Fixing Social Security and Medicare: The Top Priority Domestic Policy

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Aside from the war on terror, the biggest policy issue facing the federal government today concerns the massive long-run fiscal problems of Social Security and Medicare (and Medicaid). These programs will grow immensely in the coming years, due to the baby boom, the subsequent baby bust, a continuing increase in longevity, increased utilization of health care as the population ages, and technological progress in the health-care industry that creates new, but often costly, methods of diagnosis and treatment for disease.

By the next presidential election, some members of the baby-boom generation of approximately 75-80 million people, will begin collecting Social Security. By 2012, they will begin collecting benefits from Medicare. The longer-run problem is striking: Between now and 2030, the number of seniors will double, but the population of working-age people will rise by only one-fifth. Consequently, the number of seniors per working-age person will increase by two-thirds. To maintain the same real level of Social Security and Medicare payments per senior in 2030, under the current pay-as-you-go system, taxes per worker for those programs would have to rise by two-thirds.

The Social Security "trust fund" cannot provide for seniors without this tax increase, because that "trust fund" has invested in government bonds, which means that it has loaned money to the government. And the government has *already spent that money*. The only way for the government to repay its loans to the trust fund is to increase taxes or reduce spending on other programs. One solution or the other will probably have to begin before 2016. Until that time, the pay-as-you-go system under current law should generate sufficient revenue to fund social security outlays. Unfortunately, the Medicare system will necessitate tax increases or benefit cuts long before that – even without the extra costs of the new prescription-drug program.

One might think that another alternative – besides higher taxes or reduced benefits – would be for the government to borrow money to repay the Social Security trust fund. Alas, that is not an option, and the reason is important: The goods and services that workers and retirees consume in the future must (in discounted present value terms) equal the (discounted) value of final goods and services that the economy produces. For any level of productivity per *worker*, an increase in the number of retirees reduces the economy's production per *person*. Someone – workers or retirees – must make do with less. The *only* way to avoid this outcome is to *raise productivity per worker* along with the number of retirees per worker.

To fix ideas, focus on the year 2030, when the total number of seniors will have doubled. If those seniors each have the same living standards as today's seniors, then as a group they will consume twice as many goods and services as today, The key question is: "Where will these goods and services come from?"[1]

The possible answers are limited:

(1) Workers could accept a lower standard of living (resulting from higher taxes) – with lower consumption or a longer workweek.

(2) Seniors could accept a lower standard of living resulting from reduced social security benefits.

(3) Seniors could postpone retirement until older ages, working each year to produce approximately *half* of the value of goods and services that they consume in that year.

Assuming that solutions (1)-(3) are not palatable, that leaves only one answer:

(4) The government must adopt policies *today* that will raise *future* productivity: policies to increase the future capital stock or state of technology, thereby raising the total value of goods and services available for workers and retirees to share.[2] Those policies – aimed at raising *long-run economic growth* - include:

1. Tax reform to reduce or eliminate taxes on *saving* (including the federal income tax, the social security payroll tax, and corporate taxes).

2. Social security reform to eliminate the current pay-as-you-go system, replacing it with a system of private saving accounts (such as Individual Retirement Accounts) to provide for retirement of today's young. The discounted present value of benefits from this reform alone is approximately $10-$20 *trillion* dollars.[3]
3. Regulatory reform to reduce disincentives to invest.
4. Institutionalizing a stable monetary system to keep inflation low and to avoid policy swings that exacerbate business cycles.

How much additional long-run economic growth would be needed to solve the Social Security problem? The answer depends on the estimated size of the problem. Over the next 75 years, Social Security's total unfunded liability (the discounted present value of obligations minus expected revenues under current law) is approximately 5 trillion dollars (a figure that combines unfunded liabilities with the money needed to redeem the bonds in the trust fund). This figure is close to half of the nation's annual GDP. And Medicare's unfunded liability is roughly twice as large. So the total shortfall over the next 75 years in both programs is, in discounted present value, approximately $16 trillion.

Each one-tenth of one percent increase in long-run economic growth (e.g. from 3.0% to 3.1% annually) raises the discounted present value of future production by approximately 3 to 4 trillion dollars.[4] So a permanent one-tenth-of-one-percent increase in economic growth would provide ¾ or more of the additional production needed for Social Security to maintain its current level of benefits without a tax increase. Estimates in a wide range of studies indicate that changes in government policies can easily raise economic growth by more than enough to accomplish this. Those studies include estimates of the effects of taxes on incentives to work, to choose a retirement age, to save, and to invest, as well as estimates of the magnitude by which the current pay-as-you-go Social Security system reduces the economy's total capital stock and GDP. Can we grow out of the Social Security problem? The answer is clearly, "yes."

A larger increase in long-run economic growth, around one-half of one percent, would be required to raise enough funds for Social Security, Medicare, and Medicaid together, without reducing benefits or raising taxes. Estimates for Medicare are subject to more potential error than estimates for Social Security, because they depend partly on the utilization of health-care services and increases in health-care costs.

Medicare/Medicaid reform requires more than policies to raise economic growth and thereby raise the level of production in future decades. Serious Medicare/Medicaid reform should focus on eliminating the current "fee for service" structure that creates over-utilization of health-care services and adverse selection at HMOs. This system should be replaced with either a system of private savings to purchase health-care services along with a risk-rated voucher program for purchasing health insurance.

Similarly, Social Security reform should pay current and future retirees amounts proportional to their past tax payments to the system, create a system of private – untaxed - savings for retirement, and finance the transition by issuing debt.

Structural changes in the Social Security and Medicare/Medicaid programs, along with changes in tax and regulatory policies to raise the long-run rate of economic growth, should essentially "solve" the key fiscal problems facing the government today.

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[1] See my earlier SOMC paper, "The Only Real Solution to the Social Security Problem," Shadow Open Market Committee Meeting, October 16, 2001, available at http://www.somc.rochester.edu/Oct01/StockmanOct01.pdf

[2] "The Only Real Solution…" discusses why other solutions, such as borrowing from other countries, do not solve the problem without creating new problems. My earlier SOMC paper, "The Only Real Solution to the Social Security Problem," Shadow Open Market Committee Meeting, October 16, 2001, available at http://www.somc.rochester.edu/Oct01/StockmanOct01.pdf

[3] See Martin Feldstein,

[4] For example, a permanent increase in economic growth from 3.0% to 3.1% has a discounted present value, using an interest rate of 3%, of $3.3 trillion. An increase from 4.0% to 4.1% has a discounted present value of $4 trillion.