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The 2014 Social Security and Medicare Trustees Reports

By Mark J. Warshawsky

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In this article, Warshawsky discusses the financial state of Social Security and Medicare, arguing that projected shortfalls will soon lead to immense budget pressure on Congress and prompt the need for reform beyond the scope of payroll taxes.

The 2014 annual reports released on July 28 from the trustees of Social Security and Medicare (the trustees) show continuing deterioration in Social Security's finances, primarily because weaker economic growth reduced expected payroll tax revenues. The disability segment of the program — with its own trust fund — is expected to be insolvent in 2016 because benefit payments far exceed past projections, even after adjusting for a fully anticipated aging of the workforce. By contrast, the report for Medicare shows improvement because of a surprisingly slower rate of growth in healthcare spending, particularly in the hospital sector. Still, as the trustees emphasize, Medicare, along with Social Security, places a large and growing burden on federal finances. Therefore, as the Federal Reserve removes its monetary accommodations in the next couple of years, the expected increases in interest payments on federal debt will inevitably put pressure on the budget, leading politicians to seek Medicare and disability benefit cuts as well as revenue increases.

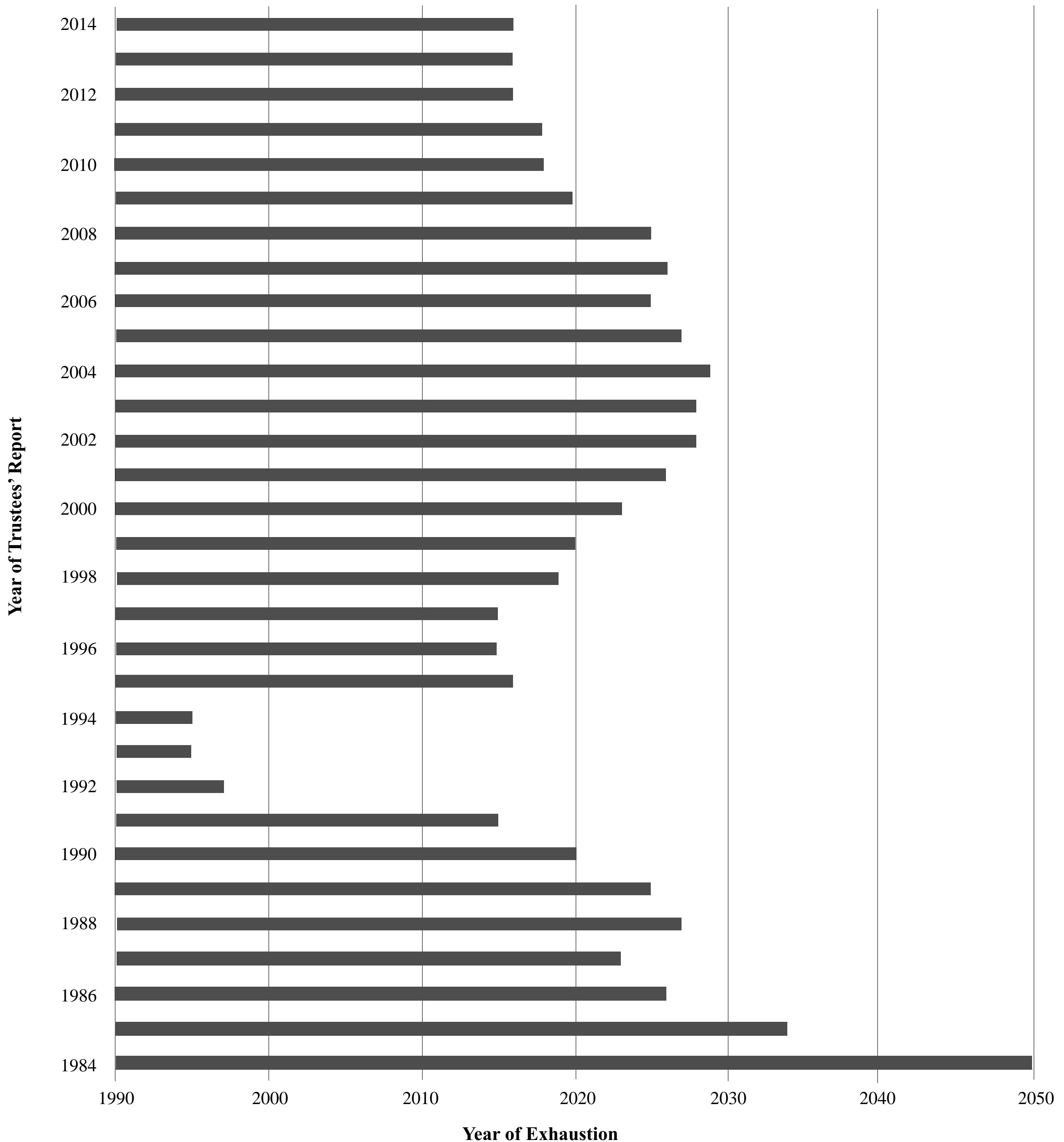
Social Security

Absent significant reform, the trustees project that the program will suffer cash flow shortfalls — gaps between payroll and benefit taxes and expenditures — forever. The shortfall was $76 billion in 2013 and is projected to be $80 billion in 2014; shortfalls will rise rapidly after 2018 with the increase in baby boomer retirements. Note that as recently as 2009, Social Security represented a positive cash flow to the federal budget, as tax revenues exceeded expenditures. The turnaround in program finances was sooner and deeper than expected.

The combined trust funds for old age, survivors (OASI), and disability insurance (DI) programs (collectively, OASDI) are projected to be exhausted of reserves in 2033. At that point, continuing tax revenue would be sufficient to pay 77 percent of scheduled benefits, declining to 72 percent by 2088. The DI trust fund, however, is expected to run out by 2016. At that point, the government must reduce disability payouts to 81 percent of scheduled benefits. Figures 1 through 3 give the trust funds' exhaustion dates projected (under the intermediate assumptions) in the annual trustees' reports since 1983, the year of the last major program reform. Note that in 1995, Congress reallocated contribution rates between the OASI and DI trust funds to remedy the expected financial shortfall in the DI Trust Fund, when the OASI Trust Fund was relatively flush. Since 2003-2004, the exhaustion dates of the trust funds have steadily moved closer, as conditions and prospects have been worse than originally expected.

Because the primary source of revenue for Social Security and, to a lesser extent, Medicare is the payroll tax, the programs' revenues and costs are traditionally expressed as percentages of taxable payroll — that is, the base amount of worker earnings taxed to support the programs (note that taxable payroll is almost 25 percent larger for Medicare than for Social Security because the Medicare payroll tax is imposed on all earnings, while Social Security taxes apply only to earnings up to an annual maximum — $117,000 in 2014). For Social Security, annual costs are projected to increase from 13.97 percent in 2013 to 17.14 percent by 2037, decline to 16.89 percent in 2050, and then rise gradually to 18.19 percent in 2088. Social Security revenue, which includes scheduled payroll taxes levied at the current 12.4 percent level and taxes on benefits, was 12.77 percent in 2013 and would increase slowly over time, to 13.29 percent in 2088, as the amount of Social Security benefits excluded from income taxation is not indexed for inflation and benefit growth.

The 75-year actuarial balance measure includes the trust fund reserve at the beginning of the period, an ending balance equal to the 76th year's costs, and projected costs and revenue over the period, all expressed as a percentage of taxable payroll for the 75 years. The balance (actually a deficit) represents the average amount of program changes needed (benefit cuts or tax increases)



Source: Annual Social Security trustees' reports.

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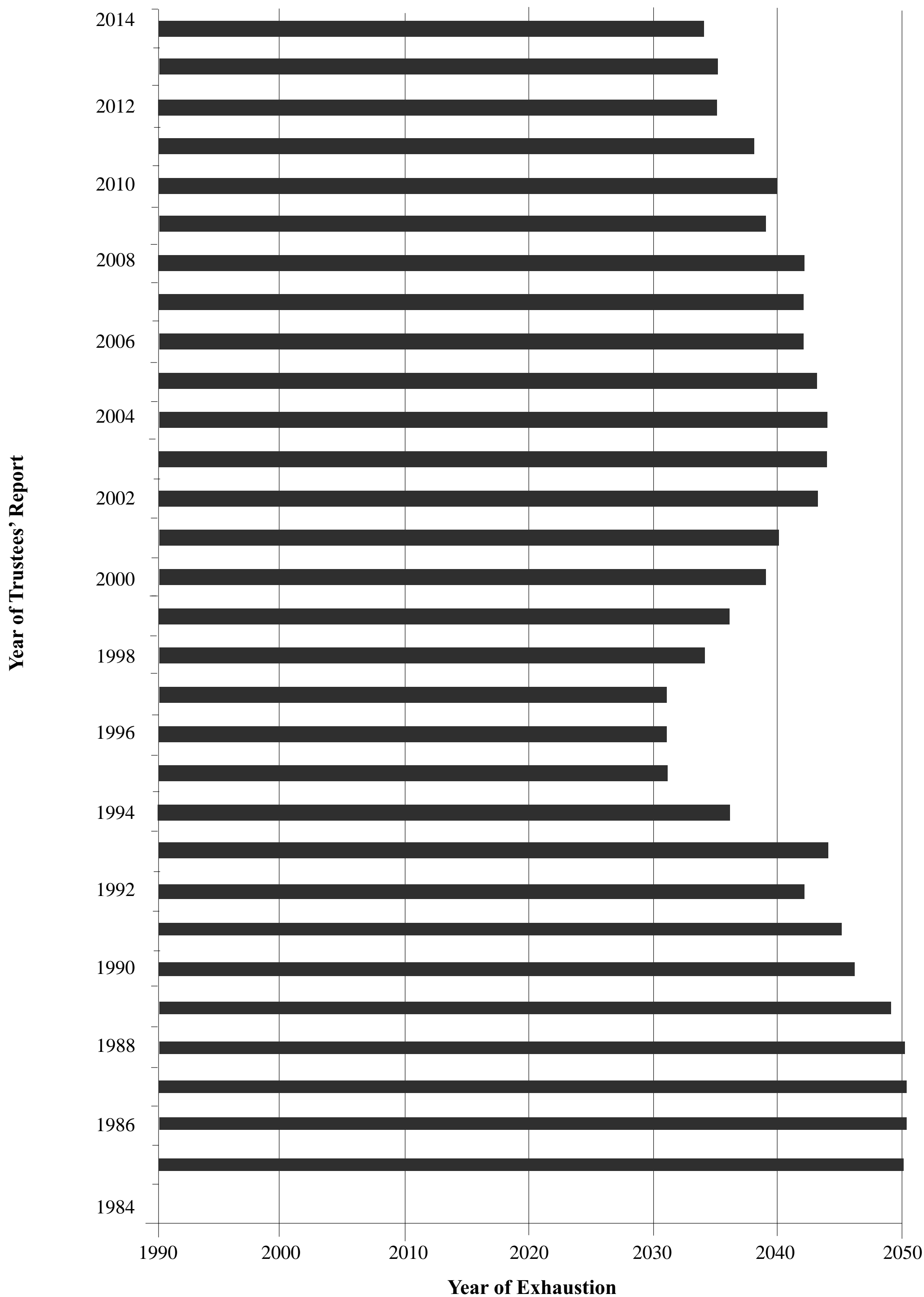
throughout the valuation period to achieve a zero balance. For OASI, the 75-year actuarial deficit is now 2.55 percent of taxable payroll; for DI, it is 0.33 percent; and for OASDI, it is 2.88 percent. The total program deficit is 0.16 percent larger than last year's measure, and as shown in Figure 4, is the highest since the programs were last reformed in 1983.

Annual deficits are 1.29 percent of taxable payroll in 2014, and will increase steadily to 3.95 percent in

Figure 2. Projected Year of Exhaustion — OASI Fund (Intermediate), 1985-2014



Source: Annual Social Security trustees' reports.

2037 and to 4.9 percent in 2088. Hence, an immediate increase in the payroll tax rate of 2.83 percentage points (or the equivalent benefit cut of 17.4 percent) would be insufficient to achieve sustainable or permanent solvency for the program. In particular, if payroll taxes were increased 2.83 percentage points now, in just a year or two, the program, measured over a 75-year valuation period, would

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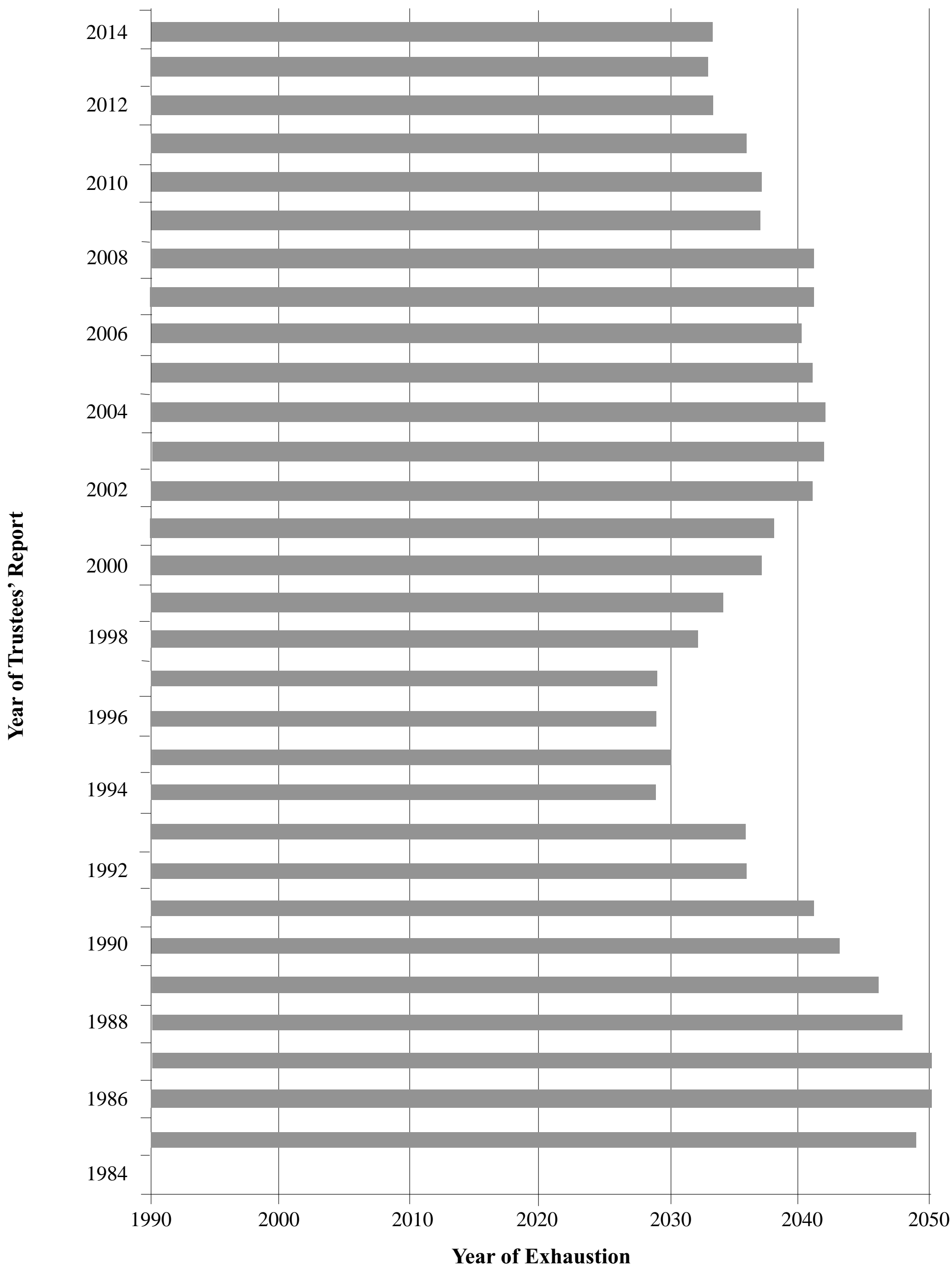
Figure 3. Projected Year of Exhaustion — Combined Fund (Intermediate), 1985-2014



Source: Annual Social Security trustees' reports.

again show an actuarial deficit, undermining public confidence in it. Those small-bore changes would lend only a temporary veneer of well-being and generational equity to the program. Every year that passes increases the deficit, demonstrating the need for an even longer valuation horizon and sustainable, permanent reforms.

A more comprehensive, ''infinite horizon'' measure, according to the trustees, would suggest raising the payroll tax rate by 4.3 percentage points, cutting benefits by 24.5 percent, or some combination of the two — presumably phased in gradually — to achieve permanent solvency and to apportion the burden of reform fairly between current and future generations.

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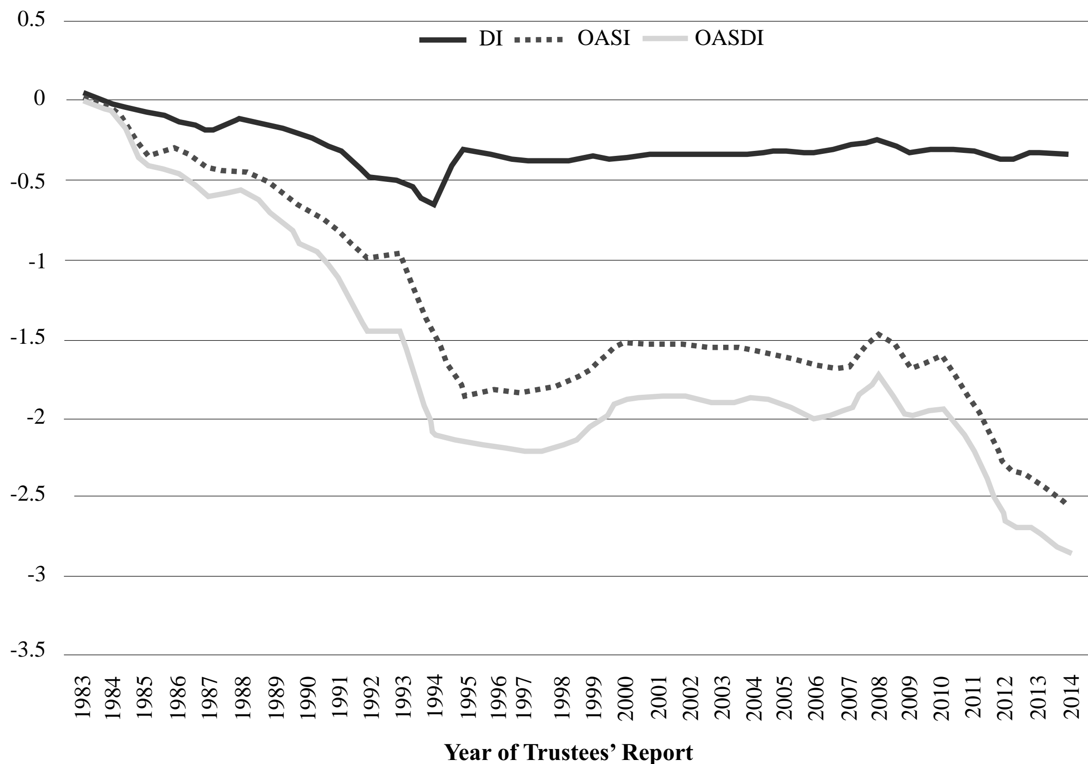
Figure 4. Social Security 75-Year Actuarial Balance (percentage of taxable payroll)



Note: Before 1995, there was an increasing trend since 1982 in the proportion of workers who were awarded disability benefits and a decreasing trend since 1970 in the proportion of beneficiaries whose disability benefits terminated as a result of recovery, death, or attainment of age 65. Therefore, in 1995, Congress reallocated contribution rates between the OASI and DI Trust Funds to remedy the expected financial shortfall.

Source: Annual Social Security trustees' reports.

As mentioned above, the DI program will soon go bankrupt. Some have proposed reallocating payroll taxes from the retirement OASI program, as was done in 1995, to avoid that outcome. Yet that ignores the worsening finances of the retirement program; the soaring disability rolls of workers removed from productive labor and paying taxes, even as the general health of the population has improved; several scandals in the adjudicative process; and the unchanging criteria for disability determinations, even with formidable assistive technologies and more accommodative working conditions. Some have claimed that the deficit in the disability program is the inevitable and predictable product of demographic trends — that is, as the workforce ages there will be an increase in the payout for disability benefits. That explanation is inconsistent, however, with the fact that the age and gender-adjusted incidence rate of disability in the program has risen significantly. Indeed, as shown in Figure 5, the official projections have underestimated the actual costs of the DI program since at least 2000 (in 11 out of 14 years), through times of both rising and falling unemployment.

Medicare

The gap between Medicare's expenditures and revenue from payroll taxes and premiums was $249.4 billion in 2013, up slightly from $243.1 billion in 2012. That shortfall represents just less than half of total program spending and is a significant drain on the federal budget. The Hospital Insurance (HI) Trust Fund — a major component of Medicare (also called Part A) and mainly financed by the payroll tax — is projected to be exhausted by 2030, four years later than projected in last year's report. At that time, dedicated revenues will be sufficient to pay 85 percent of HI costs. The share of HI costs financed by dedicated revenues is projected to decline slowly to 75 percent in 2047 and stay flat thereafter.

The projected 75-year actuarial deficit for Part A is 0.87 percent of taxable payroll, down from 1.11 percent in last year's report. The improvement in HI finances is attributable to lower-than-expected

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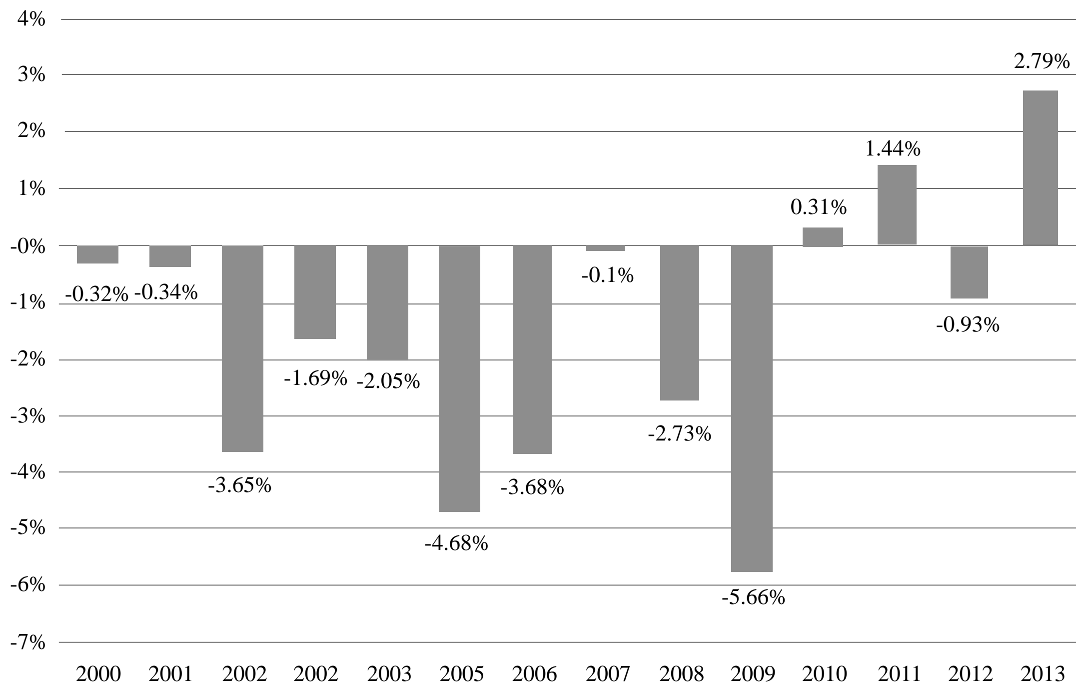

spending in 2013 for most HI service categories (for example, hospitals, skilled nursing care, and so on). That reduction represented a 1.5 percent decline in the base expenditure level. The trustees, seeing something of a trend of reduced growth over the last few years, decided to lower the projected near-term spending growth. There is great uncertainty on the reason for that slowdown. The continued weakness in the economy has surely played a part, but changes in private health plans (for example, increases in cost sharing with the insured) and public plans (for example, cuts in reimbursements to care providers and the creation of accountable care organizations in Medicare) may also be influencing outcomes, as intended.

Medicare also includes Part B, which covers physician and other services, and Part D, which covers prescription drugs.[1] Both parts are financed to some extent by enrollee premiums but mostly by general revenue transfers from the federal budget. Aggregate Part B benefit costs increased by only 3.1 percent in 2013, the smallest increase in decades. On a per capita basis, the increase was negligible, from $5,090 to $5,092. In the aggregate, as a share of GDP, we saw the first year-over-year decline, from 1.46 percent of GDP in 2012 to 1.45 percent in 2013. The trustees project Part B expenditures, as a share of GDP, will increase to 1.79 percent by 2023, 2.42 percent by 2035, and steadily to 3.13 percent by 2085. Abstracting from a significant change in method, explained below, those projections are lower than in last year's report, owing to lower-than-estimated spending in 2012 and 2013 and lower-than-estimated payment rate updates.

Unlike in past years, the Medicare Part B cost projection featured in the 2014 trustees report assumes that reductions in Medicare payment rates for physician services called for by the sustainable growth rate formula will be overridden in the future, as they have been from January 2003 through March 2015. The trustees assume that payment rates will rise 0.6 percent annually over the next 10 years. That change raises the growth rate in projected Part B costs by about 0.3 percentage points on average over the next 75 years. That is a more realistic projection method, yet the trustees continue to assume that the future significant cuts in provider payments owing to general productivity improvements, as required by the Affordable Care Act, will be put into place, despite widespread

[1]Together, parts B and D are called Supplementary Medical Insurance.

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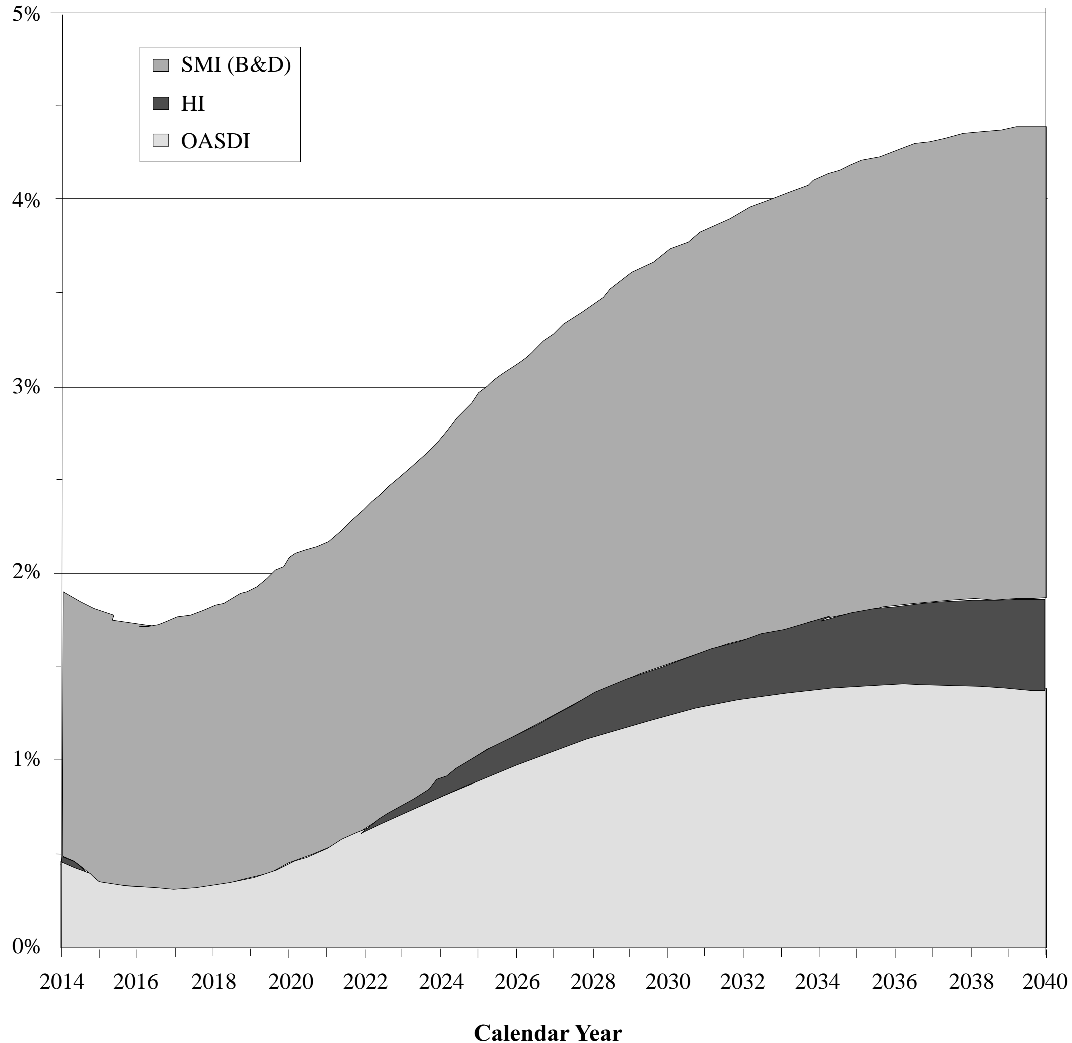
Figure 6. Projected SMI General Revenue Funding Plus OASDI and HI Tax Shortfalls (percentage of GDP)



Source: Social Security and Medicare Boards of Trustees, "A Summary of the 2014 Annual Reports," Chart D.

doubts that the healthcare sector and politicians will be able to tolerate the large and continuing cuts.

Aggregate Part D benefit costs increased 4.3 percent in 2013, almost entirely because of enrollment increases. Per capita benefits actually declined slightly, from $1,777 to $1,773, and Part D benefits as a share of GDP remained flat at 0.41 percent. The trustees attribute those changes to increases in the proportion of prescriptions filled with low-cost generic drugs and patent expirations for some major drugs in 2012. The Part D spending share in GDP is projected to increase to 0.63 percent in 2023, 1.02 percent in 2050, and 1.36 percent in 2085. That represents a slight improvement from the 2013 trustees' report.

Considering all three parts of the program together, average Medicare costs per beneficiary increased only $1 in 2013, to $12,210. The trustees project that total Medicare costs will grow from approximately 3.5 percent of GDP in 2013 to 5.3 percent of GDP by 2035, and will increase gradually thereafter to about 6.9 percent of GDP by 2088. For financing Medicare, the share of total non-interest Medicare tax income falls substantially over the 75-year valuation period (from 41 percent to 28 percent), while general revenue transfers rise (from 43 percent to 52 percent), as does the share of premiums (from 14 percent to 18 percent).

Impact on the Federal Budget

In the report, the trustees somewhat direct attention away from the trust fund exhaustion dates to

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the more immediate effect that all the programs (Social Security and Medicare) have on the unified federal budget.[2] Figure 6, reproduced above, shows the excess of projected scheduled costs over dedicated tax and premium income of those programs as percentages of GDP. In 2014 the total general fund requirements for Social Security ($80 billion) and Medicare ($25 billion for HI and $248 billion for Supplementary Medical Insurance) are $352 billion, or 2 percent of GDP. That shortfall will grow rapidly through the 2030s as the baby boom generation retires, to 4.4 percent of GDP by 2040. Clearly, reforms will be needed before then, and it is unlikely that payroll tax increases will play a major role in those reforms, given the size of the shortfalls and the growing needs in other parts of the budget. The budget pressure will soon include increasing interest payments stemming from years of deficit financing of federal government spending and the prospective rise in interest rates.

[2]That emphasis was strongly criticized by the Social Security actuary in his statement of actuarial opinion on the trustees' report. In a discussion that seems more philosophical or political in nature than actuarial or economic, the actuary invokes a concept that is not familiar to me from law or practice — "the redemption of trust fund reserves represents a deferred use of revenues earmarked for the trust fund program alone, which have been collected in prior years and saved for later use." Unlike employer pensions in the private and public sectors, Social Security benefits are not accrued or guaranteed, and may be changed at any moment by Congress for any reason, including budget pressures. That is true regardless of what amounts are stated as being in the trust fund. The actuary was also quite critical of a small change in presentation of retirement replacement rates in the report. The trustees said that the prior presentation of rates of income replacement by Social Security benefits was misleading to those who used the numbers in their financial planning exercises because the rate was calculated using average lifetime earnings rather than the more relevant earnings near retirement.

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