Baby Boomer Retirement:
The Nightmare in Our Future

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Testimony

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In 2011, the first group of baby boomers will reach the age of 65. Some will begin claiming early retirement in just three years. By the time they are through, 77 million of them will have ceased working and paying taxes and will have begun receiving taxpayer-funded health care and pension benefits. This will create a financial train wreck for Social Security, Medicare and Medicaid and all other programs for the elderly. Other countries in the developed world face even bigger problems. In Japan, Europe and North America, the number of retirees will double over the next 25 years while the number of taxpayers will grow by only 10 percent. The economic consequences of these changes are dire: higher taxes, slower growth and lower living standards relative to what otherwise would have occurred.[1]

In the United States, we have made promises to senior citizens that far exceed what we can pay for at current tax rates. As a result, future retirees will have to rely more on private savings than previous generations. For this reason, we need programs that encourage private sector saving. The ideal would be to encourage private saving and reduce future government entitlement obligations at the same time. This could be accomplished with personal retirement accounts.

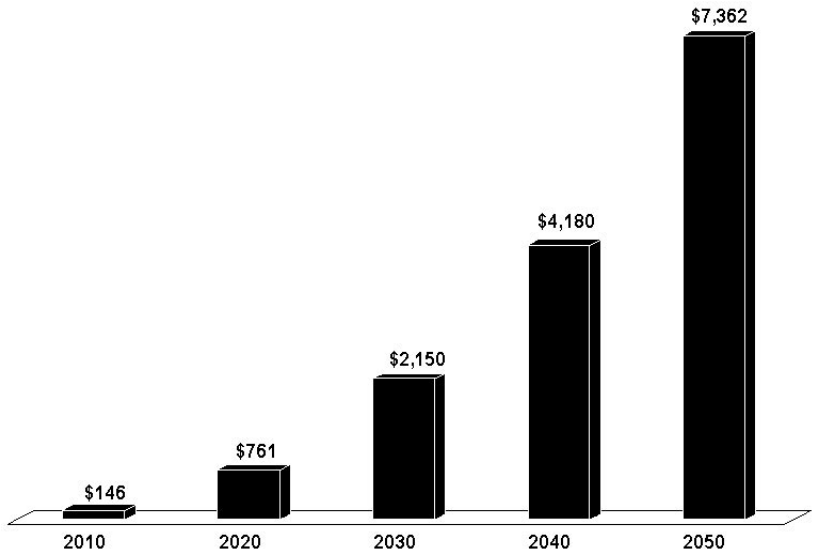
The Cash Flow Problem. In a pay-as-you-go system, what matters most is cash flow. And the cash flow drain that elderly entitlement programs portend is not a problem of the distant future, as some argue. The problem has already begun.

Social Security and Medicare have been receiving more in payroll taxes than they have been paying out in benefits for several decades. Last year, the two programs combined spent more than they took in, requiring a general revenue subsidy of about $45 billion. The magnitude of the deficits in these two programs will soar in the years to come.

For those who believe that Social Security and Medicare are in sound financial shape for decades to come, Figure I presents a sobering picture. In fact, the latest numbers from the Trustees of Social Security and Medicare are staggering. In 2010, the federal government will need $127 billion in additional funds to pay promised benefits. Five years later, the size of the annual deficit will double. Five years beyond that, it will double again. In just 15 years, the federal government will have to raise taxes, reduce other spending or borrow $761 billion to keep its promises to America's senior citizens. As the years pass, the size of the deficits will continue to grow. Without changes in worker payroll tax rates or senior citizen benefits, the shortfall in Social

FIGURE I

Annual Cash Flow Deficits in Social Security and Medicare
(Billions of dollars)



Source: 2004 Annual Reports of the Board of Trustees of Social Security and Medicare.

Security and Medicare revenues compared to promised benefits will top more than $2 trillion in 2030, $4 trillion in 2040 and $7 trillion in 2050![2]

These deficit numbers include projected inflation. Yet even in 2004 dollars, the numbers are still staggering. Valued in today's dollars, the annual Social Security deficit will top $50 billion in 2020, $250 billion in 2030 and $400 billion in 2050. Adding Medicare's deficits, the federal government will need more than $500 billion in 2020, $1 trillion in 2030 and $2 trillion in 2050 to fund elderly entitlement programs alone.[3]

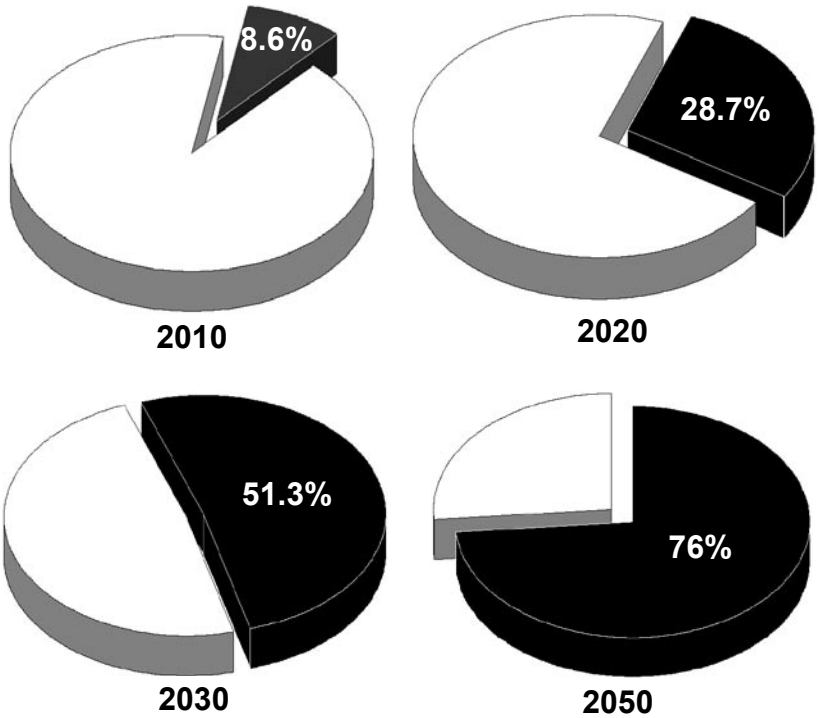
Note that these estimates, which come from the latest Social Security Trustees report, do not include the growing burden of senior health care costs under Medicaid.

Deficits as a Percentage of Other Federal Revenues. The combined budget shortfalls for Social Security and Medicare are so large that it is difficult to comprehend what the numbers mean. Figure II presents the projected deficits as a percentage of federal income tax revenues. It shows that combined Social Security and Medicare deficits will equal almost 10 percent of federal income taxes in just five years. Roughly this means that, if the federal government is to keep its promises to seniors, it will have to stop doing one in every ten things it does today. Alternatively, we will have to raise income taxes by 10 percent or borrow an equivalent sum.

Ten years later, in 2020, combined Social Security and Medicare deficits will equal almost 29 percent of federal income taxes. At that point the federal government will have to stop doing almost a third of what it does today. By 2030, about the midpoint of the baby boomer retirement years, federal guarantees to Social Security and Medicare will require one in every two income tax dollars. By 2050, they will require three in every four.[4]

FIGURE II

Percent of Federal Income Tax Revenues Needed to Fund Social Security and Medicare Deficits



Source: Andrew J. Rettenmaier and Thomas R. Saving, "The 2004 Medicare and Social Security Trustees Reports," National Center for Policy Analysis, Policy Report No. 266, June 2004; and the 2004 Annual Report of the Board of Trustees of Social Security and Medicare.

What about the Trust Funds? The Social Security and Medicare Trust Funds serve an accounting function, not an economic one. They work like this: When payroll tax revenues exceed expenses, special bonds are created to keep track of the surplus. These bonds are not purchased in the marketplace, however. For Social Security, they are created on paper and placed in filing cabinets in Parkersburg, West Virginia, (for Medicare, they are computer entries only) while the actual surplus payroll tax dollars are spent on other things. When tax revenues fall short of expenses, the process is reversed: the bonds are taken out of the filing cabinets and retired.

The Social Security Trust Fund currently holds about $1.6 trillion of these bonds. But the bonds cannot pay benefits. They cannot be sold on Wall Street or to foreign investors. Although they are treated as assets of the Trust Fund, they are also liabilities of the Treasury. Summing over both agencies of government, assets plus liabilities net out to zero. If the federal government had purchased assets with the Social Security surpluses, the trust funds would today represent real economic value. Instead, Social Security revenues were spent in other ways and the government essentially wrote IOUs to itself.

If a fire were to destroy the filing cabinets in Parkersburg, it would in no way diminish the capacity of the federal government to pay benefits. Alternatively, if a stroke of the President's pen were to double or triple the number of bonds in those filing cabinets, that would in no way increase our ability to pay benefits. If we could create value by writing IOUs to ourselves, Social Security would have no financial problems. Unfortunately, there is no free lunch.

Present Value of Unfunded Liability. Last year, for the first time since the inception of these programs, the Social Security Trustees did something private entities do routinely — they calculated the present value of the difference between the promises we have made and the expected revenues dedicated to keeping those promises. These calculations were made for the traditional 75-year horizon and (what economists consider the more accurate procedure) looking indefinitely into the future. These implied, unfunded liabilities are enormous:[5]

- Social Security's long-run cash flow deficit is $11.1 trillion — almost equal to the current size of the entire U.S. economy.
- The total shortfall of Medicare Part A (hospital insurance) and Part B (doctors' services) is $47.7 trillion; and the new prescription drug benefit will require $17.7 trillion.
- The unfunded liability of Medicare and Social Security combined totals more than $76.5 trillion — more than seven times the size of our economy.

This means that without ever raising taxes or cutting benefits, we need $76.5 trillion invested right now at the government's borrowing rate. And because we have not made that investment, our unfunded liability under Social Security is growing at the rate of $667 billion per year. The unfunded liability under Medicare is growing at a rate of $4 trillion per year.

Moving to a Funded System. The underlying problem in the United States and throughout the developed world is reliance on pay-as-you-go finance. Every dollar that is collected in payroll taxes is spent. It is spent the very day, the very hour, the very minute it is received. No money is being stashed away in bank vaults. No investments are being made in real assets.

In a pay-as-you-go system, promises made today can be kept only if future taxpayers (many of whom are not yet born) pay a much higher tax rate than workers pay today. And even if they do shoulder a much greater burden, they would have no assurance that their benefits would be paid as the necessary tax burden grows through time. In any event, this chain letter approach to paying for retirement benefits must eventually come to an end. The question is: can we find an orderly way to transform the system that minimizes the pain.

The alternative to a pay-as-you-go system is a funded system, where worker contributions are saved and invested. Instead of depending on future generations of taxpayers to pay ever-escalating tax rates, in a funded system each generation pays its own way.

Thirty countries have already gone through the process of transforming their pay-as-you-go systems into partially or fully funded systems. These countries have acted responsibly to deal with a problem that the United States so far has refused to face.[6]

Personal Retirement Accounts. It is possible to fund a retirement system without creating individually owned and controlled accounts. After World War II, almost two dozen former British colonies set up forced savings plans (called provident schemes) as an alternative to the pay-as-you-go approach so popular elsewhere around the world. The most successful of these was established by Singapore.[7]

Despite the evolution and success of Singapore's system, in most cases provident funds have had a spotty and disappointing record. The reason: when funds were managed and controlled by governments, all too often politicians succumbed to the temptation to spend the funds rather than invest them.

Personal retirement accounts create a check on government power. By creating ownership rights and reinforcing the principle of ownership by allowing individual worker investment choices, the odds greatly increase that funds invested today will be able to pay retirement benefits tomorrow.

Notes

[1] Laurence Kotlikoff, Hans Fehr and Sabine Jokisch, "Aging, the Word Economy and the Coming Generational Storm," National Center for Policy Analysis, Policy Report No. 273, February 4, 2005.

[2] The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds and the 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

[3] Ibid.

[4] The Trustees reports express these deficits as a percent of GDP. Here they are converted to a percent of federal income tax revenues, assuming federal revenues are 10.8% of GDP, which is the 50 year average.

[5] Social Security Trustees Report Table IV.B7, and 2005 Medicare Trustees Report Tables II.B12, III.C17 and III.C23.

[6] Estelle James, "Reforming Social Security: Lessons from Thirty Countries," National Center for Policy Analysis, Policy Report No. 277, May 2005.

[7] John C. Goodman, Peter J. Ferrara and John M. Olin, "Private Alternatives to Social Security in Other Countries," National Center for Policy Analysis, Policy Report No. 132, April 1988.