FEDERAL RESERVE BANK of ATLANTA

Some Unpleasant Facts on Social Security and Medicare Finances

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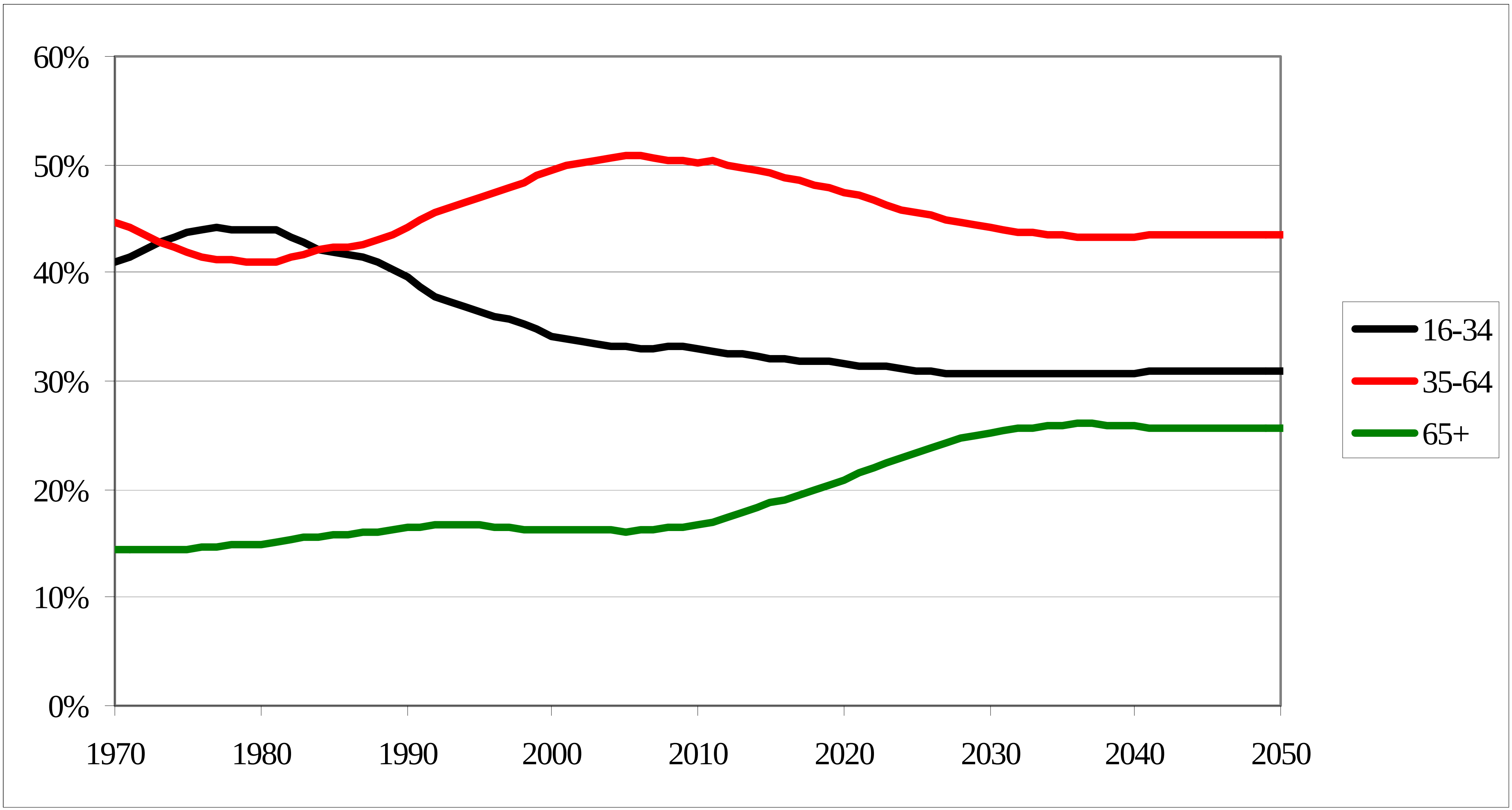
Outline

- Social Security and Medicare face major financial trouble in the future
- Source of the problem: Elvis generation, a.k.a. the baby boomers
- Trust funds will offer no help:
  - Day of reckoning is sooner than we think
  - Tax increases, benefit cuts in 2020!

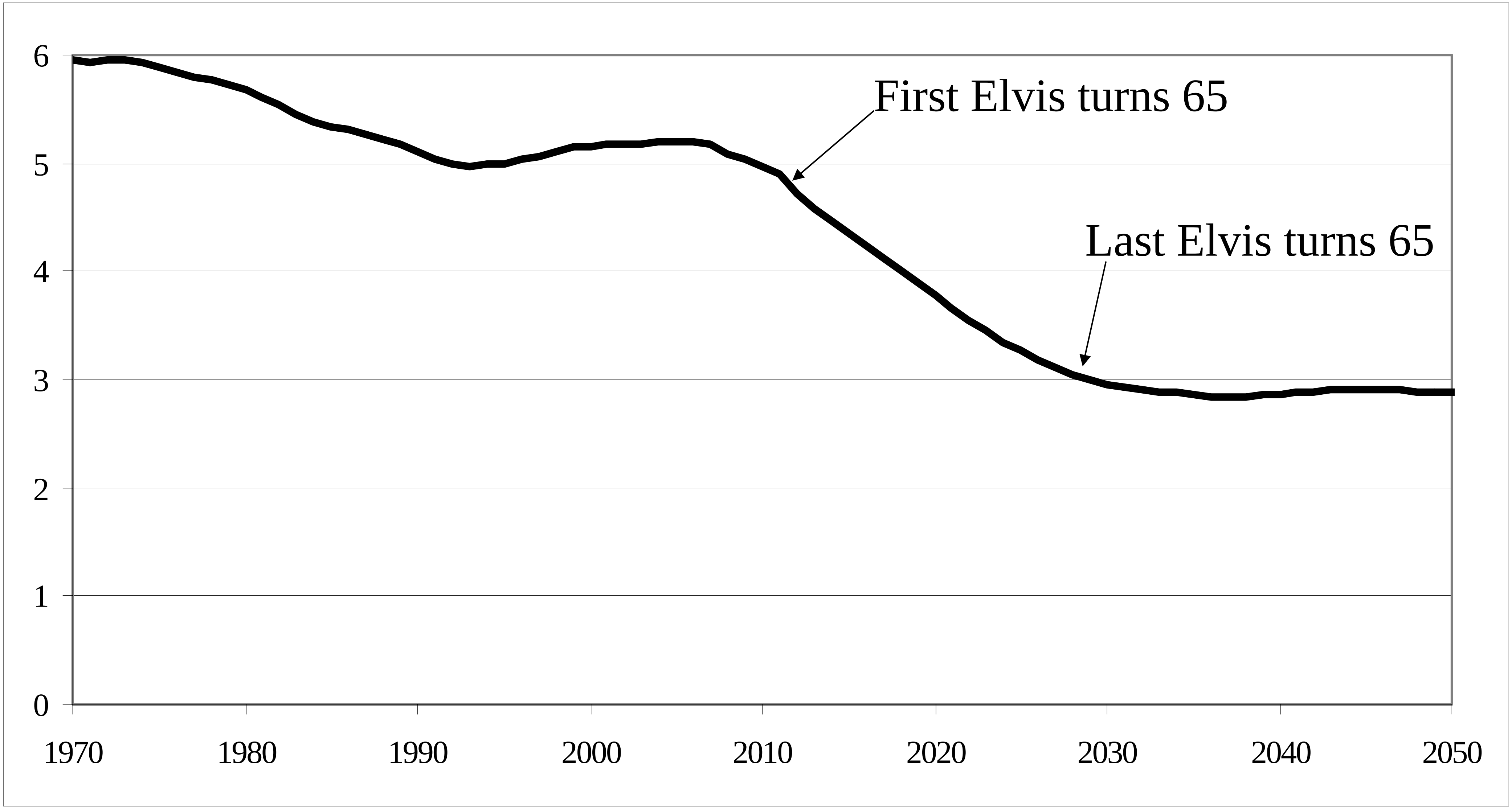
How can Social Security and Medicare run out of money?

- Isn’t there a lockbox?
- There is no lockbox! Current contributions finance current retirees’ benefits
- Demographic change: Elvis generation will start retiring soon
- Soon after that contributions will not be able to keep up with payments to retirees

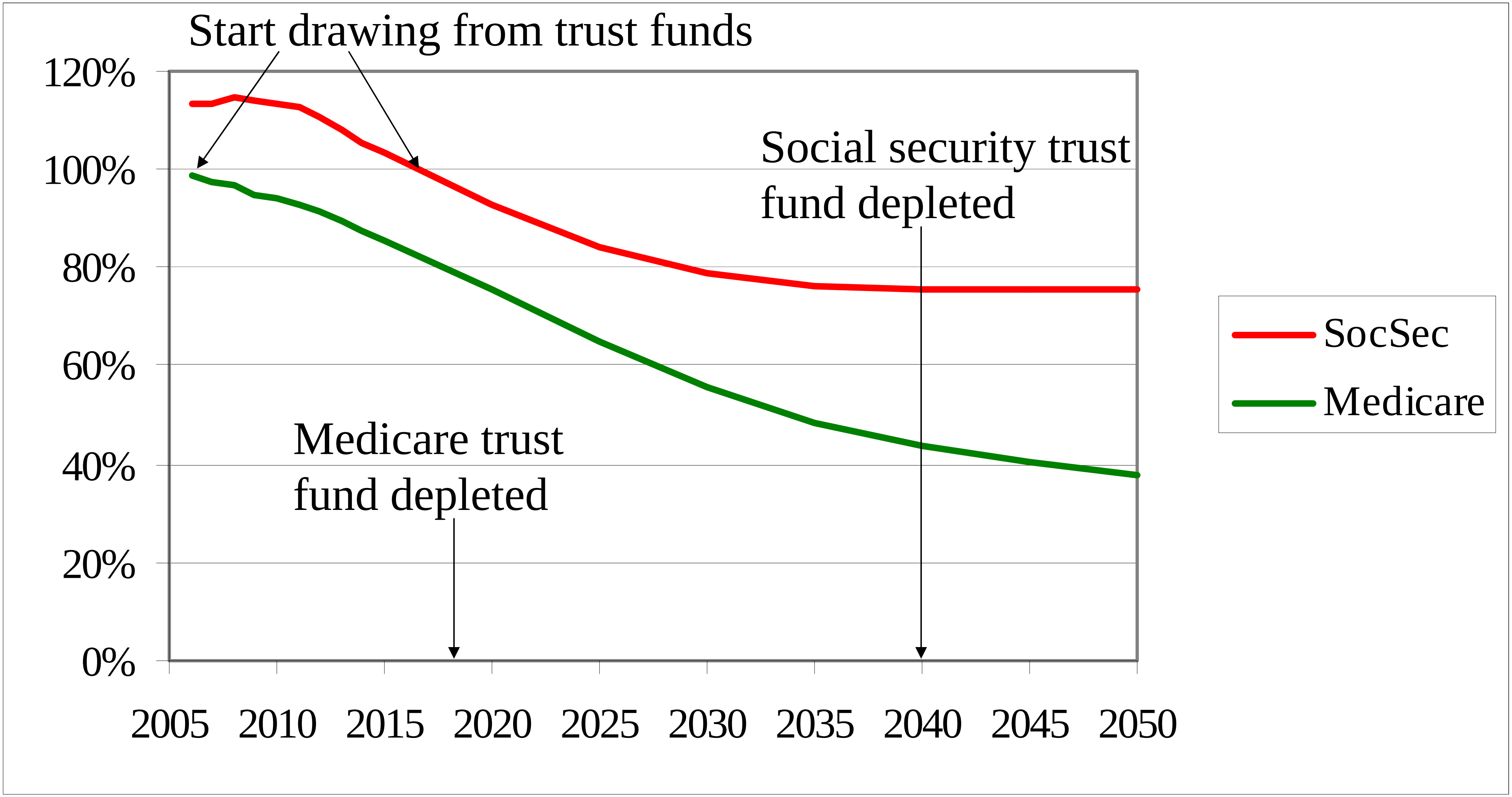
Relative size of different generations over time (Census projections after 2005)



Number of 16-64 year olds for each 65+ year old



Funding ratio: How much of expenditure is covered by tax revenue?



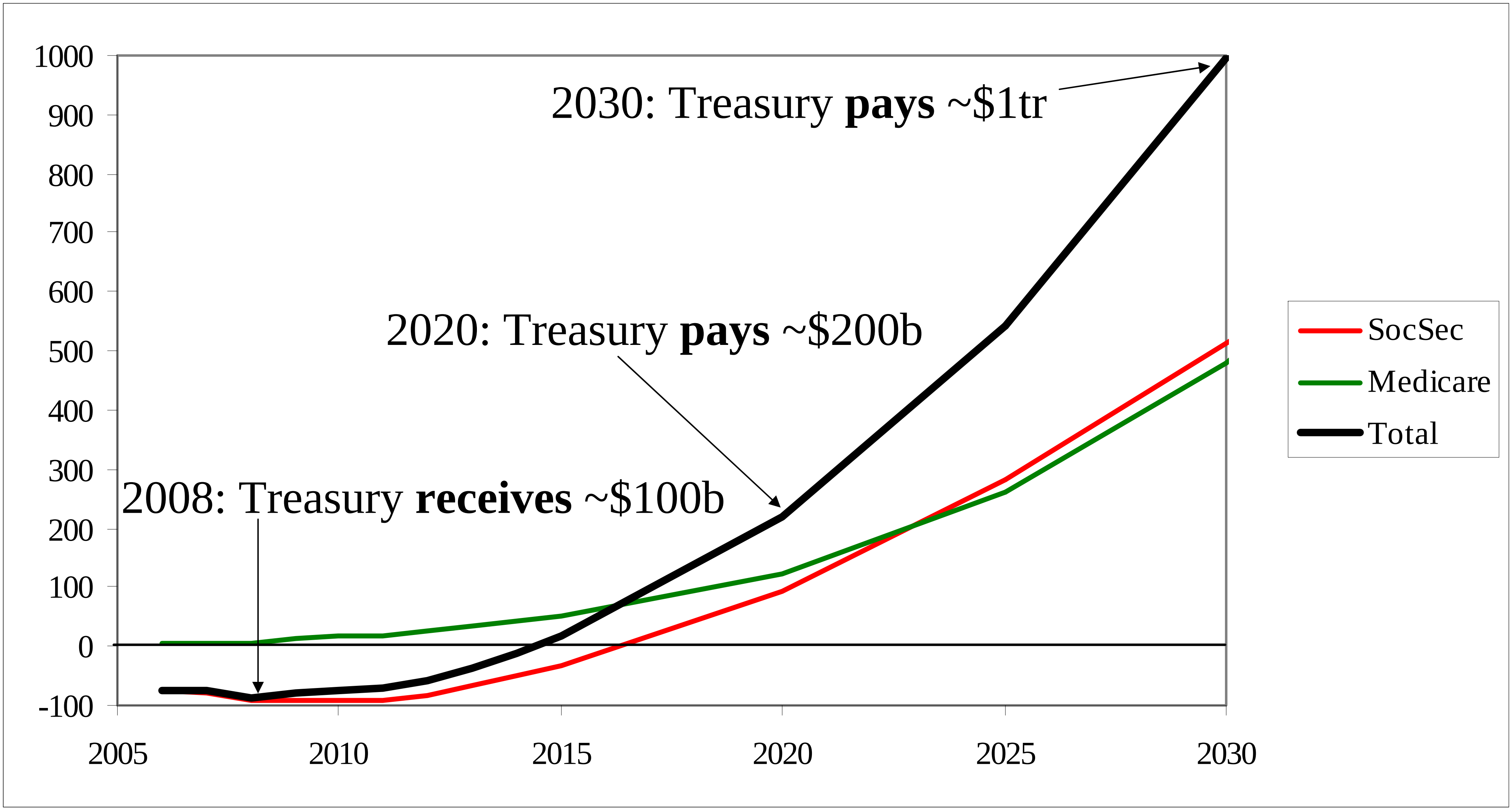
Trust funds: Important dates

- Medicare and Social Security saved past surpluses in trust funds
- Medicare:
  - Receives net transfer out of trust fund already
  - Trust fund will run out of money in 2018
- Social Security
  - will dip into trust fund at around 2016
  - Trust fund runs out of money at around 2040

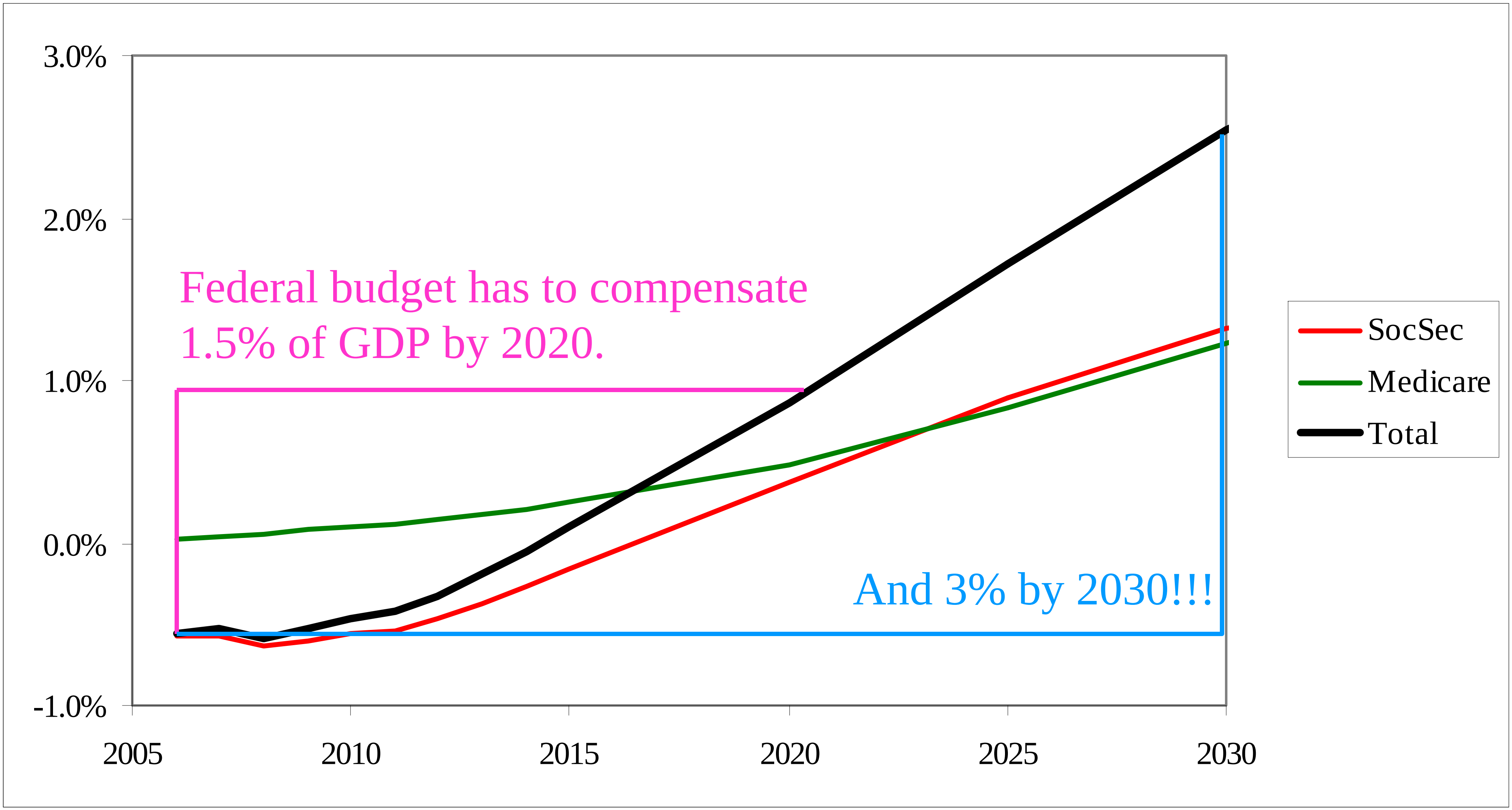
Where do trust funds invest their money?

- U.S. government bonds
- Advantage: Safe investment
- Disadvantage: The Treasury is on the hook for Social Security and Medicare deficits: **Robbing Peter to pay Paul!**
- The Treasury has to pay
  - for the deficits of Medicare already
  - for the deficits of Social Security after 2016

Projected transfers from Treasury to Social Security and Medicare in $b



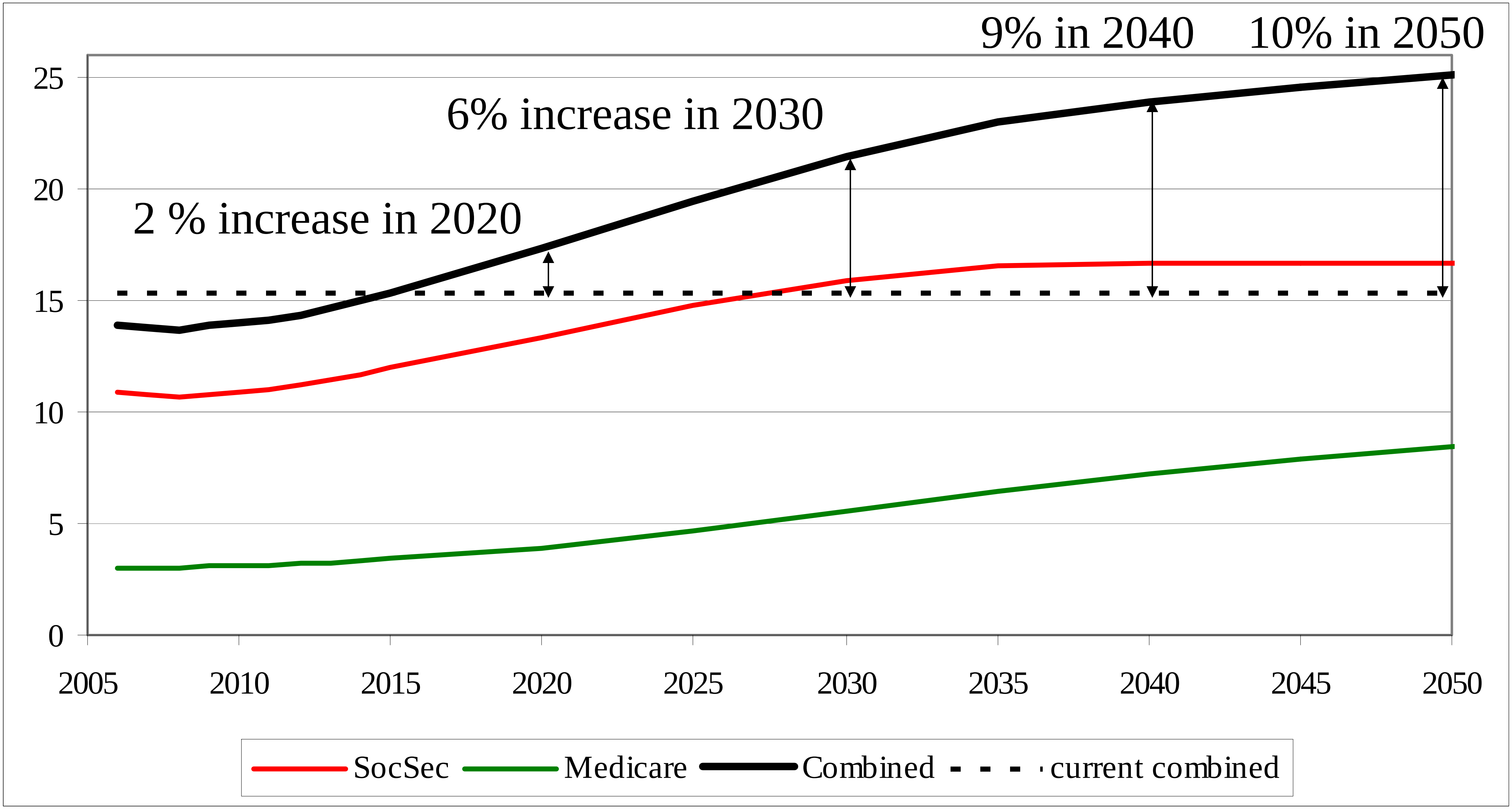
Transfers from Treasury to Social Security and Medicare in % of GDP



How big a deal is 1.5% of GDP?

- In 2005 the federal government spent:
  - 4.7% of GDP on national defense
  - 2.3% of GDP on non-defense
- Hard to reduce that spending
- More likely scenarios:
  - Increase payroll taxes
  - Increase income taxes
  - Decrease benefits
  - Issue more debt

Payroll taxes necessary to cover expenditures (in %)



Conclusion

- Demographic change creates problems for Social Security and Medicare
  - Medicare is already running deficits
  - Social Security will start running deficits in 2016
- Trust funds are no solution:
  - Social Security and Medicare may be funded …
  - …, but the treasury is on the hook for paying back the trust funds!
  - Budget squeeze comes by 2020 rather than 2040.