The Impact of Social Security and Medicare on the Federal Budget

Summary
The difference between the income and expenditures credited to the trust funds of the Social Security and Medicare programs, the nation’s two largest social insurance programs, is often viewed as a measure of the impact that those programs have on the financial condition of the federal government. Under the Congressional Budget Office’s latest budget projections for the next 10 years, those trust funds are estimated to run sizable surpluses. However, those surpluses reflect more than an excess of dedicated revenues over spending. A substantial portion results from internal transfers between Treasury accounts—credits from the general fund of the Treasury to the trust funds. Thus, although the trust fund surpluses may accurately reflect the programs’ spending authority, using them to gauge the programs’ budgetary impact distorts their net effects.

That distortion, which is large, obscures the growing strains that the programs are placing on the government’s finances. When the intragovernmental transfers are excluded, instead of running a combined surplus of $3.3 trillion over the next 10 years, the two programs are expected to run a deficit of $96 billion. Similarly, from 2003 to 2026, instead of running a cumulative surplus totaling $6.5 trillion, as estimated by the Social Security and Medicare trustees, the programs would run a cumulative deficit totaling $6.6 trillion.

Expressed as a percentage of the nation’s gross domestic product, spending for the programs under the trustees’ projections would rise from 6.7 percent today to 12.1 percent in 2040, while revenues for the programs would hover around 7 percent. Trust fund accounting, which by law includes intragovernmental transfers, masks much of that widening gap and thus the growing amount of resources that may have to be drawn from the economy to cover the programs’ expenditures.

The looming fiscal strains are not a temporary phenomenon caused by the retirement of post-World War II baby boomers over the next few decades. They reflect a growing imbalance driven by currently prescribed entitlements as well as long-lasting and powerful demographic trends that could have major unfavorable consequences for the economy. Enacting changes to the Social Security and Medicare programs sooner is better than enacting them later because future beneficiaries would have longer to prepare, because the revisions could be less drastic, and because the changes could enhance economic growth.

What the Budget Currently Shows
The difference between the income and expenditures credited to the Social Security and Medicare trust funds is often used to show the impact that the programs have on the fiscal condition of the government. However, the trust fund accounting for the programs that is required by law is designed to show their total spending authority and expenditures—not governmental receipts and expenditures.

According to the Congressional Budget Office’s (CBO’s) estimates for fiscal years 2003 through 2012, under current policies Social Security would run trust fund surpluses totaling $2.5 trillion, and the rest of the budget would run deficits totaling $1.5 trillion. Many observers therefore conclude

that Social Security surpluses finance government activities besides ones within the program, reduce the deficit, and account for any overall budget surplus that appears in the 10-year horizon.

However, less than $1 trillion of the program’s projected $2.5 trillion in surpluses results from Social Security taxes exceeding Social Security spending. More than $1.5 trillion is from intragovernmental transfers between the Treasury’s general fund and the Social Security trust funds—the largest being interest on federal securities held by the trust funds and the government’s share of Social Security taxes as an employer.

Those intragovernmental transfers, while required by law, do not affect the government’s overall surplus or deficit—they augment the program’s spending authority, but they are merely paper transactions among government accounts, or credits from one account to another. Altogether, they amount to almost 60 percent of the cumulative 10-year surplus of the Social Security trust funds (see Figure 1).

The situation for Medicare is even more striking. By CBO’s estimates, under current policies the Medicare trust funds would run a cumulative surplus of $820 billion from fiscal year 2003 to fiscal year 2012. However, when only the program’s tax and premium receipts are considered, its projected 10-year surplus turns into a deficit of nearly $1.1 trillion. The difference—almost $2 trillion of Medicare’s trust fund income over the period—would arise from intragovernmental transfers (see Figure 2). The largest portion would go toward the Supplementary Medical Insurance (SMI) part of Medicare because the government covers 75 percent of SMI’s costs with its general resources.²

Some observers assert that interest credited by the government to Social Security and the Hospital Insurance (HI) part of Medicare represents interest saved elsewhere because the surplus tax receipts and premiums of those programs are used to fund other government activities in lieu of borrowing funds from the public.³ But what other spending and revenues might have been if Social Security and the HI part of Medicare did not exist is unknowable. Moreover, a number of times in the past, income tax reductions were motivated in part by a desire to offset the bite of Social Security and HI payroll taxes felt by taxpayers. So surplus Social Security and HI revenues may not be responsible for less government borrowing. They may have displaced other taxes; they may also have permitted higher spending.

Long-Term Pressures
Long-range projections by the program’s trustees show Social Security trust fund surpluses totaling $5.9 trillion from 2003 through 2026. However, if the transfers that the trust funds receive from the general fund are excluded, Social Security surpluses would disappear in 2017, and for the 2003-2026 period as a whole, the program would run a cumulative deficit of $0.7 trillion. Projections by the Medicare trustees show surpluses through much of the same period, but if transfers from the general fund are excluded, the program would run a cumulative deficit of $5.8 trillion. All told, a $6.5 trillion

2. About $1.6 trillion in transfers would be credited to the SMI trust fund, and about $0.3 trillion would go to the Hospital Insurance (HI) trust fund. With intragovernmental transfers excluded, the HI fund would run a surplus of $0.1 trillion over the 10-year period, while the SMI fund would run a deficit of $1.2 trillion.

3. Certainly, this argument cannot be made for the SMI part of the program because the premiums that the government collects have always been far less than the program costs.
surplus for both the Social Security and Medicare programs turns into a $6.6 trillion deficit.

Without changes to the programs, an ever-expanding share of the nation’s production would have to be devoted to them (as shown by the outlays charted in Figure 3). Whether the money would be obtained from higher taxes or more borrowing in the future, it would have to be drawn out of the economy. Under the current laws governing the programs, tax revenues and Medicare premiums would hover around 7 percent of gross domestic product (GDP) over the long term, according to the trustees’ projections. However, beginning in 2010, the programs’ expenditures would exceed their revenues, and the gap would grow quickly. In contrast, viewed through trust fund accounting, the programs would appear to run surpluses until 2025 because of intragovernmental transfers credited to their trust funds. At that point, their spending would have risen to 10 percent of GDP, and the programs would be running a cash deficit equal to about 3 percent of GDP. By 2040, spending for the programs would have risen to 12 percent of GDP, and the programs’ cash deficit would be 5 percent of GDP.

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4. Based on the intermediate projections in Social Security Administration, The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (March 26, 2002); and Department of Health and Human Services, Centers for Medicare and Medicaid Services, Office of the Actuary, 2002 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds (March 26, 2002). The projections are for calendar years and are in nominal terms. It should be noted that in computing these cumulative deficits, no separate estimate of the government’s share of payroll taxes as an employer was available. Only estimates of aggregate payroll taxes were used. Thus, the amount of intragovernmental transfers assumed in the calculations is understated. If the government’s share of payroll taxes had been included as an intragovernmental transfer, the deficit figures would be larger.

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Conclusion

In the coming decades, society’s changing demographics and the accompanying demands for goods and services are likely to create a significant economic challenge. However, there is not a lot of time to prepare. The budget commitments arising from Social Security and Medicare, along with other federal entitlements, are the result of provisions now incorporated in law coupled with a steadily aging population—particularly baby boomers approaching their advanced years (the oldest of whom are now age 56). Moreover, the aging of the population is projected to continue long after the baby boomers pass on. Under current projections, life expectancy at age 65 is projected to increase by 20 percent to 25 percent between now and 2075.\(^5\) In addition, while there were 4.3 workers for every person 65 or older in 2000, there will be 2.6 in 2030, 2.4 in 2050, and 2.2 in 2075. The looming fiscal strains are not a temporary phenomenon caused by the baby boomers, but rather a growing imbalance driven by current policies and long-lasting and powerful demographic trends.

The result can be major unfavorable consequences for the economy. Therefore, fostering economic growth and increasing the strength of the economy to meet the challenge are critical. In particular, running budget surpluses overall and using them to reduce the government’s debt would be a means of promoting growth and easing the strains: money previously held by investors in the form of government bonds would be freed up for private investment. However, the rise in Social Security and Medicare spending will probably make avoiding deficits difficult, if not impossible, which in turn could impair economic growth. The choices that policymakers have to address deficits—to raise taxes or to constrain spending—are likely to have very different effects on economic growth and the capacity of the economy to sustain Social Security and Medicare and the other activities of government.

Changes to the Social Security and Medicare programs would be best accomplished sooner rather than later because future beneficiaries would have longer to prepare, because those changes could be less drastic, and because they could enhance economic growth.

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