

PHOTO BY GARY GAY, GETTY IMAGES

THE FUTURE OF MEDICARE AND SOCIAL SECURITY:

FUTURE FUNDING OF BOTH PROGRAMS 'WOEFULLY INADEQUATE'

In the government's race to catch up with Social Security spending, there is an even bigger problem that is about to outpace it: Medicare.

Just like Social Security, the cost of Medicare benefits promised to recipients soon will exceed the program's pool of money. However, Medicare's financial woes will far surpass Social Security's as healthcare costs continue to rise faster than economic growth, says Craig Hakkio, senior vice president and director of research for the Federal Reserve Bank of Kansas City. Hakkio and researcher Elisha Wiseman recently explored the challenges of the future of Medicare and Social Security.

Neither program is sustainable under its current financial arrangement. Under current law with no changes, Social Security benefits will be cut in 2041 and Medicare's Hospital Insurance (HI) program benefits will be cut in 2020, according to the Trustees of Social Security and Medicare. And Medicare's Supplementary Medical Insurance (SMI) program will become a larger burden—by 2080, the federal government likely will pay six times as much as it currently pays in SMI benefits.

For both Medicare and Social Security, revenue collected by the government is "woefully inadequate" to pay for benefits promised under the current law, Hakkio says. This means slashed

benefits or tax increases will be necessary to keep the programs viable in the future.

And although the spotlight of concern seems to be shining most prominently on Social Security, the total Medicare HI and SMI shortfall will be about five times that of Social Security's by 2080. While the implications of reduced Social Security benefits are disturbing, reduced Medicare benefits could mean life or death, Hakkio says.

"Finding long-term solutions to these problems is critical," he says. "And the problems only become larger the longer reforms are delayed."

In the beginning

A relatively new program, Medicare came about as an amendment to Social Security in 1965. It has evolved to cover more individuals and offer new benefits, including the recent prescription drug plan, which is part of the Medicare SMI program. Medicare HI benefits are funded primarily by payroll taxes, recipient premiums and income taxes on Social Security benefits that are split with Social Security. Seventy-five percent of Medicare SMI is paid for by the government, resulting in a direct drain on the federal budget.

Social Security was created by President Franklin Roosevelt in 1935 as a post-retirement support program for those 65 and older. There are two programs: one that pays benefits to retired workers or survivors of deceased workers, and a second that pays benefits to disabled workers and their families. Benefits are funded through the payroll taxes of current workers and the income taxes on benefits that are split with Medicare. There is a trust fund that accounts for Social Security revenues and expenditures. Benefits paid by the government are debited from this account, and tax revenue paid to the government is credited to this account.

In 2004, Social Security beneficiaries received \$497.1 billion, while Medicare HI and SMI benefits were \$167.6 billion and \$135.4 billion, respectively. Based on predicted growth and current expenditures, providing all promised benefits in the future for either program will not be possible under current law. While Medicare and Social Security are financially

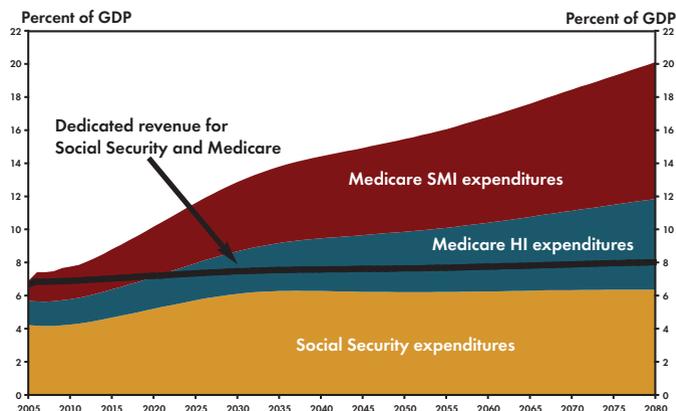
possible now, changes will have to be made to ensure that promised benefits can be paid in full in the future.

"Together, Social Security and Medicare pose a severe challenge," Hakkio says.

The Social Security challenge

Social Security is challenged because the baby boom generation will soon reach retirement age, and program spending is growing faster than both the economy and dedicated revenues. Because all spending must be paid for, the government will be challenged to find additional revenue to pay benefits. Otherwise, spending must be cut.

Federal Spending on and Revenue from Social Security and Medicare



SOURCE: Tables VI.F4 and VI.F9, 2005 Social Security Trustees Report; Tables III.A2, III.A4, II.E1, III.B4, 2005 Medicare Trustees Report

The number of aging baby boomers is expected to grow much faster than the number of workers. As a result, Social Security expenditures likely will jump from the current 4.3 percent to 6.1 percent of the Gross Domestic Product, or the country's total output. This is predicted to happen in 2030, when the last baby boomer turns 65. Beyond that, the level of expenditures will rise only slightly to 6.4 percent of the Gross Domestic Product in 2080.

"Over the next decade or so, Social Security is in sound financial shape, as dedicated revenues will more than pay for promised expenditures, even as expenditures rise," Hakkio says.

TIMELINE

1935

Social Security programs were enacted under President Franklin Roosevelt

1965

Medicare programs emerge as an amendment to Social Security

2003

Medicare Prescription Drug Improvement and Modernization Act enacted

2004

Medicare Hospital Insurance (HI) expenditures exceeded dedicated revenue

2005

Social Security spending was about 1.6 times larger than Medicare spending

2017

Social Security expenditures projected to exceed dedicated revenues

2020

Medicare HI Trust Fund projected to be depleted; benefits will be reduced

2024

Medicare expenditures projected to exceed Social Security's

2030

Last baby boomers turn 65

2041

Social Security Trust Fund projected to be depleted; benefits will be reduced

2080

Medicare's total deficit projected to be about five times Social Security's

But beginning in 2017, everything changes. Projected expenditures will exceed dedicated revenues, and the Social Security Trust Fund, which is principally funded by workers' and beneficiaries' taxes and debited as the government pays benefits, becomes another challenge. The fund will hold a positive balance for a while, and benefits will be paid. But when revenues fall below promised benefits, the government will be forced to find other sources to pay those benefits. This means if there are no changes in other government spending or revenue, the government's total budget deficit will grow.

Between 2017 and 2027, the Trust Fund will spend some of its interest income. But beyond that, through 2040, the fund will continue to pay benefits by selling assets. Without change, the trustees project that the fund will run out in 2041.

"In this event, new revenue sources will be needed if the government is going to continue paying promised expenditures," Hakkio says. "Or else, under current law, promised benefits must be cut to match revenues."

Inarguably, both Medicare and Social Security expenses will soar steadily as the baby boom generation ages. But Medicare is facing another obstacle: sharply rising healthcare costs.

The Medicare challenge

From now through 2023, Social Security's projected expenditures exceed Medicare's. Last year, Social Security's expenditures were about 1.6 times greater than those of Medicare. However, beginning in 2024, Medicare expenditures will be larger than Social Security's and, by 2080, are projected to more than double them.

Medicare benefits depend on the cost of healthcare, unlike Social Security's dependence on past earnings. As a result, Medicare spending will rise much faster than Social Security's, making its fiscal challenge pale by comparison, Hakkio says. Healthcare costs are increasing more rapidly than the economy—about 2 percentage points faster during the past 50 years. Medicare HI expenditures already exceeded dedicated revenues in 2004 and are predicted to keep doing so, depleting the Trust Fund in

2020. Once this happens, promised expenditures will have to decrease to equal revenues, just like Social Security.

A sizable feat

The main long-term problem is that the Social Security and Medicare programs' spending is growing faster than the economy, while the revenue is growing at about the same rate as the economy. Combined benefits currently total about 6 percent of the Gross Domestic Product, but by 2080, that number is estimated to grow to 20 percent. Because this spending must be paid for and dedicated revenue won't cover the cost, the government must find additional money to pay benefits. Otherwise, benefits must be cut to reduce spending.

"The dedicated sources of revenue available to the government are woefully inadequate for financing the benefits promised to current and future beneficiaries," Hakkio says.

It is estimated that the present value of the combined programs' future shortfall during the next 75 years is \$35.6 trillion, or about \$119,000 per person. Funds need to be increased by this amount (in present value), or benefits would need to be cut in order to balance revenues and expenditures during this time period.

The size of this predicted shortfall is unprecedented. In comparison, it is more than four-and-a-half times the amount of the current government debt, which was \$7.9 trillion at the end of the 2005 fiscal year. And beyond 2080, the projected shortfall is even larger.

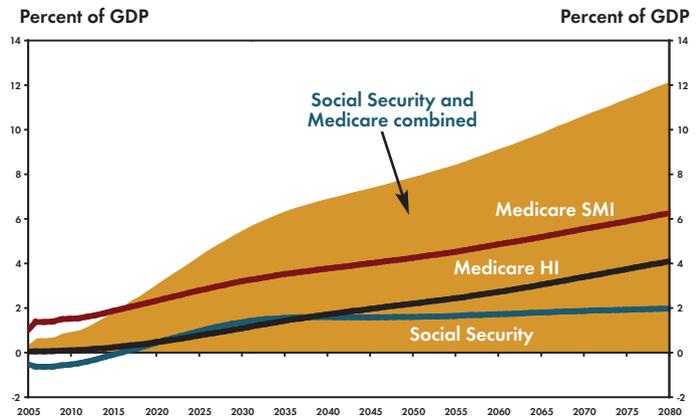
"The magnitude of the fiscal challenge facing the United States—finding the revenue to pay for these expenditures—is growing," Hakkio says.

The future: Don't wait

"With a fiscal challenge so large, there may be a tendency to postpone taking action," Hakkio says.

Delayed action is a mistake for a couple of reasons. First, if benefits have to be cut or if taxes have to be raised, then individuals would need ample time to plan and adjust. Additionally, the problem only gets larger the longer the government waits to act.

Federal Revenue Shortfall from Social Security and Medicare



SOURCE: Tables VI.F4 and VI.F9, 2005 Social Security Trustees Report; Tables III.A2, III.A4, II.E1, III.B4, 2005 Medicare Trustees Report

With the gap between benefits and dedicated revenue so large, changes must be made to the Medicare and Social Security programs. There are three options: reduce government spending on these or other government programs; increase revenues from payroll taxes, from premium income, or from other government taxes, or run larger budget deficits and have the government borrow money from the public. Because of the massive size of the challenge, it is not likely that larger budget deficits would be feasible.

"Any viable solution is likely to involve changes in the Social Security and Medicare programs themselves, along with changes in other government spending of revenue," Hakkio says.

T

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

SOCIAL SECURITY AND MEDICARE: THE IMPENDING FISCAL CHALLENGE

www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.