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

First Elvis turns 65

Last Elvis turns 65
Funding ratio: How much of expenditure is covered by tax revenue?

- Social security trust fund depleted around 2035
- Medicare trust fund depleted around 2025

Start drawing from trust funds
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

2008: Treasury receives ~$100b
2020: Treasury pays ~$200b
2030: Treasury pays ~$1tr
Transfers from Treasury to Social Security and Medicare in % of GDP

Federal budget has to compensate 1.5% of GDP by 2020.

And 3% by 2030!!!
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 %)

- 2% increase in 2020
- 6% increase in 2030
- 9% in 2040
- 10% in 2050

Legend:
- Red: SocSec
- Green: Medicare
- Black: Combined
- Dashed: current combined
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.