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Social Security & Medicare Forecast: 2004

by Matt Moore

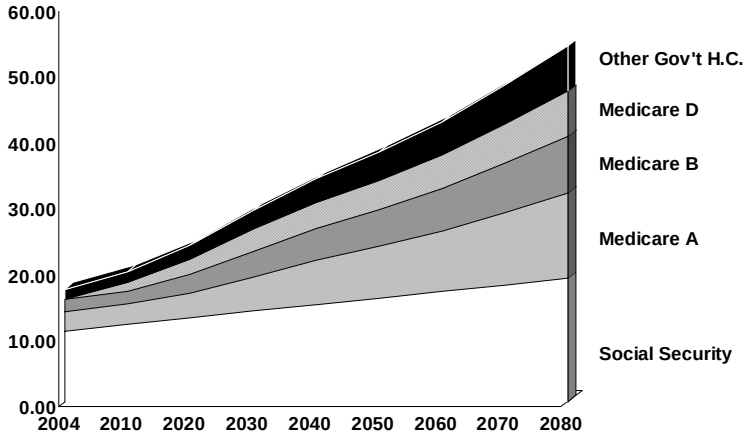
The 2004 annual reports for Social Security and Medicare examine the short- and long-term health of these programs, and highlight the financial burdens they will create for future generations. If not reformed in a timely and responsible way, Social Security and Medicare will consume an ever-increasing portion of workers' incomes or the government must break its promises to future retirees.

Rising Payroll Tax Rates: Intermediate Projections. Social Security and Medicare Part A (Hospital Insurance) payments are funded by a 15.3 percent payroll tax on wages (12.4 percent for Social Security; 2.9 percent for Medicare). Since the two programs together consume only 13.7 percent of taxable payroll, they run a small surplus each year. This will not last. According to the Social Security and Medicare Trustees' "intermediate" forecast [see Figure I]:

FIGURE I

Elderly Entitlement Spending as a Percent of Taxable Payroll

Intermediate Forecast



Source: 2004 Social Security and Medicare Trustees Reports and NCPA calculations.

- When today's college students reach retirement age in 2050, their children and grandchildren will face a payroll tax rate of 17 percent just to pay Social Security benefits — a 37 percent increase over today's rate.
- When Medicare Part A is included, the payroll tax burden will have to rise to 24.9 percent — almost one of every four dollars workers will earn that year.

In addition to these two programs, there is also Medicare Part B (Supplementary Medical Insurance) and Medicare Part D (the newly-enacted Medicare prescription drug benefit). Also, taxpayers fund seniors' medical bills through other government programs, including Medicaid and the Veterans Health Administration. Although the costs for these programs are paid from general revenues and state transfers, they too can be expressed as a percentage of taxable payroll:

- If the federal and state governments' shares of Medicare Part B and Part D are added to Social Security and Medicare Part A, the burden on workers will climb to 34.9 percent by 2050 — more than one in three dollars of taxable payroll.
- When other government-funded health care expenses are added, the total burden will reach 39.17 percent by mid-century.

Thus, about 40 percent of the wages workers earn in 2050 has already been committed to pay benefits promised under current law. That's before any bridges or highways are built and before any teachers' or police officers' salaries are paid. If any new entitlement benefits such as more generous prescription drug coverage or long-term care benefits are added, the future burden will be even higher.

Rising Payroll Tax Rates: Pessimistic Projections. Nor is this the worst that can happen. The estimates in Figure I are based on the Trustees' intermediate projections. Under their pessimistic projection, by 2050 the total amount needed to support elderly benefits will climb to 67.8 percent of taxable payroll, claiming more than two-thirds of the incomes of future workers. [See Figure II.]

The intermediate assumptions are touted as "most likely" to happen. However, the pessimistic assumptions may more accurately predict future health care expenditures. In recent years, medical cost inflation has been moderate compared to annual increases a few years ago. Many believe the recent lower inflation rate is temporary and that health care costs will soar.

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Rising Income Tax Rates. While the problems grow over time, their effects are already being felt. Social Security and Medicare Part A have collected more in payroll taxes than they have paid in benefits for many years; but, this year alone, the two programs will drain about $45 billion from general revenues. And with each passing year, the drain will become larger — if there is no change in taxes or benefits.

For example, the amount of general revenues needed to fund Social Security and Medicare benefits will double in less than five years. They will double again in another five years, so that 10 years from now, one in seven dollars collected in income taxes will be spent on elderly entitlements — in addition to all they will receive from payroll taxes.

- By 2030, about the midpoint of the baby boomer retirement years, the two programs will need about half of all federal income taxes to pay full benefits.
- By 2050, Social Security and Medicare will require three in four income tax dollars collected, in addition to payroll taxes.
- By 2070, all federal income tax revenues will be needed to provide full promised Social Security and Medicare benefits.

Again, these figures are based on the intermediate projections, so the reality could be worse.

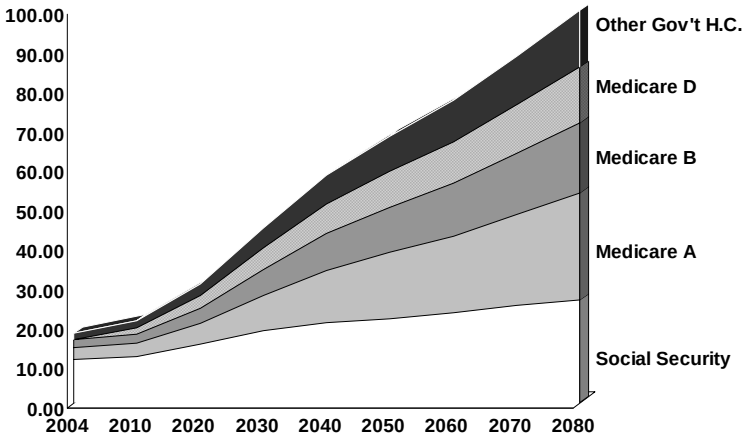
Social Security and Medicare Are Pay-As-You-Go. Elderly entitlement programs are in trouble precisely because they are based on pay-as-you-go financing. Every dollar in payroll taxes is spent. Nothing is saved. Nothing is invested. The payroll taxes contributed by today's workers pay the benefits of today's retirees. Likewise, when today's workers retire, their benefits will be paid only if the next generation of workers agrees to pay even higher taxes.

What About the Trust Funds? Unfortunately, the Social Security and Medicare Trust Funds exist purely for accounting purposes — to keep track of surpluses and deficits in the inflow and outflow of money. The accumulated Social Security surplus consists of paper certificates (nonnegotiable bonds) kept in filing cabinets in Social Security offices in West Virginia. These bonds cannot be sold on Wall Street or to foreign investors. They can only be returned to the Treasury. In essence, they are little more than IOUs the government writes to itself.

FIGURE II

Elderly Entitlement Spending as a Percent of Taxable Payroll

Pessimistic Forecast



Source: 2004 Social Security and Medicare Trustees Reports and NCPA calculations.

Every payroll tax check signed by employers is written to the U.S. Treasury. Every Social Security benefit check comes from the U.S. Treasury. The trust funds neither receive money nor disburse it. Moreover, every asset of the trust funds is a liability of the Treasury. Summing over both agencies of government (the trust funds plus the Treasury), the balance is zero. For the Treasury to write a Social Security check, the government must first tax or borrow.

Solutions. President Bush and others have proposed personal retirement accounts as a solution to Social Security's financial problem. The Bush plan would allow younger workers to set aside some of their Social Security contributions in personal accounts, which would be invested in the market. The accounts would earn market returns over the workers' lives and pay part of their Social Security benefits at retirement. Since each generation would save toward its own retirement, the burden of Social Security on future generations would be dramatically reduced.

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