16. Social Security and Medicare

Social Security and Medicare constitute almost one-third of total federal spending and over half of federal domestic spending. Therefore, any effort to reduce the deficit cannot ignore those programs. Moreover, Social Security and Medicare face severe and overwhelming structural problems that demand fundamental reform. To reform Medicare and Social Security, Congress should

- **resist any increase in the Medicare payroll tax;**
- **gradually increase the Medicare deductible;**
- **allow the elderly to opt out of the Medicare system;**
- **increase the retirement age, index Social Security benefits to prices rather than wages, eliminate preretirement survivors benefits, reduce benefits to nonworking spouses, means test benefits for the upper income elderly;**
- **begin privatizing Social Security.**

The "Long-Term" Financing Crisis—Sooner Than You Think

Everyone has probably heard by now about the long-term financing crisis of Social Security and Medicare, but what may be surprising is how soon that "long-term" crisis begins—1999.

The crisis starts sooner than generally thought because the difficulties begin, not when the trust funds run out, but when they peak and start to decline. At that point the trust funds must start turning in bonds to the federal government to obtain the cash needed to finance benefits. But the federal government has no cash or other assets with which to pay off those bonds. It can obtain the cash only by borrowing and running a bigger deficit, increasing taxes, or cutting other government spending.

Three trust funds are financed by payroll taxes: the Old-Age and Survivors Insurance Trust Fund (OASI), which pays Social Security cash retirement and survivors benefits; the Disability Insurance Trust Fund (DI),

which pays the system's disability insurance benefits; and the Hospital Insurance Trust Fund (HI), which pays hospital bills for the elderly under Medicare Part A.

Those three trust funds today are together running a surplus, with payroll tax revenues exceeding expenditures. For fiscal year 1994, the net surplus was about $15 billion. The total federal deficit is effectively reduced each year by the amount of the surplus.

But according to the government's own intermediate projections, the three trust funds combined will start running a deficit in 1999, just four years from now (see Table 16.1). The amount of that deficit will be relatively small in the first year, about $2.6 billion. (All figures in this chapter are in constant 1995 dollars.) But that marks a critical turning point, because in 1999 the trust funds will be increasing the federal deficit by that amount rather than reducing it for the first time in almost 20 years.

Moreover, by 2010 the deficit in the three trust funds combined will have grown to $72.6 billion. Just five years later, the deficit will have more than doubled to $155.9 billion. In other words, in 2015 the trust funds alone will be increasing the total federal deficit by about three-fourths of the entire current federal deficit.

But even that does not measure the magnitude of the entire crisis. The federal government finances about 75 percent of Medicare Part B, also called Supplementary Medical Insurance (SMI), out of general revenue rather than payroll taxes. The general revenue contributions for SMI effectively increase the total federal deficit by an equivalent amount each year.

The general revenue contribution for SMI was approximately $36 billion for FY94. But by 2005, with current rates of growth, general revenue contributions will nearly triple to $104.4 billion. Adding in that year's deficit in the three trust funds financed by the payroll tax, Social Security and Medicare together will increase the total federal deficit by about $140 billion.

By 2010 that amount will have grown to about $200 billion, about the same as the entire current deficit. And by 2017 Social Security and Medicare will be contributing an overwhelming $376.9 billion to the deficit, almost double today's entire deficit.

All that will occur before the trust funds are exhausted. If all three trust funds are combined, with each drawing from the others to keep the system going for as long as possible, then under the intermediate assumptions they will all be exhausted by 2017. The next year, paying all promised

Table 16.1
Effect of Social Security and Medicare on the Federal Deficit: Intermediate Assumptions (billions of 1995 dollars)

Year	Annual Deficits in OASDHI Trust Funds	Annual General Revenue Subsidies for Medicare Part B	Total Effect of Social Security and Medicare on the Federal Deficit
1995	+ 16.0	41.0	25.0
1996	+ 12.6	56.8	44.2
1997	+8.7	60.7	52.3
1998	+2.7	65.6	62.9
1999	-2.6	70.5	73.1
2000	-7.6	75.8	83.4
2001	-13.7	81.8	95.5
2002	-20.2	88.2	108.4
2003	-26.1	95.5	121.6
2004	-31.6	100.2	131.8
2005	-36.6	104.4	141.0
2006	-45.0	109.6	154.6
2007	-52.7	114.3	167.0
2008	-59.9	118.7	178.6
2009	-66.5	122.8	189.3
2010	-72.6	126.3	198.9
2011	-91.9	133.2	225.1
2012	−109.7	139.6	249.3
2013	−126.6	145.5	272.1
2014	−141.8	150.9	292.7
2015	−155.9	156.1	312.0
2016	−182.0	163.7	345.7
2017	-206.1	170.8	376.9

SOURCE: Calculated from *1994 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, April 11, 1994); and *1994 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund* (Washington: Government Printing Office, April 11, 1994).

benefits would require an increase in the total payroll tax, including the employer and employee shares, to about 20 percent, an increase of 30 percent. By the time those entering the workforce today retire, me total payroll tax will have to increase to approximately 27 percent (see Table 16.2).

Even that is not the whole story. The projections discussed above are all based on the government's intermediate assumptions. But the annual

Table 16.2
Total Social Security Tax Rates Needed to Finance All Promised Benefits after Trust Funds Are Exhausted under Intermediate Assumptions

Year	Rate (percent)
2020	21.59
2025	23.92
2030	25.69
2035	26.67
2040	26.97
2045	27.22
2050	27.63

SOURCE: *1994 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, April 11, 1994), Table HI. A. 2.

NOTE: Current rate is 15.3 percent

trust fund reports also include so-called pessimistic assumptions, which assume slightly higher unemployment and inflation rates and an increase in life expectancy at retirement much closer to actual experience in recent decades. Under those quite plausible "pessimistic" projections, the OASI, DI, and HI trust funds combined start running a deficit in 1996. By 2000 those three trust funds alone would be adding $66.3 billion to the federal deficit. By 2005 that amount would grow to almost $125 billion (see Table 16.3).

In addition, according to those projections, in 2000, just five years from now, the annual general revenue contribution for SMI grows to about $80 billion. Social Security and Medicare alone would be adding almost $150 billion to the federal deficit, about three-fourths as much as the entire deficit today. By 2005, just over a decade from now, Social Security and Medicare would be increasing the total federal deficit by an overwhelming $240.9 billion.

Under those assumptions, if all three trust funds were combined, then, incredibly, they would all be exhausted in 2005, only a decade from now. The total payroll tax rate would then have to be raised to about 20 percent to pay all promised benefits. By the time those entering the workforce today retire, the total combined payroll tax rate would have to be increased to approximately 40 percent, almost three times today's rates (see Table 16.4).

In addition to those financial difficulties, other severe problems plague Social Security and Medicare. Probably the most important is that Social

Table 16.3
Effect of Social Security and Medicare on the Federal Deficit under Pessimistic Assumptions (billions of 1995 dollars)

Year	Annual Deficits in OASDHI Trust Funds	Annual General Revenue Subsidies for Medicare Part B	Total Effect of Social Security and Medicare on the Federal Deficit
1995	+1.0	41.8	40.8
1996	-7.6	57.4	65.0
1997	−16.9	61.7	78.6
1998	-42.5	66.5	109.0
1999	-56.7	72.7	129.4
2000	-66.3	79.9	146.2
2001	-77.8	87.7	165.5
2002	-90.9	96.1	187.0
2003	−103.9	105.5	209.4
2004	−114.2	112.0	226.2
2005	−123.2	117.7	240.9

SOURCE: Calculated from *1994 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, D.C., April 11, 1994); and *1994 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund* (Washington: Government Printing Office, April 11, 1994).

Table 76.4
Total Social Security Tax Rates Needed to Finance All Promised Benefits after Trust Funds Are Exhausted under Pessimistic Assumptions

Year	Rate (percent)
2005	19.22
2010	20.74
2015	23.64
2020	27.62
2025	32.00
2030	35.99
2035	38.93
2040	40.70
2045	41.98
2050	43.39

SOURCE: *1994 Animal Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, April 11, 1994), Table III. A. 2.

NOTE: Current rate is 15.3 percent

Security is now a bad deal for today's young workers. Payroll taxes are already so high that even if today's young workers receive the promised benefits, those benefits will amount to a low, below-market return on payroll taxes. Studies show that for most young workers benefits would amount to a real return of 1 percent or less on the required taxes. For many, the real return would be zero or even negative. Those workers can now get far higher returns and benefits through private savings, investment, and insurance.

For example, take a couple entering the workforce in the mid-1980s and earning average incomes over their entire careers. At even a 4 percent real rate of return, which is just over half the return earned in the stock market over the last 70 years, that couple would retire with a trust fund of over $1 million in today's dollars. The fund would pay more than Social Security out of the continuing interest alone and still allow the couple to leave the $1 million fund to their children or other heirs. Or the fund could pay the couple about three times what Social Security would pay, each year for the rest of their lives.

Solving the Medicare Crisis

Clearly the 104th Congress will have to act quickly to address the Medicare crisis. However, in doing so, Congress should resist any attempt to increase the Medicare payroll tax. Payroll taxes are already far too high, placing an unacceptable burden on today's young people. Moreover, payroll taxes are a de facto tax on employment, depressing wages and destroying jobs.

Congress should also resist calls to increase Medicare premiums on the elderly, which finance about 25 percent of Medicare Part B. The growth of those premiums, which are already a heavy burden on many elderly people, should be limited to grow no faster than the rate of increase in incomes. Finally, general revenue contributions to Medicare Part B should also be limited to grow no faster than economic growth. Such subsidies could no longer become a greater burden relative to the economy.

Both Part A and Part B Medicare benefits should then be subject to an added deductible, adjusted each year to be large enough to keep Medicare expenditures no greater than Medicare revenues. The amount would be a modest amount in the first year, and it would grow slowly over time. Several decades down the line, the deductible would be several thousand dollars per year. At the same time, Medicare would cover catastrophic

expenses without limit. Consequently, Medicare would be transformed from a first-dollar insurance plan to a back-up catastrophic program.

At the same time, individual retirement accounts (IRAs) should be expanded for everyone so workers can now start saving to cover future noncatastrophic expenses below the deductible. If necessary, vouchers could be provided to low-income elderly to enable them to buy insurance to cover the added deductible.

In addition, each retiree should have the right to opt out of the Medicare system and receive a voucher equal to the average per capita expenditure under Medicare. That voucher could be used to purchase private insurance or HMO coverage or make contributions to a medical savings account. The elderly would be protected from both catastrophic expenses and increasingly burdensome Medicare premiums. The vouchers would also allow them to escape the increasing rationing and reduced quality of care under Medicare and choose the private coverage and services they prefer.

Social Security Reform

Congress has traditionally been reluctant to address the serious structural problems of Social Security. However, recently Sen. Robert Kerrey (D-Neb.) and former senator John Danforth (R-Mo.), the cochairmen of the Bipartisan Commission on Entitlement and Tax Reform, recommended the first tentative steps toward Social Security reform. Among their recommendations:

- Raising the Social Security and Medicare retirement age to 70, phased in over the next 30 years;
- Indexing future Social Security benefits to prices rather than wages, maintaining benefits at the same level as today in real terms but preventing escalation in those benefits;
- Reducing the extra benefits paid to nonworking spouses from 50 percent of the worker's primary benefits to 33 percent;
- Shifting approximately 10 percent of Social Security taxes into individual accounts for each worker that can be invested at the worker's direction and used to support future benefits.

Those proposals represent a realistic starting point for discussing reform of Social Security's financing problem. Indeed, the delay in the retirement age can and should be phased in much faster. Congress should also

eliminate completely preretirement survivors benefits. Those benefits can and should be provided by private life insurance.

Finally, Congress should face up to the necessity of means testing Social Security benefits for upper income individuals. There is a fundamental unfairness in a system that taxes the working poor in order to provide benefits to millionaires.

But those changes would also make Social Security an even worse deal for today's young workers, when it is already an unacceptably poor deal for them. Moreover, the delay in the retirement age would fall most harshly on African-Americans and other minorities with lower life expectancies, who tend to live fewer years in retirement to collect benefits. Delaying the retirement age would take away more of the benefits of this group than of others. Consequently, such reforms would be desirable only if combined with a private-sector option for today's young workers, similar to the reform adopted in Chile almost 15 years ago.

In 1981 Chile faced the same difficulties as presented by the U.S. Social Security system today. In response, the government allowed workers the freedom to save and invest for their retirement in private investment accounts, similar to IRAs in the United States, rather than through social security. Workers could also buy private life, disability, and health insurance through the accounts to replace public insurance, disability, and health benefits. Workers already in the old system at the time of the reform received government bonds for their past taxes. The bonds can be used to fund part of their future retirement benefits.

Those reforms have been wildly popular, with more than 90 percent of workers choosing the private investment system. Required contributions are nearly 25 percent lower than under the old social security system. Yet because the retirement funds earn full market investment returns, the new system is projected to pay much higher benefits. In addition, because the private system is backed by fully funded investments, it stops the massive accumulation of long-term debt under social security and eliminates long-term funding deficits. Moreover, Chile's government credits the private retirement system with generating huge amounts of increased savings and investment, which are sharply increasing economic growth in that country.

Chile's reforms are seen as such a huge economic and political success that countries throughout Latin America, including Argentina, Peru, and Colombia, are beginning to implement similar changes. Mexico has implemented a new privatized Social Security system operating alongside its old state-run system. Britain has allowed some people to opt out of its

upper tier of benefits, and Italy has begun to privatize some aspects of its Social Security system. Such reforms would ultimately be quite popular in the United States as well.

Interestingly, Kerrey and Danforth took the first step in that direction with their proposal to shift some Social Security revenues into individual investment accounts. However, Kerrey and Danforth would allow individuals to control only 10 percent of their Social Security payments. Congress should allow individuals the option of shifting their entire Social Security payment to individually controlled accounts.

Suggested Readings

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