

A MESSAGE TO THE PUBLIC:

Each year the Trustees of the Social Security and Medicare trust funds report on the current status and projected condition of the funds over the next 75 years. This message summarizes the 2006 Annual Reports.

The fundamentals of the financial status of Social Security and Medicare remain problematic under the intermediate economic and demographic assumptions. Social Security's current annual surpluses of tax income over expenditures will soon begin to decline, and will be followed by deficits that begin to grow rapidly toward the end of the next decade as the baby-boom generation retires. Expenditures of Medicare's Hospital Insurance (HI) Trust Fund that pays hospital benefits are projected to exceed taxes and other dedicated revenues in 2006, with annual cash flow deficits expected to continue and to grow rapidly after 2010 as baby boomers begin to retire. The projected growing deficits in both programs will exhaust HI trust fund reserves in 2018 and Social Security reserves in 2040, under current financing arrangements. In addition, the Medicare Supplementary Medical Insurance (SMI) Trust Fund that pays for physician services and the new prescription drug benefit will require substantial increases over time in both general revenue financing and beneficiary premium charges. As Social Security and HI reserves are drawn down and SMI general revenue financing requirements continue to grow, pressure on the Federal budget will intensify. We do not believe the currently projected long-run growth rates of Social Security or Medicare are sustainable under current financing arrangements.

Social Security

The annual cost of Social Security benefits represents 4.2 percent of gross domestic product (GDP) in 2005 and is projected to rise to 6.2 percent of GDP in 2030, and then slightly to 6.3 percent of GDP in 2080. The projected 75-year actuarial deficit in the combined Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds is 2.02 percent of taxable payroll, up from 1.92 percent in last year's report. This increase is due primarily to advancing the projection period, the availability of recent data that led to revisions in key assumptions, and to changes in methods. Although the program passes our short-range test of financial adequacy, it continues to fail our long-range test of close actuarial balance by a wide margin. Projected OASDI tax income will begin to fall short of outlays in 2017, and will be sufficient to finance only 74 percent of scheduled annual benefits in 2040, when the combined OASDI trust fund is projected to be exhausted.

Social Security could be brought into actuarial balance over the next 75 years in various ways, including an immediate increase of 16 percent in payroll tax revenues or an immediate reduction in benefits of 13 percent (or some combination of the two). To the extent that changes are delayed or phased in gradually, greater adjustments in scheduled benefits and revenues would be required. Ensuring that the system is solvent on a sustainable basis over the next 75 years and beyond would also require larger changes.

Medicare

As we reported last year, Medicare's financial difficulties come sooner—and are much more severe—than those confronting Social Security. While both programs face demographic challenges, the impact is more severe for Medicare because health care costs increase at older ages. Moreover, underlying health care costs per enrollee are projected to rise faster than the wages per worker on which the payroll tax is paid and on which Social Security benefits are based. As a result, while Medicare's annual costs were 2.7 percent of GDP in 2005, or over 60 percent of Social Security's, they are now projected to surpass Social Security expenditures in a little more than 20 years and reach 11 percent of GDP in 2080.

The projected 75-year actuarial deficit in the HI Trust Fund is now 3.51 percent of taxable payroll, up from 3.09 percent in last year's report due primarily to greater costs in 2005 than expected, changes in managed care assumptions, advancing the projection period, and more recent data that suggests higher utilization of health services in the future. The fund again fails our test of short-range financial adequacy, as assets drop below the level of the next year's projected expenditures within 10 years—in 2012. The fund also continues to fail our long-range test of close actuarial balance by a wide margin. The projected date of HI Trust Fund exhaustion moves forward to 2018, from 2020 in last year's report, and projected HI tax income falls short of outlays in this and all future years. HI could be brought into actuarial balance over the next 75 years by an immediate 121 percent increase in program income, or an immediate 51 percent reduction in program outlays (or some combination of the two). As with Social Security, however, adjustments of far greater magnitude would be necessary to the extent changes are delayed or phased in gradually, or to make the program solvent on a sustainable basis over the next 75 years and beyond.

Part B of the SMI Trust Fund, which pays doctors' bills and other outpatient expenses, and the recent Part D, which pays for access to prescription drug coverage, are both projected to remain adequately financed into the indefinite future by operation of current law that automatically sets financing each year to meet next year's expected costs. Expected rapid cost increases, however, will result in rapidly growing general revenue financing needs—projected to rise from just under 1 percent of GDP today to almost 5.0 percent in 2080— as well as substantial increases over time in beneficiary premium charges.

The Medicare Modernization Act of 2003 requires that the Medicare Report include a determination of whether the difference between total Medicare outlays and dedicated financing sources (such as premiums and payroll taxes) exceeds 45 percent of total outlays within the first seven years of the projection period (2006-2012 for the 2006 Report). The Act requires that an affirmative determination in two consecutive reports be treated as a funding warning for Medicare that would, in turn, require a Presidential proposal to respond to the warning and expedited Congressional consideration of such proposal. The 2006 Report projects that the difference will reach 45 percent in 2012, marking the first time a determination of “excess general revenue Medicare funding” has been made. A similar determination in next year's report would trigger the Medicare funding warning.

Conclusion

Though highly challenging, the financial difficulties facing Social Security and Medicare are not insurmountable. We must, however, take action to address them in a timely manner. The sooner these challenges are addressed, the more varied and less disruptive their solutions can be. With informed public discussion and creative thinking that relates the principles underlying these programs to the economic and demographic realities, and to the changing needs and preferences of working and retired households, Social Security and Medicare can continue to play a critical role in the lives of all Americans.

By the Trustees:

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A SUMMARY OF THE 2006 ANNUAL SOCIAL SECURITY AND MEDICARE TRUST FUND REPORTS

Who Are the Trustees? There are six Trustees, four of whom serve by virtue of their positions in the Federal Government: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two Trustees are public representatives appointed by the President: John L. Palmer, University Professor and Dean-Emeritus of the Maxwell School of Citizenship and Public Affairs at Syracuse University, and Thomas R. Saving, Director of the Private Enterprise Research Center and Professor of Economics at Texas A & M University.

What Are the Trust Funds? The trust funds were created in the U.S. Treasury to account for all program income and disbursements. Social Security and Medicare taxes, premiums and other income are credited to the funds. Benefit payments and program administrative costs are the only purposes for which disbursements from the funds can be made.

Program revenues not needed in the current year to pay benefits and administrative costs are invested in special non-marketable securities of the U.S. Government on which a market rate of interest is credited. Thus, the trust funds represent the accumulated value, including interest, of all prior program annual surpluses and deficits, and provide automatic authority to pay benefits.

There are four separate trust funds. For Social Security, the Old-Age and Survivors Insurance (OASI) Trust Fund pays retirement and survivors benefits, and the Disability Insurance (DI) Trust Fund pays disability benefits. (The combined trust funds are described as OASDI.) For Medicare, the Hospital Insurance (HI) Trust Fund pays for inpatient hospital and related care. The Supplementary Medical Insurance (SMI) Trust Fund is composed of Part B, which pays for physician and outpatient services, and Part D, which provides the new prescription drug benefit. Medicare benefits are provided to most people age 65 and over and to most workers who are receiving Social Security disability benefits.

What Were the Trust Fund Results in 2005? In December 2005, 40.1 million people received OASI benefits, 8.3 million received DI benefits, and 42.5 million were covered under Medicare. Trust fund operations, in billions of dollars, are shown below (totals may not add due to rounding). All four trust funds showed net increases in assets during 2005.

	OASI	DI	HI	SMI
Assets (end of 2004)	\$1,500.6	\$186.2	\$269.3	\$19.4
Income during 2005	604.3	97.4	199.4	158.1
Outgo during 2005	441.9	88.0	182.9	153.5

	OASI	DI	HI	SMI
Net increase in assets	162.4	9.4	16.4	4.6
Assets (end of 2005)	1,663.0	195.6	285.8	24.0

How Has the Outlook for the Trust Funds Changed Since Last Year?

Under the intermediate assumptions, the combined OASDI Trust Funds show a 75-year actuarial deficit equal to 2.02 percent of taxable payroll, somewhat larger than last year’s estimate of 1.92 percent. That change is largely attributable to two factors. First, moving the valuation period forward a year from 2005-79 to 2006-80, adds a year (2080) with a large projected deficit into the estimate of long-range funding adequacy. Second, in light of recent evidence, the assumed long-term real interest rate has been lowered from 3.0 to 2.9 percent, increasing the present value of projected annual deficits in program finances later in the valuation period. The OASDI Trust Funds, separately and combined, are adequately financed over the next 10 years under the intermediate assumptions.

Medicare’s HI Trust Fund now has a projected 75-year actuarial deficit equal to 3.51 percent of payroll compared with last year’s estimate of 3.09 percent under the intermediate assumptions. That change results from multiple factors that include moving the valuation period forward by a year to include 2080 (a high deficit year), higher than anticipated HI costs in 2005 that are judged likely to persist, higher assumed costs for managed care and non-hospital services, and improvements in projection methods. The HI Trust Fund is inadequately funded over the next 10 years, with trust fund assets projected to fall short of 100 percent of expenditures in 2012. The SMI Trust Fund is adequately financed in both the short and long term because of the automatic financing established for Medicare Parts B and D.

How Are Social Security and Medicare Financed? For OASDI and HI, the major source of financing is payroll taxes on earnings that are paid by employees, their employers, and by the self-employed. The self-employed are charged the equivalent of the combined employer and employee tax rates. During 2005, an estimated 159 million people had earnings covered by Social Security and paid payroll taxes; for Medicare, the corresponding figure was 163 million people. The payroll tax rates are set by law and for OASDI apply to earnings up to an annual maximum (\$94,200 in 2006) that increases with the growth in nationwide average wages. HI taxes are paid on total earnings. The tax rates (in percent) for 2006 and later are:

	OASI	DI	OASDI	HI	Total
Employees	5.30	0.90	6.20	1.45	7.65
Employers	5.30	0.90	6.20	1.45	7.65
Combined total . . .	10.60	1.80	12.40	2.90	15.30

Within SMI both Part B and Part D are financed largely (about 75 percent) by payments from Federal general fund revenues supplemented by

monthly premiums charged beneficiaries. In 2006, the Part B premium is \$88.50. The national average Part D premium for 2006 is estimated to be \$32.20. (Actual premium amounts charged to Part D beneficiaries depend on the specific plan in which they are enrolled.) Part D also receives payments from States beginning in 2006 for Federal assumption of Medicaid responsibilities for premium and cost-sharing subsidies for individuals eligible for both Medicare and Medicaid, which will initially cover 12 percent of Part D costs but gradually decline to 9 percent. Part B and Part D premium amounts are based on methods defined in law and increase as the estimated costs of those programs rise. Income to each trust fund by source in 2005 is shown in the table below (totals may not add due to rounding).

Source (<i>in billions</i>)	OASI	DI	HI	SMI
Payroll taxes	\$506.9	\$86.1	\$171.4	—
General fund revenue	—	—	0.5	\$119.2
Interest earnings.	84.0	10.3	15.2	1.4
Beneficiary premiums	—	—	2.4	37.5
Taxes on benefits	13.8	1.1	8.8	—
Other	-0.3	—	1.1	—
Total	604.3	97.4	199.4	158.1

What Were the Administrative Expenses in 2005? Administrative expenses, as a percentage of total expenditures, were:

	OASI	DI	HI	SMI
Administrative expenses 2005. . .	0.7	2.6	1.6	2.1

How Are Estimates of the Trust Funds’ Future Status Made?

Short-range (10-year) and long-range (75-year) estimates are reported for all funds. The estimates are based on current law and assumptions about all of the factors that affect the income and outgo of each trust fund. Assumptions include economic growth, wage growth, inflation, unemployment, fertility, immigration, and mortality, as well as factors relating to disability incidence and the cost of hospital, medical, and prescription drug services.

Because the future is inherently uncertain, three alternative sets of economic and demographic assumptions are used to show a range of possibilities. The intermediate assumptions (alternative II) reflect the Trustees’ best estimate of future experience. The low-cost alternative I is more optimistic for trust fund financing, and the high-cost alternative III is more pessimistic; they show trust fund projections for more and less favorable economic and demographic conditions for trust fund financing than the

best estimate. The statistics and analysis presented in the rest of the Summary are based on the intermediate assumptions.

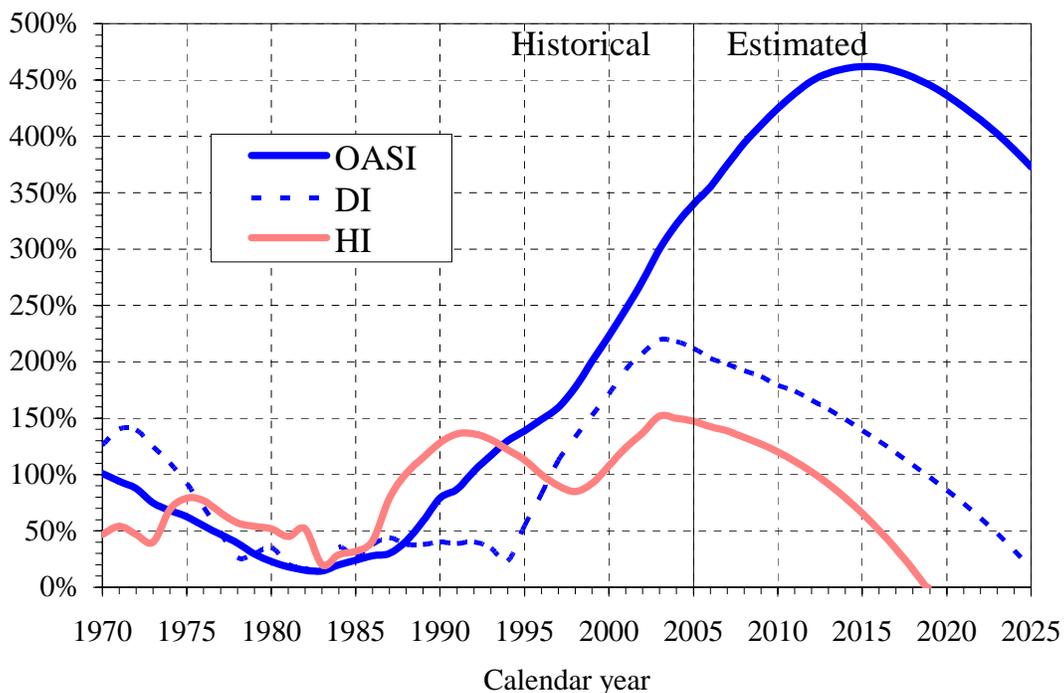
The assumptions are reexamined each year in light of recent experience and new information about future trends, and are revised as warranted. For example, the intermediate assumptions in this year's reports include a lower long-term real rate of interest (2.9 percent), a higher ultimate total fertility rate (2.0), and an increased long-term rate of growth in productivity (1.7 percent). In general, greater confidence can be placed in the assumptions and estimates for earlier projection years than for later years.

What is the Short-Range Outlook (2006-2015) for the Trust Funds?

For the short range, the adequacy of the OASI, DI, and HI Trust Funds is measured by comparing their assets at the beginning of a year to projected costs for that year (the "trust fund ratio"). A trust fund ratio of 100 percent or more—that is, assets at least equal to projected benefit payments for a year—is considered a good indicator of a fund's short-term adequacy. This level of projected assets for any year means that even if expenditures exceed income, the trust fund reserves, combined with annual tax revenues, would be sufficient to pay full benefits for several years, allowing time for legislative action to restore financial adequacy.

By this measure, the OASI and DI funds are considered financially adequate throughout the short range because the assets of each fund exceed the 100 percent level through the year 2015. The HI fund does not meet the short-range test of financial adequacy because its assets fall below the 100 percent level of one year's outgo during 2012. Chart A shows these trust fund ratios under the intermediate assumptions through 2025.

Chart A—OASI, DI, and HI Trust Fund Ratios
[Assets as a percentage of annual expenditures]



For SMI, a less stringent annual “contingency reserve” asset test applies to both Part B and Part D because the financing of each of those accounts is provided by beneficiary premiums and Federal general fund revenue payments automatically adjusted each year to meet expected costs. Thus, under current law both SMI accounts are fully financed during the next decade and beyond no matter what the costs may be; however, these projections of solvency for the SMI Trust Fund do not obviate concern about the large projected increases in SMI costs.

The following table shows the projected income and outgo, and the change in the balance of each trust fund except SMI, over the next 10 years. Note the separation of SMI income and expenditures into columns for Parts B and D. The change in SMI is not shown because of its automatic annual adjustments in income to meet the next year’s projected expenditures.

ESTIMATED OPERATIONS OF TRUST FUNDS

(In billions—totals may not add due to rounding)

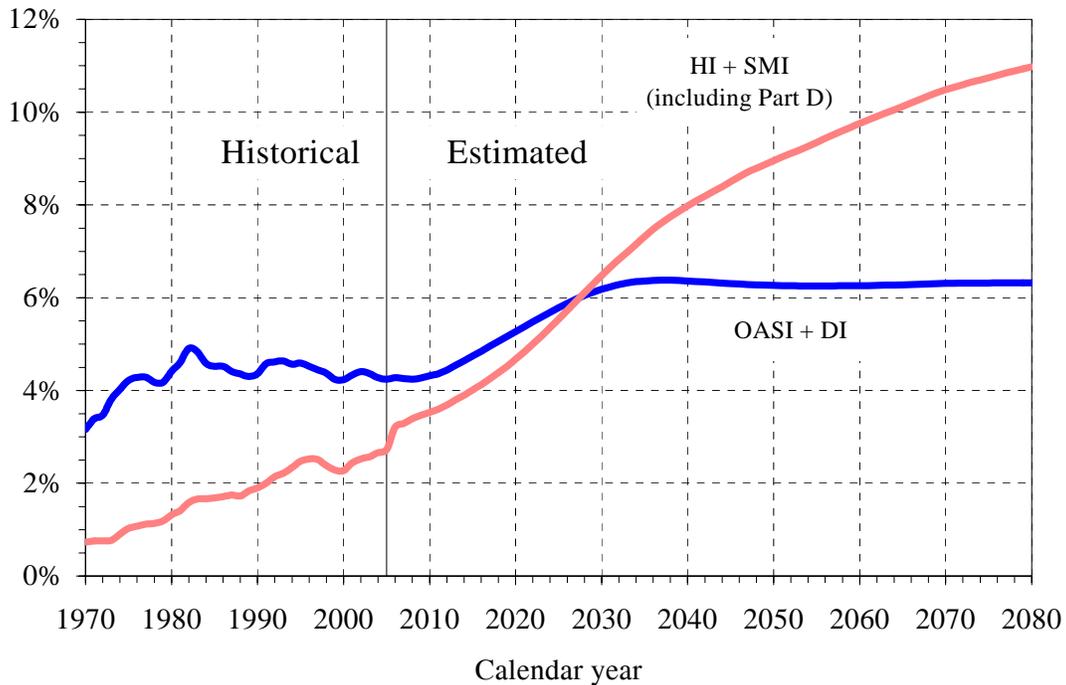
Year	Income					Expenditures					Change in fund		
	OASI	DI	HI	SMI		OASI	DI	HI	SMI		OASI	DI	HI
				B	D				B	D			
2006	\$639	\$102	\$210	\$177	\$58	\$468	\$96	\$200	\$173	\$58	\$171	\$6	\$10
2007	673	107	219	199	68	489	102	213	182	68	184	5	6
2008	720	113	233	204	78	513	107	227	194	78	207	6	7
2009	763	118	246	228	87	542	113	243	208	87	221	5	3
2010	810	124	257	204	94	576	121	259	220	94	235	3	-2
2011	861	130	271	235	104	612	127	277	233	104	250	4	-6
2012	911	136	284	251	115	653	135	296	248	115	258	1	-12
2013	960	142	296	268	127	699	142	318	265	127	261	-1	-21
2014	1,011	148	308	285	140	749	150	340	282	140	261	-3	-31
2015	1,063	153	320	304	155	803	159	363	300	155	260	-5	-42

What is the Long-Range (2006-2080) Outlook for Social Security and Medicare Costs? An instructive way to view the projected cost of Social Security and Medicare is to compare the real resource requirements for the two programs with gross domestic product (GDP), the most frequently used measure of the total U.S. economy (Chart B). Costs for both programs increase steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. But Medicare costs increase at a faster rate because of the rising cost of health services, increasing utilization rates, and anticipated increases in the complexity of services. Beyond 2030, Social Security costs grow slowly but continue to increase primarily because of projected increases in life expectancy. Medicare costs, however, will continue to grow rapidly due to expected increases in the cost of health care. The continued development, adoption, and use of new technology will likely cause per capita health care expenditures to continue to grow faster in the long term, as they have in the past, than the economy as a whole.

The 75-year projected cost outlook for Social Security is very similar to that described in last year's report. In contrast, there are two aspects of the Medicare projections that are notably different. Perhaps most important is a substantial downward revision in the estimated cost of Medicare Part D benefits. This year's report projects Part D costs at 0.4 percent of GDP in 2006, rising to 2.3 percent of GDP in 2080. By comparison, last year's projections were for costs to equal 0.6 percent of GDP in 2006, increasing to 3.3 percent in 2079. The main reasons for the revised projections are lower than expected drug spending in 2004 and 2005, anticipated drug cost savings in 2006 and later years in Part D plans, and lower than previously anticipated enrollments in stand-alone prescription drug plans. The second important factor that affects the time path of Medicare cost projections is a change in projection methodology. In recent reports, the increase in average expenditures per beneficiary during the 25th through 75th years of the projection period has been assumed to equal the growth in per capita GDP plus 1 percentage point. This report implements a scenario in which health care cost growth rates gradually decline from their recent rates of 2 to 3 percentage points above annual GDP growth to an ultimate assumed level equal to the rate of GDP growth. Over the 2006-80 reference period, the change effectively increases projected costs earlier in the period but lowers them in later years.

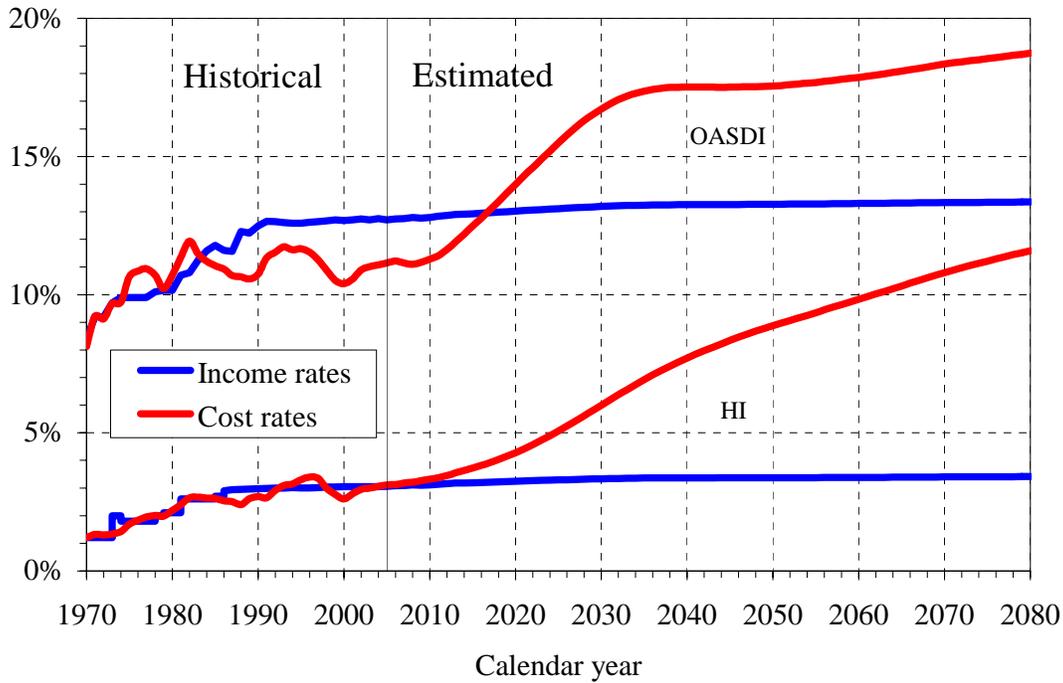
In 2005, the combined cost of the Social Security and Medicare programs represented nearly 7 percent of GDP. Social Security outgo amounted to 4.2 percent of GDP in 2005 and is projected to increase to 6.3 percent of GDP in 2080. Medicare's cost was smaller in 2005, 2.7 percent of GDP, but will surpass the cost of Social Security in just over two decades. It is projected to grow to 11.0 percent of GDP in 2080—a fourfold increase—when it will be 75 percent larger than the cost of Social Security. The Medicare cost projection for 2080 is substantially lower than the 13.6 percent figure for 2079 presented in last year's report. In 2080, the combined cost of the programs will represent 17.3 percent of GDP. By way of comparison, in 2005 all Federal receipts amounted to 17.5 percent of GDP.

Chart B—Social Security and Medicare Cost as a Percentage of GDP



What is the Outlook for OASDI and HI Costs Relative to Tax Income? Although Medicare's and Social Security's costs are projected to grow substantially faster than the economy over the next several decades, tax income to the HI and OASDI Trust Funds is not. Because the primary source of income for HI and OASDI is the payroll tax, it is customary to compare the programs' income and cost rates as percentages of taxable payroll, as in Chart C. Note that the income rate lines do not rise substantially over the long run. This is because payroll tax rates are not scheduled to change and income from the other tax source to these programs, taxation of OASDI benefits, will rise only gradually from a greater proportion of beneficiaries being subject to taxation in future years.

Chart C—Income and Cost Rates
[Percentage of taxable payroll]



What is the Long-Range Actuarial Balance of the OASI, DI, and HI Trust Funds? The traditional way to view the outlook of the payroll tax financed trust funds is in terms of their actuarial balances for the 75-year valuation period. The actuarial balance of a fund is essentially the difference between annual income and costs, expressed as a percentage of taxable payroll, summarized over the 75-year projection period. Because SMI is brought into balance annually through premium increases and general revenue transfers, actuarial balance is not a useful concept for that program.

The OASI, DI, and HI Trust Funds each have an actuarial deficit under the intermediate assumptions, as shown below. Each actuarial deficit can be interpreted as the percentage points that could be either added to the current law income rate or subtracted from the cost rate for each of the next 75 years to bring the funds into actuarial balance, defined as a terminal trust fund balance equal to the following year’s expenditures. However, such uniform changes, while adequate for this period as a whole, would close less than half of the gap in 2080 between the annual income and cost rates for OASDI and HI shown in Chart C.

**LONG-RANGE ACTUARIAL DEFICIT OF THE
OASI, DI, AND HI TRUST FUNDS**

(As a percentage of taxable payroll; totals may not add due to rounding)

	<u>OASI</u>	<u>DI</u>	<u>OASDI</u>	<u>HI</u>
Actuarial Deficit	1.68	0.33	2.02	3.51

What Are Key Dates in Long-Range OASI, DI, and HI Financing?

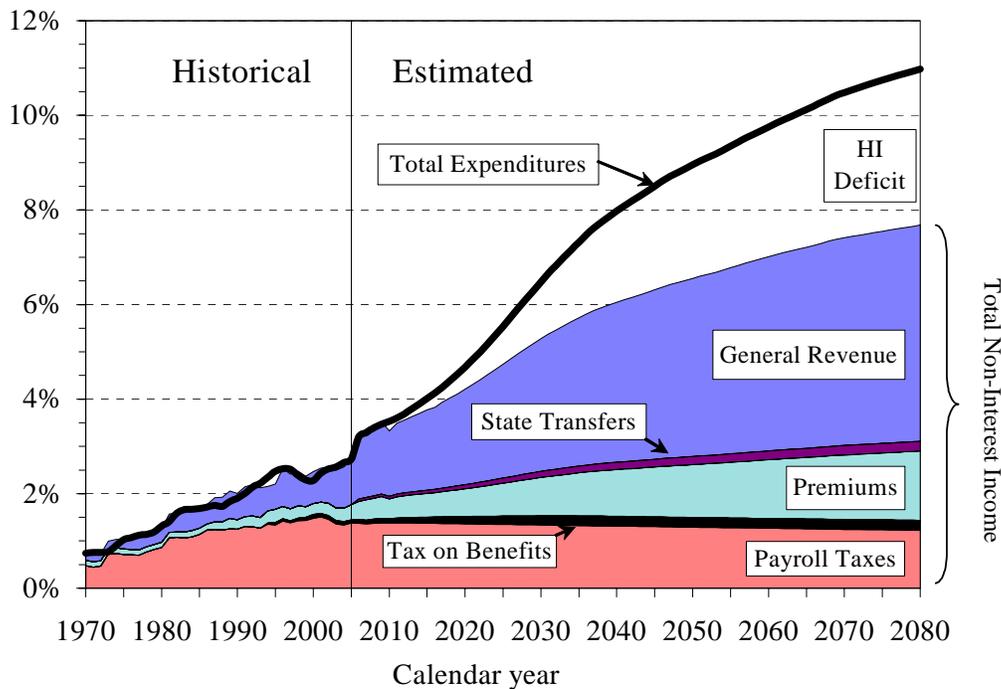
When costs exceed income excluding interest (shown in Chart C), use of trust fund assets occurs in stages. For HI, the process is predicted to start anew in 2006, when net redemptions of trust fund assets will begin to be needed to help pay benefits. In fact, that already occurred in 2004, but not in 2005 due to an unexpected adjustment to tax revenue for earlier years. Beginning in 2010 the amount of assets that will have to be redeemed each year will exceed the annual interest earned on the fund assets. The trust fund is projected to be exhausted in 2018. Those dates are two years earlier than reported last year due to higher than expected costs in 2005 that are likely to persist and higher utilization rates anticipated for HI services. In 2018, tax income is estimated to be sufficient to pay 80 percent of HI costs—and by 2080 only 29 percent. For OASDI the onset of net trust fund redemptions occurs in 2017 and redemptions begin to exceed annual interest income in 2027. OASDI assets are now projected to be exhausted in 2040—a year earlier than indicated in last year’s report—when tax income would cover 74 percent of costs. By 2080, tax income would cover 70 percent of scheduled benefits. The key dates regarding cash flows are shown below.

KEY DATES FOR THE TRUST FUNDS

	OASI	DI	OASDI	HI
First year outgo exceeds income excluding interest	2018	2005	2017	2006
First year outgo exceeds income including interest	2028	2013	2027	2010
Year trust fund assets are exhausted	2042	2025	2040	2018

How Do the Sources of Medicare Financing Change? As Medicare costs grow over time, general revenues and beneficiary premiums will play a larger role in financing the program. Chart D shows expenditures and current law non-interest revenue sources for HI and SMI combined as a percentage of GDP. The total expenditure line is the same as shown in Chart B and shows Medicare costs rising to 11.0 percent of GDP by 2080. Revenues from taxes are expected to remain roughly 1.5 percent of GDP, while general fund revenue contributions are projected to rise from 1.4 percent in 2006 to 4.6 percent in 2080, and beneficiary premiums from 0.4 to 1.5 percent of GDP. Thus, revenues from taxes will fall substantially as a share of total non-interest Medicare income (from 45 percent to 19 percent) while general fund revenues will rise (from 42 to 60 percent), as will premiums (from 12 percent to 19 percent). The gap between total non-interest income and expenditures steadily widens due to growing annual HI deficits, which reach 3.5 percent of GDP by 2080. All told, by 2080 the Medicare program is projected to require general revenue transfers equal to 8.1 percent of GDP, assuming that the HI deficit would be so covered, which is not automatic under current law.

Chart D—Medicare Expenditures and Non-Interest Income by Source as a Percent of GDP



The Medicare Modernization Act (2003) requires that the Board of Trustees determine whether the difference between program outlays and dedicated financing sources (HI payroll taxes, the HI share of income taxes on Social Security benefits, Part D State transfers, and beneficiary premiums) exceeds 45 percent of Medicare outlays within the first seven years of the 75-year projection period. Because that difference (35 percent in 2005) is projected to reach 45 percent in 2012, a determination of “excess general revenue Medicare funding” is made in this year’s report. If two consecutive annual reports contain such a determination, a “Medicare funding warning” is triggered. That finding would require the President to submit proposed legislation to respond to the warning and Congress to act upon it on an expedited basis.

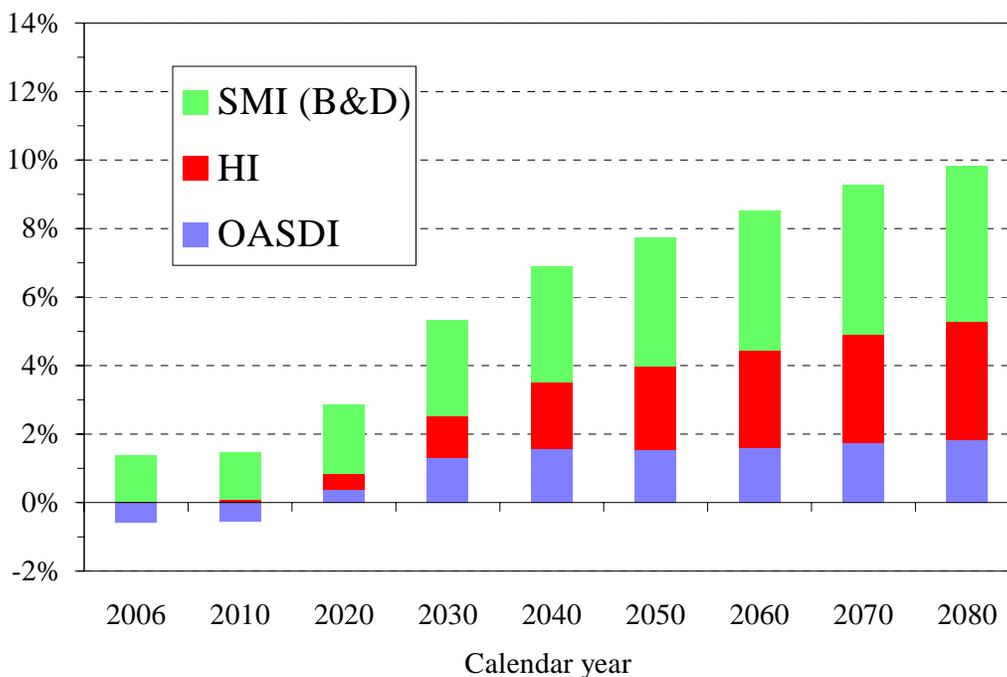
Why is Reform to Improve the Medicare and Social Security Financial Imbalance Needed? Public discussion of the financial status of Medicare and Social Security tends to focus on the HI and OASDI Trust Fund exhaustion dates, when projected finances under current law would be insufficient to pay the full amount of scheduled benefits. A more fundamental reason for concern is the growing demands that the programs will place on Federal general fund revenues well before their trust funds are exhausted.

The mounting financial shortfall in these programs is illustrated in Chart E. It shows, as a percentage of GDP, the gap between annual HI and OASDI tax income and the cost of scheduled benefits, plus the 75 percent

general fund revenue contributions to SMI's Part B (75 percent of expenditures) and Part D. The initial negative amounts for OASDI in 2005 and for more than a decade thereafter represent net revenues to the Treasury that result in the issuance of Treasury bonds to the trust funds in years of annual cash flow surpluses. The positive amounts that begin in 2017 for OASDI and in 2010 for HI initially represent payments the Treasury must make to the funds when assets are redeemed to help pay benefits in the years leading up to exhaustion of the funds. After the exhaustion dates, (2040 for OASDI, 2018 for HI), those amounts depict growing shortfalls in program finances.

In 2006, the Social Security tax income surplus is estimated to be more than offset by the shortfall in tax and premium income for Medicare, resulting in a small overall cash shortfall that must be covered by transfers from general fund revenues. The combined shortfall is projected to grow each year, such that by 2017 net revenue flows from the general fund to the trust funds will total \$487 billion, or 2.2 percent of GDP. Because neither the interest paid on the Treasury bonds held in the HI and OASDI Trust Funds, nor their redemption, provides any net new income to the Treasury, the full amount of the required Treasury payments to the trust funds must be financed by some combination of increased taxation, increased Federal borrowing from and debt held by the public, and a reduction in other government expenditures. Thus, these payments along with the 75 percent general fund revenue contributions to SMI will add greatly to pressures on Federal general fund revenues much sooner than is generally appreciated.

Chart E—OASDI and HI Tax Income Shortfall to Pay Scheduled Benefits, and the 75 Percent General Fund Revenue Contribution to SMI
(Percentage of GDP)



It is also evident from Chart E that currently projected benefit costs for Medicare and Social Security pose a far more serious long-term financing problem than is generally recognized. The shortfall of dedicated payroll tax and premium income will grow rapidly in the 2010 to 2030 period as the baby-boom generation reaches retirement age. Beyond 2030, the shortfall continues to increase rapidly due to health care costs that grow faster than GDP and because of the increasing life expectancy of beneficiaries. In 2005, the combined annual cost of HI, SMI, and OASDI amounted to about 40 percent of total Federal revenues and about 7 percent of GDP. These costs are projected to double to 14 percent of GDP by 2040 and then to rise further to 17 percent of GDP in 2080. Over the past four decades, the average share of total Federal revenues as a percentage of GDP has been 18 percent and has never exceeded 21 percent. Assuming the continued need to fund a wide range of other government functions, the anticipated growth in Social Security and Medicare costs would require that the total Federal revenue share of GDP increase to wholly unprecedented levels.

This year's Trustees Reports describe large long-term financial imbalances for Social Security and especially Medicare, and demonstrate the need for timely and effective action. The sooner that solutions are adopted, the more varied and gradual they can be.

A MESSAGE FROM THE PUBLIC TRUSTEES

These are the sixth consecutive annual Trustees Reports in which we have participated since first being appointed Public Trustees by President Clinton in 2000. When we wrote our message last year, we did not expect to continue in this role, but we were recently reappointed by President Bush. As Public Trustees we have always striven to work in a nonpartisan way to ensure the integrity of the process by which these reports are prepared and the credibility of the information they contain. Despite the inherent uncertainty of the projections in these reports due to numerous assumptions that must be made, we believe they provide the most reliable picture available of the financial outlook under current law for the Medicare and Social Security programs.

Social Security

This year's OASDI report shows very minor deviations from last year's in the financial status of Social Security. In essence, there has been a slight deterioration in the outlook for the combined trust funds through mid-century—largely due to the negative consequences of an assumed lower interest rate for the income generated by trust fund assets—and a slight improvement in the latter part of the 75-year projection period—largely due to the positive consequences of an assumed higher fertility rate for the growth of the labor force. As a result of these changes and the extension of the valuation period by one year, the date of trust fund exhaustion has advanced from 2041 to 2040 and there have been increases in both the 75-year actuarial deficit (from 1.92 to 2.02 of taxable payroll) and the open group unfunded obligation (from \$4.0 to \$4.6 trillion in present value); whereas the program's annual cost and deficit in 2080 have both declined in relative terms (from 6.4 to 6.3 percent of GDP and from 5.8 to 5.4 percent of taxable payroll, respectively).

But the larger picture for Social Security remains the same. Current annual surpluses of tax income over expenditures for the combined OASDI trust funds will soon begin to decline with the retirement of the baby-boom generation and, in little more than a decade, they become rapidly growing deficits covered by cash transfers from the General Fund of the Treasury (resulting from redemption of trust fund assets) that will reach 15 percent of Federal income tax revenues (projected at their historical average of GDP over the past four decades) by the time of trust fund exhaustion. At that time, annual Social Security tax income will be sufficient to pay only about three-quarters of scheduled benefits, and the

gap between the two will gradually increase over the remainder of the 75-year projection period with continued improvements in life expectancies.

As we noted in last year's Message, demographic change is the major force shaping the financial outlook for Social Security; only highly unlikely changes in expected rates of fertility, mortality, and immigration could dramatically alter this outlook. The same is true of the long-term growth rate of the economy. Certainly the financial outlook for Social Security would substantially improve were the economy to expand as rapidly in future decades as in past ones, but the marked slowdown in the growth of the labor force over the next two decades virtually prohibits this.

Long-run economic growth is largely determined by increases in the size of the labor force and in output per hour worked, or total economy productivity. The labor force has grown at a rate averaging 1.6 percent annually over the past four decades, mainly because of high birth rates in the decades immediately following World War II and the large increase in the labor force participation rate of women over the final third of the century. Along with an average annual growth rate in productivity of about 1.7 percent for the past 40 years, this has resulted in the economy growing over the same period at an annual average rate of 3.0 percent (after adjusting for inflation). But women's labor force participation is not expected to increase much further and the baby-boom generation will soon begin exiting the labor force. In consequence, even though the Trustees assume the continuation of relatively robust rates of fertility and immigration, this year's report—like last year's—shows the annual growth rate of the labor force declining to 0.5 percent in less than a decade and to only 0.3 percent within two decades and thereafter. The result is a long-term rate of real economic growth not much above 2 percent, unless prospective increases in productivity far exceed any historic norms and the most optimistic expert projections. The Trustees currently assume 1.7 percent for the ultimate growth rate of productivity, and we know of no expert forecast that would place it significantly above 2 percent.

Medicare

The changes from last year in the financial outlook for Medicare are much more substantial and complex than for Social Security. Currently, HI tax income and other dedicated revenues fall slightly below annual expenditures. These “cash flow” deficits are now projected to grow more rapidly in the near term due to somewhat higher than expected costs in

2005 and upward revision in the short-term assumptions about utilization of HI services. In consequence, the HI trust fund exhaustion date advances from 2020 to 2018, at which time annual tax income will be sufficient to pay only 80 percent of estimated expenditures. The immediate outlook for Part B has also worsened somewhat due to higher-than-anticipated costs in 2004 and 2005 and a recently legislated increase in the physician fee schedule update for 2006. Even so, the projected Part B payments are unrealistically constrained because they must assume the sizeable annual reductions in this fee schedule in subsequent years mandated by current law actually occur—despite the fact that Congress overrode such reductions in each of the past four years and is highly likely to do so again in the future. In contrast to HI and Part B, costs in the near term for the new Part D drug benefit are projected to be significantly lower than those in the 2005 report due to recent slower growth in overall prescription drug spending and lower enrollment in stand-alone prescription drug plans than was expected a year ago, among other factors.

In addition to the factors just noted, Medicare's long-range financial outlook also reflects a refinement in the long-term growth assumption used by the Trustees for all three program components that has the effect of raising projected costs in the intermediate term while significantly lowering them toward the end of the 75-year projection period.¹ This refinement provides for a more gradual transition from current health care cost growth rates—which have averaged 2 to 3 percentage points above the level of GDP growth—to the ultimate assumed rate equal to that of GDP growth, in such a way that the overall cost for the next 75 years as a whole is consistent with the previous “GDP plus 1 percent” assumption, other things held constant. Under the new methodology, costs for all Medicare services are assumed to grow about 1.4 percent faster than GDP in 2030 but only 0.8 percent faster by 2050 and 0.2 percent by 2080—as opposed to a constant 1.0 percent faster than GDP over this 50-year period.

¹ The assumed long range rate of growth in annual Medicare expenditures per beneficiary is a crucial determinant of the projected cost of Medicare-covered services in the more distant future. In recent reports, this growth rate was assumed be one percent higher than that of GDP per capita for years 25 through 75 of the projection period. With the inclusion of infinite-horizon projections starting in the 2004 report, per beneficiary expenditures after the 75th year were assumed to increase at the same rate as per capita GDP.

As a result of all updates and changes in assumptions and methodology from last year, expenditures for HI are now projected to grow by 2080 from their current levels of 3.1 percent of taxable payroll and 1.5 percent of GDP to 'only' 11.6 and 4.9 percent, respectively, rather than to 12.9 and 5.4 percent as previously projected. But the actuarial deficit for HI over the next 75 years shown in this year's report has increased from 3.09 to 3.51 percent of taxable payroll, and the corresponding unfunded obligation from \$8.6 to \$11.0 trillion in present value. The pattern of higher initial, followed by lower ultimate, annual costs is largely attributable to the refinement in the long-term growth rate assumption; whereas the higher 75-year actuarial deficit is largely attributable to the addition of 2080 (a high deficit year) in the valuation period and the worse-than-expected experience in 2005 and utilization adjustments described earlier.

In a similar vein, expenditures for Medicare Part B are now projected ultimately to grow to 'only' 3.8 percent of GDP—up from their current level of 1.3 percent—in contrast to 4.9 percent in last year's report; while the present value of the 75-year general revenue transfer required by the program has risen from \$12.4 trillion to \$13.1 trillion (and would have risen much more were it not for the unrealistic assumption about future reductions in physician reimbursement rates mandated by current law).

Projected expenditures for Part D are also now much lower at the end of the 75-year period: 2.3 percent of GDP rather than 3.3 percent. But, in contrast to HI and Part B, this year's report shows Part D on a lower growth trajectory throughout the entire 75-year period. This is because the program-specific factors leading to the slower near-term cost growth for Part D noted earlier are assumed to continue in the longer run and dominate the faster growth effects during the intermediate years as projected using the new methodology for the long-term cost growth path shared by all three components of Medicare. As a consequence, the present value of the 75-year general revenue transfer required by Part D is now projected to be \$8.0 trillion, down from \$8.7 trillion.

In last year's message we noted that there is considerably more uncertainty inherent in the Medicare projections than in those for Social Security, particularly for the long run. Both share the same economic and demographic assumptions, but projections for Medicare also depend

upon assumptions about the development and utilization of new medical technologies. Scientific breakthroughs, new blockbuster drugs, the development of new medical treatment techniques, and the broader use of existing technologies are all important to the long-term course of Medicare costs, and these and related factors are extremely difficult to assess. As demonstrated by the refinement in methodology for projecting these costs discussed earlier, small changes in what is assumed about the course of Medicare expenditures relative to GDP over the long run can produce major changes in the financial outlook for the program. But the fact that, under current law, Medicare is on a trajectory of rapidly rising costs relative to earmarked sources of revenue is not going to change, and this has predictable and problematic consequences for the Federal budget, taxpayers and Medicare beneficiaries—as well as for the HI trust fund—in the near future. Last year, general revenue transfers to Medicare were equal to 7 percent of Federal income tax revenues. If the Trustee's projections prove a reliable guide to the next few decades, absent an increase in earmarked sources of revenue for the program, in just 15 years payment of currently scheduled Medicare benefits would require General Fund transfers equal to 25 percent of Federal income tax revenues (projected at their historic level of GDP)—more than triple their 2005 fiscal burden—and less than 10 years later the General Fund transfer would equal nearly 40 percent of Federal income tax revenues. Similarly, Medicare beneficiaries' out-of-pocket expenses for health care will be consuming a rapidly growing share of their available income over this period.

We should further note here that, while it seems reasonable to assume (per capita) health care and Medicare expenditure growth will gradually slow to the rate of growth of GDP—because there is presumably some upper limit to what share of their growing incomes Americans will want to devote to health care—no such slowdown has materialized over the past half-century. At present there are no clear indications of when, or even how, the past trend might abate. If it does not soon, then the serious fiscal problem discussed above will become dire. Clearly we must not only adjust Medicare's funding, but also work much harder to improve our understanding of the long-term determinants of overall spending on health care and how best to slow the growth of that spending.

Conclusion

Both Social Security and Medicare are projected to be in poor fiscal shape, though Social Security poses a far more manageable problem—in analytic and dollar terms—than does Medicare. The fiscal problems of both programs are driven by inexorable demographics and, in the case of Medicare, inexorable health care cost inflation, and are not likely to be ameliorated by economic growth or mere tinkering with program financing.

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