How Are We to Pay for All This?

By Thomas R. Saving
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Social Security checks for many seniors in January will be smaller than they will be in December. The reason: Medicare (Part B) premiums, which are automatically deducted from Social Security, will rise by 17%. But the cost of living increases for Social Security for the last several years has averaged only 2.4%. These changes are automatic and reflect the bipartisan will of Congress. Cost of living increases protect the elderly from inflation. Medicare premium hikes assure that seniors pay on-time the cost, leaving taxpayers to pay the remainder.

Yet in anticipation of senior backlash, some politicians are seeking to slow the growth in the consumer price index, thus establishing a new and expensive entitlement. It’s hard to imagine a more inappropriate approach.

The latest report from the Trustees of Social Security and Medicare calculates the present values of the cash flow deficits for both programs and the numbers are staggering. Social Security’s funding gap for the next 75 years stands at $32.2 trillion. Medicare’s unfunded costs come to $32.2 trillion, including $8.1 trillion due to the new prescription drug benefit. The combined $40.3 trillion shortfall is about three times the current size of our economy.

Eke out as this picture is, over a longer horizon the situation is worse. Consider people retiring 75 years from now. A 75-year calculation counts all of the payroll taxes these people will pay out living years. Medicare will expect to receive. To measure what happens after the 75th year and beyond, the trustees now calculate the unfunded obligations over an infinite horizon.

The Social Security system’s long-run cash flow deficit is $32.1 trillion, and the new prescription drug benefit will require $11.3 trillion. Add in Medicare Part A (hospital insurance, complete for all seniors) and Part B (doctor’s insurance, three-fifths funded by taxpayers) and the total Medicare shortfall comes to $59.3 trillion. Over and above payroll taxes and premium payments made by the elderly, the unfunded liability in these two programs combined totals more than the debt of other nations like Greece at almost the size of our economy. A new entitlement, keeping Part B premiums from rising as fast as the rate of inflation, would make this burden even worse. My colleague Andrew Reiterman has calculated that if this policy were to be continued indeterminately, the new unfunded liability would make up 10% of GDP before the end of the century.

Some have argued that the financial problems of Medicare and Social Security will be alleviated by federal tax cuts, which appear insufficient to fill the black hole created by Social Security’s unfunded liability.

One has to ask, what will happen to those seniors over 75 who will retire before the government can come up with enough tax cuts to eliminate Social Security’s unfunded liability? As it stands, Social Security’s unfunded liability is over $40 trillion.

Pity the Kids

General Revenue Transfers to Social Security and Medicare as a percentage of income taxes:

<table>
<thead>
<tr>
<th>Year</th>
<th>Social Security</th>
<th>Medicare</th>
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</thead>
<tbody>
<tr>
<td>2003</td>
<td>16%</td>
<td>25%</td>
</tr>
<tr>
<td>2004</td>
<td>17%</td>
<td>26%</td>
</tr>
<tr>
<td>2005</td>
<td>18%</td>
<td>26%</td>
</tr>
<tr>
<td>2006</td>
<td>19%</td>
<td>26%</td>
</tr>
<tr>
<td>2007</td>
<td>20%</td>
<td>26%</td>
</tr>
</tbody>
</table>

The Increased Federal Income Taxes are estimated to be 10.9% of GDP.

Source: Social Security and Medicare Trust Reports and estimates.

It is time to face reality. Current entitlement programs saddled our generation and the generation before ours with increasing implicit debts. We must introduce reforms that capture the earning potential of the baby boom generation before they escape into retirement and leave the young with a burden that cannot be paid. Unless we increase our level of saving now, we will leave our children and grandchildren strapped with escalating tax rates.

Some have suggested that we can wait and raise taxes or benefits when the cash flow crisis arrives, but this is not a policy that tweaking will solve. The tax implied by the Trustees’ forecast is an implied tax cut that will hurt retirees who have planned on receiving benefits in return for the taxes they paid over their working lives. Others have argued that economic growth will ease the burden in the future. But the forecasts made by the Trustees take into account the growth in the nation’s output. If output grows more rapidly than the Trustees project, benefits will also rise proportionally.

Due to the changing demographic structure and rising expenditures on medical care, the share of the nation’s output consumed by the elderly will rise. This is a rising share of the economy, financed in large part by Social Security and Medicare, and will create a growing tax burden. Saving now for retirement reduces the burden on future taxpayers while at the same time increasing the nation’s capacity to produce.

This generation of workers faces a clear choice: Will they tighten their belts and save more? Or will they ask their children and grandchildren to make up for these between these regimes? The choice is clear: The nation’s capacity to produce.

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