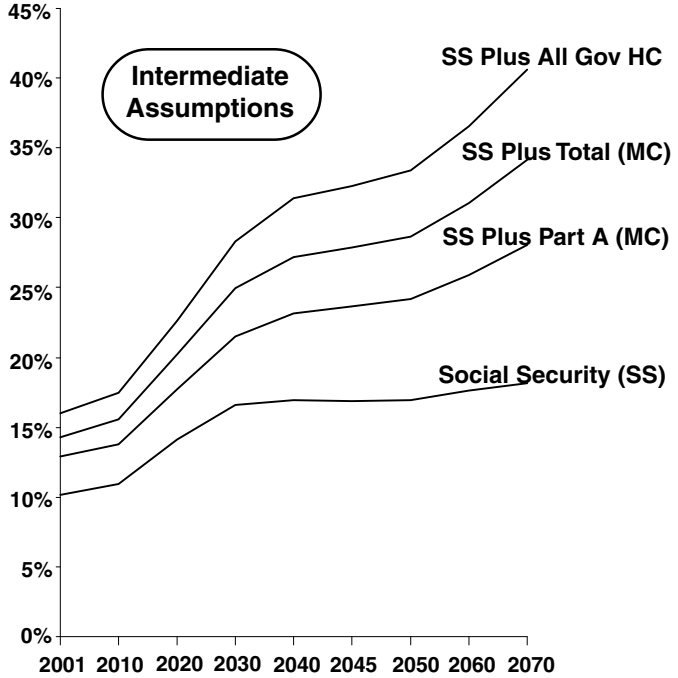
How Pay-As-You-Go Finance Works. Under the current system, every dollar collected in (FICA) payroll taxes is spent — the very minute, the very hour, the very day it comes in the door. Payroll tax revenues are mainly spent on Social Security benefits and Medicare expenses. If anything is left over, the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

Social Security and Medicare are pay-as-you-go programs. That means taxes taken from today's workers primarily pay for the benefits government provides to today's retirees. And when today's workers retire, their benefits will be paid only if higher taxes are collected from the next generation of workers.

Rising Tax Rates: Intermediate Projections. As Figure I shows, the tax rates needed to support Social Security, Medicare and other health care benefits for the elderly will grow continuously — as far as the eye can see.

FIGURE I

Elderly Entitlement Spending As a Percent of Taxable Payroll



Source: National Center for Policy Analysis calculations and *2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

- Today the payroll tax rate for Social Security retirement and disability insurance is 12.4 percent.
- By the year 2030, when all the baby boomers will have reached retirement age, the government will need 16.6 percent of workers' incomes to pay Social Security benefits.
- Add Medicare Part A (primarily hospital bills) and the government's share of Medicare Part B (primarily physicians' fees) and the burden will climb to 24.6 percent.
- When other elderly health care expenses like Medicaid and the Veterans Administration are included, the total bill rises to 27.9 percent of payroll.

When today's 18-year-olds become eligible for retirement in 2050, their children and grandchildren will face a payroll tax of 17 percent to pay Social Security benefits. Include Medicare Part A and B and other health care benefits and the payroll tax will have to be 32.8 percent. [See Figure II.] That's almost a third of future workers' incomes just to pay benefits already included in current law. Moreover, this burden will come on top of all the other services taxpayers will be expected to fund — from roads and bridges to salaries for teachers and police officers. And it will be even greater if Congress tacks on a new Medicare prescription drug benefit (which is imminent) or a long-term care benefit (which seems likely in a few years).

Rising Tax Rates: Pessimistic Projection. Nor is this the worst that can happen. These numbers are based on the intermediate (most likely) projections of the Social Security Board of Trustees. Under pessimistic

Dallas Headquarters: 12655 N. Central Expy., Suite 720 • Dallas, TX 75243-1739 • 972/386-6272 • Fax 972/386-0924
Washington Office: 655 15th St. N.W., Suite 375 • Washington, DC 20005 • 202/628-6671 • Fax 202/628-6474
For more information: Sean Tuffnell in Dallas at 972/386-6272 or Joan Kirby in Washington at 202/628-6671

projections made by the trustees, by 2050 the total taxes needed to support elderly benefits will climb to 55.4 percent. On this projection, we have already pledged more than half of the incomes of future workers — most of whom are not yet born and who could not have agreed to be part of a chain-letter approach to funding retirement benefits.

Why the Trust Funds Don't Matter. Payroll tax collections currently exceed benefit payments and are expected to do so for a number of years. The resulting surplus is credited to the Social Security and Medicare trust funds and is then borrowed by the federal government in exchange for special Treasury bonds. The bonds, however, cannot be sold on Wall Street or to foreign investors; they 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 28 months, and the Medicare trust fund can "pay" benefits for about 16 months. 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, the government 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. Alternatively, with the stroke of a pen, the government could double or triple the number of IOUs in the trust funds. 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.

Reforming Pay-As-You-Go Can Help. These dismal financial outcomes can be avoided. Instead of a pay-as-you-go approach that forces retirees to rely on the taxes paid by younger generations, we could have a fully funded system in which each generation pays its own way.

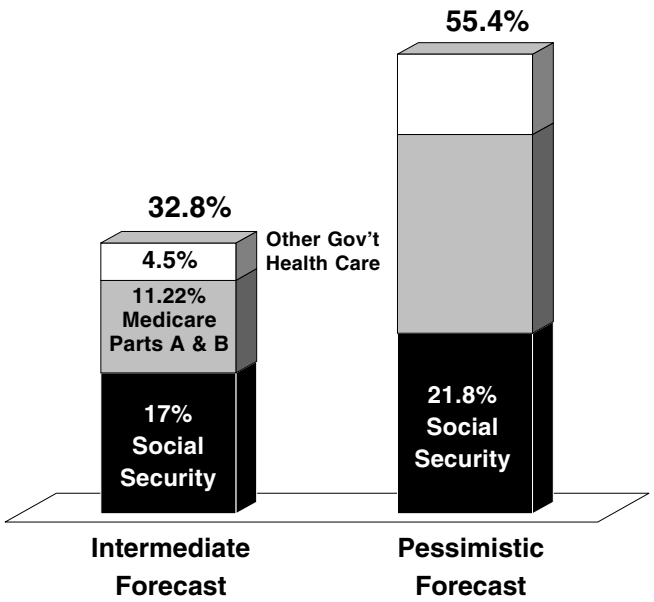


FIGURE II

Payroll Tax Burden in 2050

Source: National Center for Policy Analysis calculations and *2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Most Social Security reform proposals would allow workers to invest a portion of their payroll taxes in a personal retirement account. The higher long-run rates of return offered by equities markets would allow individual workers to earn more on their investment than Social Security pays. Over time, the personal accounts would grow, assuming an increasing portion of the government's Social Security burden. The government would curtail spending and retirees would reap a larger benefit than under the current system.

Conclusion. Higher taxes to meet the future burdens of Social Security and Medicare are inevitable. However, by replacing the pay-as-you-go structure of these programs with a partially fully funded system, the government can provide secure retirement benefits without skyrocketing tax rates and at least ameliorate the nightmare in our future.

Matt Moore is a policy analyst with the National Center for Policy Analysis.