

A MESSAGE TO THE PUBLIC:

Each year the Trustees of the Social Security and Medicare trust funds report on the current and projected financial status of the two programs. This message summarizes our 2007 Annual Reports.

The financial condition of the Social Security and Medicare programs remains problematic; we believe their currently projected long run growth rates are not sustainable under current financing arrangements. Social Security's current annual surpluses of tax income over expenditures will soon begin to decline and then turn into rapidly growing deficits as the baby boom generation retires. Medicare's financial status is even worse. Medicare's Hospital Insurance (HI) Trust Fund is already expected to pay out more in hospital benefits this year than it receives in taxes and other dedicated revenues. The growing annual deficits in both programs are projected to exhaust HI reserves in 2019 and Social Security reserves in 2041. In addition, the Medicare Supplementary Medical Insurance (SMI) Trust Fund that pays for physician services and the new prescription drug benefit will continue to require general revenue financing and charges on beneficiaries that grow faster than the economy and beneficiary incomes over time.

The drawdown of Social Security and HI Trust Fund reserves and the general revenue transfers into SMI will place mounting pressure on the Federal budget. In fact, this pressure is already evident. For the first time, a "Medicare funding warning" is being triggered, signaling that non-dedicated sources of revenues—primarily general revenues—will soon account for more than 45 percent of Medicare's outlays. By law, this warning requires that the President propose, and the Congress consider, remedial action.

We are increasingly concerned about inaction on the financial challenges facing the Social Security and Medicare programs. The longer we wait to address these challenges, the more limited will be the options available, the greater will be the required adjustments, and the more severe the potential detrimental economic impact on our nation.

Social Security

The annual cost of Social Security benefits represented 4.2 percent of Gross Domestic Product (GDP) in 2006, is projected to increase to 6.2 percent of GDP in 2030, and then rise slowly to 6.3 percent of GDP in 2081. The projected 75-year actuarial deficit in the combined Old-Age

and Survivors and Disability Insurance (OASDI) Trust Fund is 1.95 percent of taxable payroll, down from 2.02 percent in last year's report. This decrease is due primarily 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 75 percent of scheduled annual benefits in 2041, 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. Ensuring that the system is solvent on a sustainable basis beyond the next 75 years would require larger changes. To the extent that changes are delayed or phased in gradually, larger adjustments in scheduled benefits and revenues would be required that would be spread over fewer generations.

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 greater 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 payroll taxes and Social Security benefits are based. As a result, while Medicare's annual costs were 3.1 percent of GDP in 2006, or about 72 percent of Social Security's, they are projected to surpass Social Security expenditures in 2028 and exceed 11 percent of GDP in 2081.

The projected 75-year actuarial deficit in the Hospital Insurance (HI) Trust Fund is now 3.55 percent of taxable payroll, up slightly from 3.51 percent in last year's report. The fund again fails our test of short-range financial adequacy, as projected annual assets drop below projected annual expenditures within 10 years—in 2013. 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 is 2019, one year later than in last year's report, when tax income will be sufficient to pay only 79 percent of HI costs. HI tax income falls short of outlays in this and all future years. The program could be brought into actuarial balance over the next

75 years by an immediate 122 percent increase in the payroll tax, or an immediate 51 percent reduction in program outlays or some combination of the two. As with Social Security, adjustments of 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 beyond the 75-year horizon.

Part B of the Supplementary Medical Insurance (SMI) Trust Fund, which pays doctors' bills and other outpatient expenses, and Part D, which pays for access to prescription drug coverage, are both projected to remain adequately financed into the indefinite future because current law automatically provides financing each year to meet next year's expected costs. However, expected steep cost increases will result in rapidly growing general revenue financing needs—projected to rise from 1.3 percent of GDP in 2006 to 4.7 percent in 2081—as well as substantial increases over time in beneficiary premium charges.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 requires that the Medicare Report include a determination of whether the difference between total Medicare outlays and dedicated financing (such as premiums and payroll taxes) exceeds 45 percent of total outlays within the first 7 years of the projection period (2007-2013 for the 2007 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 2007 Report projects that the difference will surpass 45 percent in 2013 and therefore makes a determination of excess general revenue funding. Because the 2006 report also made such a determination, a “Medicare funding warning” is hereby triggered that requires the President to propose legislation that responds to this warning within 15 days of the submission of the Fiscal Year 2009 budget and for Congress to consider the proposal on an expedited basis. This requirement will help call additional attention to Medicare's impact on the Federal budget.

Conclusion

The financial difficulties facing Social Security and Medicare pose enormous, but not insurmountable, challenges. The sooner these challenges are addressed, the more varied and less disruptive their solutions can be. We urge the public to engage in informed discussion and policymakers to think creatively about the changing needs and preferences of working and

retired Americans. Such a national conversation and timely political action are essential to ensure that Social Security and Medicare continue to play a critical role in the lives of all Americans.

By the Trustees:

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A SUMMARY OF THE 2007 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? Congress established the trust funds 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. Disbursements from the funds can be made only to pay benefits and program administrative costs.

The Department of the Treasury invests program revenues not needed in the current year to pay benefits and administrative costs 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 two trust funds are jointly designated as OASDI.) For Medicare, the Hospital Insurance (HI) Trust Fund pays for inpatient hospital and related care. The Supplementary Medical Insurance (SMI) Trust Fund comprises two separate accounts: Part B, which pays for physician and outpatient services, and Part D, which covers the prescription drug benefit that began in 2006. Medicare benefits are provided to most people age 65 and over and to most individuals who receive Social Security disability benefits.

What Were the Trust Fund Results in 2006? In December 2006, 40.5 million people received OASI benefits, 8.6 million received DI benefits, and 43.2 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 in 2006.

	OASI	DI	HI	SMI
Assets (end of 2005)	\$1,663.0	\$195.6	\$285.8	\$24.0
Income during 2006	642.2	102.6	211.5	225.5
Outgo during 2006	461.0	94.5	191.9	216.4
Net increase in assets	181.3	8.2	19.6	9.1
Assets (end of 2006)	1,844.3	203.8	305.4	33.1

How Has the Financial Outlook for Social Security and Medicare Changed Since Last Year? Under the intermediate assumptions, the combined OASDI Trust Funds show a 75-year actuarial deficit equal to 1.95 percent of taxable payroll, slightly smaller than last year’s estimate of 2.02 percent. That change is largely due to improved methodology and lower assumed rates of disability incidence. The OASDI Trust Funds, separately and combined, are adequately financed over the next 10 years.

Medicare’s HI Trust Fund now has a projected 75-year actuarial deficit equal to 3.55 percent of payroll compared with last year’s estimate of 3.51 percent under the intermediate assumptions. That change is primarily caused by moving the valuation period forward by one year from 2006-80 to 2007-81, which adds a year (2081) with a high projected deficit into the estimate. The HI Trust Fund is also inadequately funded over the next 10 years, with trust fund assets projected to fall short of 100 percent of annual expenditures in 2013.

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. Nonetheless, projected SMI cost growth over the long term will require increased general revenue funding that will average 6.5 percent annually, placing an ever-increasing burden on Federal revenues.

Although there have been no substantial changes in the overall Medicare outlook, this year’s Trustees Report is the second consecutive report in which the annual general revenue funding contribution to total Medicare expenditures is projected to exceed 45 percent within the first 7 years of the 75-year projection period. Therefore, by law, a “Medicare funding warning” is triggered by the report’s findings. This warning requires the President to respond by submitting proposed legislation within 15 days of the next budget submission (early February, 2008) to address the problem, and for Congress to consider the proposal on an expedited basis.

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 and their employers. The self-employed are charged the equivalent of the combined employer and employee tax rates. During 2006, an estimated 162 million people had earnings covered by Social Security and paid payroll taxes; for Medicare, the corresponding figure was 166 million people. The payroll tax rates are set by law and for OASDI apply to earnings up to an annual maximum (\$97,500 in 2007) that increases with the growth in nationwide average wages. HI taxes are paid on total earnings. The tax rates (in percent) for 2007 and later are:

	<u>OASI</u>	<u>DI</u>	<u>OASDI</u>	<u>HI</u>	<u>Total</u>
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

About 75 percent of SMI Part B and Part D expenditures are paid from Federal general fund revenues, with most of the remaining costs covered by monthly premiums charged to beneficiaries. Part B and Part D premium amounts are based on methods defined in law and increase as the estimated costs of those programs rise.

In 2007, the Part B standard monthly premium paid by most enrollees is \$93.50. During 2007-09, an income-related premium surcharge is being phased in for Part B beneficiaries whose modified adjusted gross income exceeds inflation-indexed thresholds (in 2007, \$80,000 for individual tax returns, \$160,000 for joint returns).

In 2007, the national average Part D base monthly premium is estimated to be \$27.35. (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 for the Federal assumption of Medicaid responsibilities for prescription drug costs for individuals eligible for both Medicare and Medicaid. In 2007, State payments are estimated to cover 13 percent of Part D costs, but that percentage is projected to decline to 9 percent by 2012 as Part D outlays increase.

Income to each trust fund, by source, in 2006 is shown in the table below (totals may not add due to rounding).

<u>Source (in billions)</u>	<u>OASI</u>	<u>DI</u>	<u>HI</u>	<u>SMI</u>
Payroll taxes	\$534.8	\$90.8	\$181.3	—
General fund revenue	—	—	0.5	\$171.9
Interest earnings	91.8	10.6	15.7	1.8
Beneficiary premiums	—	—	2.6	46.3
Taxes on benefits	15.6	1.2	10.3	—
Other	*	—	1.0	5.5
Total	642.2	102.6	211.5	225.5

* Less than \$50 million.

What Were the Administrative Expenses in 2006? Administrative expenses, as a percentage of total expenditures, were:

	<u>OASI</u>	<u>DI</u>	<u>HI</u>	<u>SMI</u>
Administrative expenses 2006. . .	0.7	2.5	1.5	1.6

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

Short-range (10-year) and long-range (75-year) projections are reported for all funds. Estimates are based on current law and assumptions about factors that affect the income and outgo of each trust fund. Assumptions include economic growth, wage growth, inflation, unemployment, fertil-

ity, 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 assumptions are reexamined each year in light of recent experience and new information about future trends, and are revised as warranted. In general, greater confidence can be placed in the assumptions and estimates for earlier projection years than for later years. The statistics and analysis presented in this Summary are based on the intermediate assumptions.

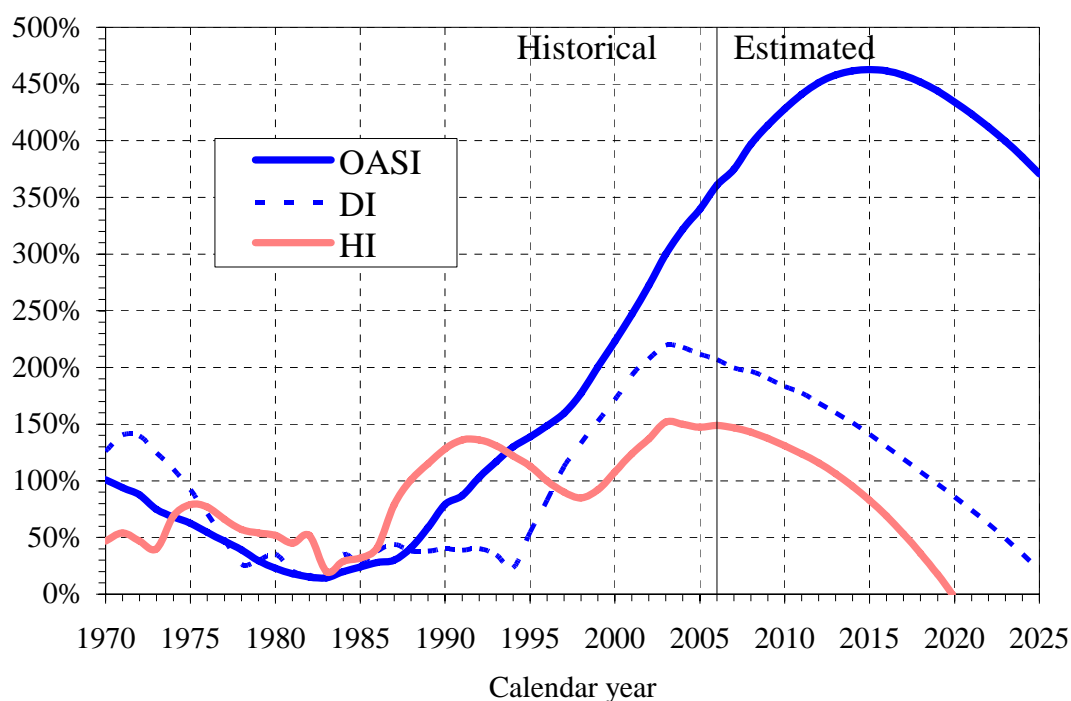
What is the Short-Range Outlook (2007-2016) for the Trust Funds?

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 2016. 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 2013. Chart A shows these trust fund ratios under the intermediate assumptions through 2025.

For SMI Part B, a less stringent annual "contingency reserve" asset test applies because the bulk of the financing for that account is provided by beneficiary premiums and Federal general fund revenue payments automatically adjusted each year to meet expected costs. Part D is similarly financed on an annual basis. Moreover, the operation of Part D through private insurance plans, together with a flexible appropriation for Federal costs, eliminates the need for a contingency reserve in that account. Note, however, that the cost estimates for Part B are likely to be too low (perhaps by 25 to 40 percent in the long range) because they assume that current law governing the structure of physician payment updates will persist. That would lead to substantial reductions in physician payments per service during 2008-16 and slow the growth of projected Part B costs.

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



In each year since 2001, Congress has passed legislation to increase physician payments rather than allow the current law reductions. Thus, experience indicates that the apparent reductions are unlikely to occur before legislative changes intervene. The underestimated physician payments affect projected costs for Part B, total SMI, and total Medicare.

The following table shows the projected income and outgo, and the change in the balance of each trust fund, excepting SMI, over the next 10 years. SMI income and expenditures are shown in separate columns for Parts B and D. Changes in the SMI Trust Funds are not shown because of the automatic annual adjustments in program income to meet the following year's projected expenditures.

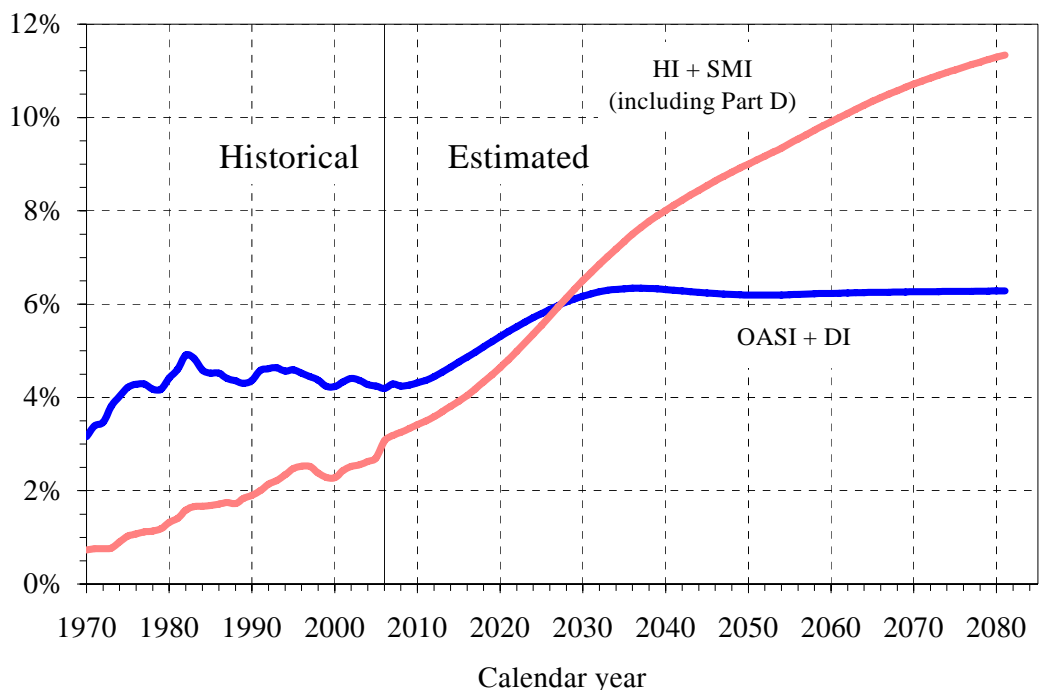
ESTIMATED OPERATIONS OF TRUST FUNDS
(In billions—totals may not add due to rounding)

Year	Income			Expenditures						Change in fund			
	OASI	DI	HI	SMI		OASI	DI	HI	SMI		OASI	DI	HI
				B	D				B	D			
2007	\$676	\$107	\$224	\$188	\$50	\$492	\$102	\$208	\$180	\$50	\$183	\$5	\$15
2008	715	112	234	198	62	511	106	224	191	62	204	6	10
2009	763	119	248	224	70	539	113	241	203	70	223	6	7
2010	810	125	261	201	79	574	121	258	216	79	237	4	3
2011	861	131	274	232	89	611	127	275	229	89	250	4	-1
2012	911	137	288	249	101	652	136	294	244	101	259	1	-6
2013	962	143	301	266	112	699	144	314	262	112	263	-1	-14
2014	1,014	149	314	285	125	750	152	336	280	125	263	-3	-23
2015	1,067	155	327	332	139	805	160	360	300	139	262	-6	-33
2016	1,123	161	340	300	156	864	169	385	322	156	258	-9	-45

What is the Long-Range (2007-2081) Outlook for Social Security and Medicare Costs? An instructive way to view the projected cost of Social Security and Medicare is to compare the financing required to pay all scheduled benefits 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 rise steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. During those years Medicare costs increase at an even faster rate than Social Security 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, continue to grow rapidly after 2030 due to expected increases in the cost of health care.

The 75-year projected cost outlook for Social Security and Medicare is similar to that described in last year’s report. In 2006, the combined cost of the Social Security and Medicare programs represented roughly 7.3 percent of GDP. Social Security outgo amounted to 4.2 percent of GDP in 2006 and is projected to increase to 6.3 percent of GDP in 2081. Medicare’s cost was smaller in 2006—3.1 percent of GDP—but is projected to surpass the cost of Social Security in 2028, growing to 11.3 percent of GDP in 2081 when it will be 80 percent larger than Social Security’s cost. In 2081, the combined cost of the programs will represent 17.6 percent of GDP. As a point of comparison, in 2006 all Federal receipts amounted to 18.5 percent of GDP.

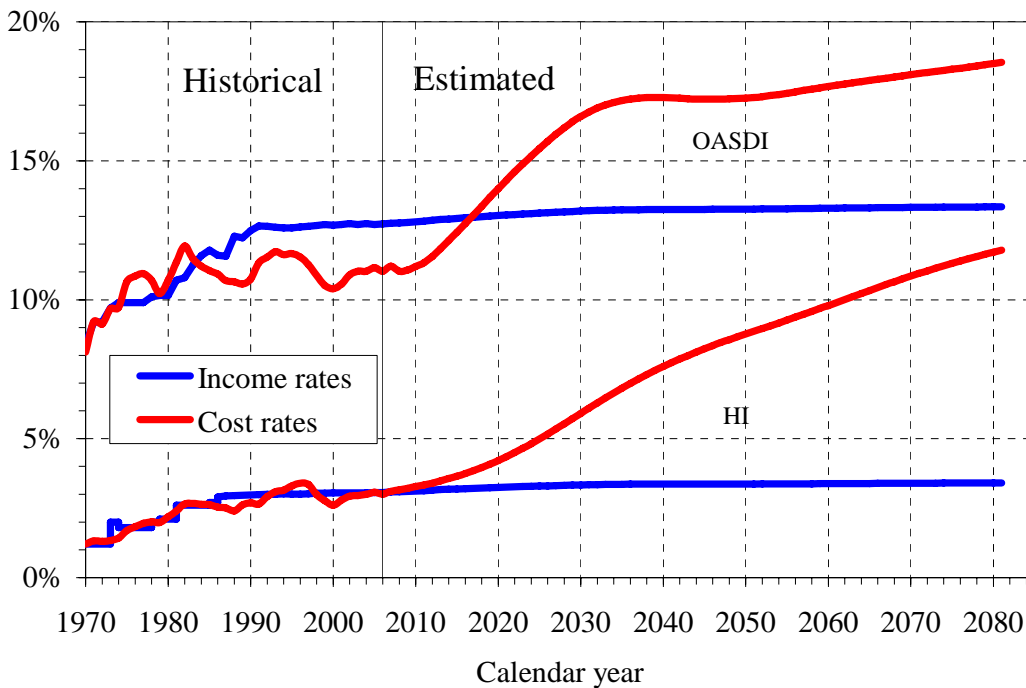
Chart B—Social Security and Medicare Cost as a Percentage of GDP



What is the Outlook for OASDI and HI Costs Relative to Tax

Income? Both Medicare and Social Security costs are projected to grow substantially faster than the economy over the next several decades, but unless current law is changed, tax income to the HI and OASDI Trust Funds will not. Because the primary source of income for HI and OASDI is the payroll tax, it is customary to compare the programs' income and costs expressed as percentages of taxable payroll. These income and cost rates are shown in Chart C. Although both the Medicare and Social Security annual cost rates increase markedly from their 2006 levels (3.01 and 11.02 percent), income rates increase very little over the long run. The reason is that payroll tax rates are not scheduled to change and income from the other tax source to these programs, taxation of OASDI benefits, will increase only gradually as a greater proportion of beneficiaries is 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 an appropriate concept for that program.

The OASI, DI, and HI Trust Funds each have an actuarial deficit under the intermediate assumptions, as shown in the following table. Each actu-

arial 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. Because large and growing annual deficits are projected at the end of the long-range period, adequate financing beyond 2081 would likely require even larger changes than are needed for solvency in 2007-81.

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

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

	<u>OASI</u>	<u>DI</u>	<u>OASDI</u>	<u>HI</u>
Actuarial Deficit	1.69	0.27	1.95	3.55

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

When costs exceed income excluding interest (Chart C), use of trust fund assets occurs in stages. For HI, the process is expected to start in 2007, when interest earnings on trust fund assets will be used to help pay benefits. Beginning in 2011, costs are projected to exceed income including interest, and assets must be redeemed each year until the trust fund is exhausted in 2019. Those dates are one year later than reported last year due to slightly higher projected payroll tax income and slightly lower projected benefits than previously estimated. In 2019, tax income is estimated to be sufficient to pay 79 percent of HI costs—and by 2081 only 29 percent.

For OASDI, interest income will first be needed to pay a portion of benefits in 2017, although the trust funds will continue to accumulate assets. In 2027, trust fund assets will begin to be depleted and are projected to be exhausted in 2041—a year later than indicated in last year's report—when tax income would cover 75 percent of costs. By 2081, tax income would cover 70 percent of scheduled benefits. The key dates regarding cash flows are shown below.

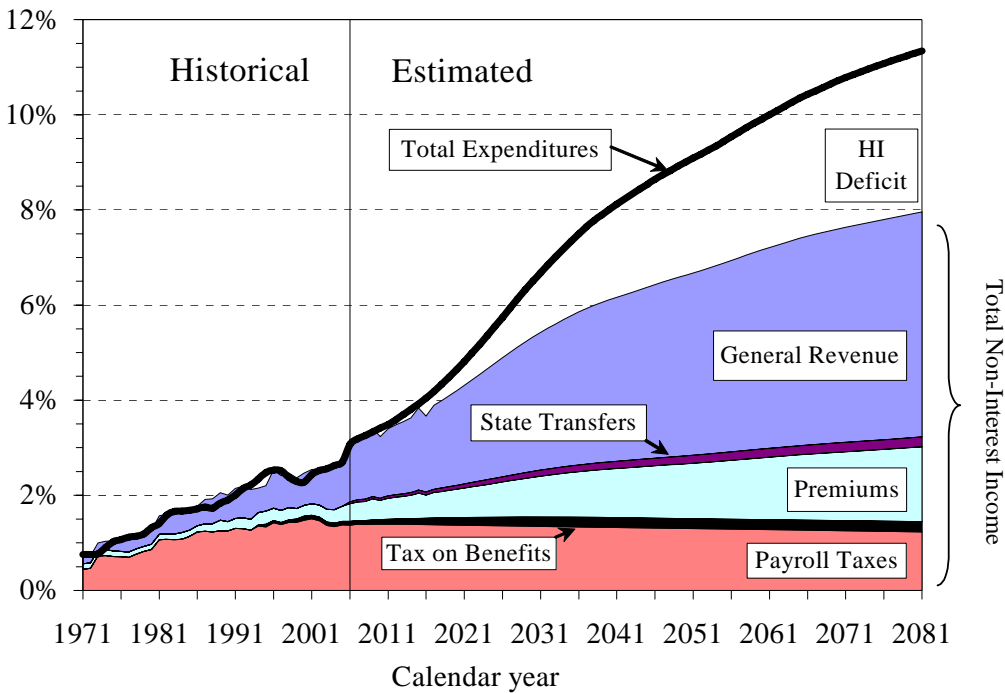
KEY DATES FOR THE TRUST FUNDS

	<u>OASI</u>	<u>DI</u>	<u>OASDI</u>	<u>HI</u>
First year outgo exceeds income excluding interest	2018	2005	2017	2007
First year outgo exceeds income including interest	2028	2013	2027	2011
Year trust fund assets are exhausted	2042	2026	2041	2019

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 displayed in Chart B and shows Medicare costs rising to 11.3 percent of GDP by 2081. Revenues from taxes are expected to remain at about 1.5 percent of GDP, while general fund revenue contributions are projected to increase from 1.3 percent in 2007 to 4.7 percent in 2081, and beneficiary premiums from 0.4 to 1.6 percent of GDP. Thus, revenues from taxes will fall substantially as a share of total non-interest Medicare income (from 46 percent to 18 percent) while general fund revenues will rise (from 41 to 59 percent), as will premiums (from 12 percent to 20 percent). The gap between total non-interest income and expenditures steadily widens due to growing annual HI deficits, which reach 3.4 percent of GDP by 2081. All told, by 2081 the Medicare program is projected to require SMI general revenue transfers equal to 4.7 percent of GDP. Moreover, the HI deficit would equal another 3.6 percent of GDP, and there is no provision to address this deficit under current law through general fund transfers or any other means.

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



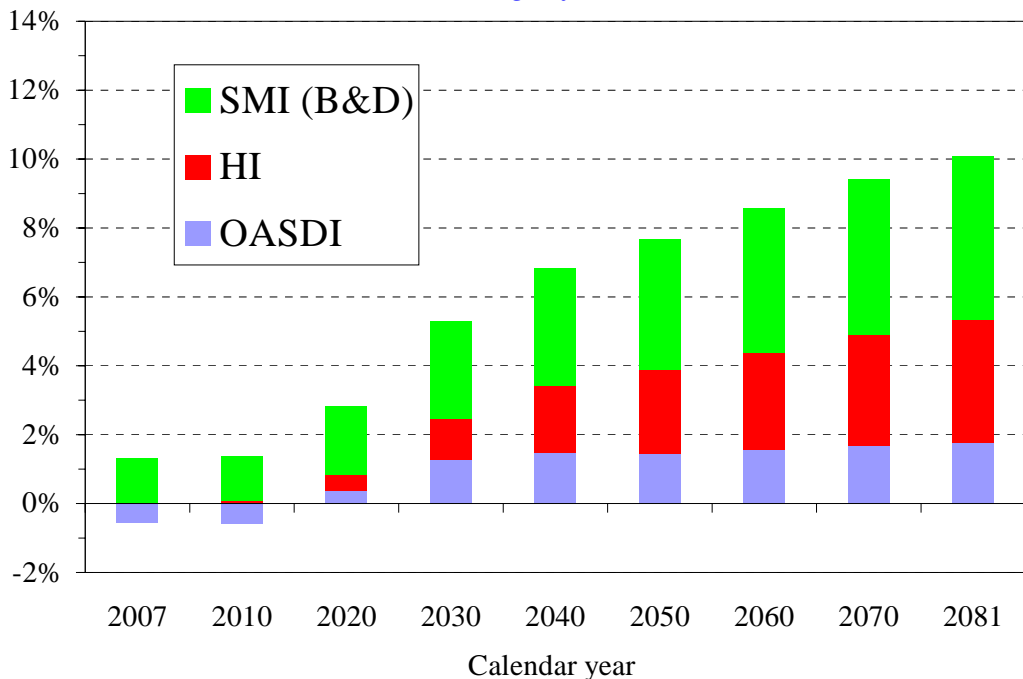
The Medicare Modernization Act (2003) requires that the Board of Trustees determine each year whether the annual difference between program outlays and dedicated revenues (the bottom four layers of Chart D) exceeds 45 percent of total Medicare outlays within the first 7 years of the 75-year projection period. The law effectively establishes a threshold condition that signals that a trust fund’s dedicated financing is inadequate or that general revenue financing of Medicare is becoming excessive. A first “excess general revenue Medicare funding” determination was issued by

the Trustees in their 2006 Report. This year’s Report estimates that the difference between projected outlays and dedicated financing revenues will exceed 45 percent in 2013 (compared with 41 percent in 2006), again leading to an “excess general revenue Medicare funding” determination. Because the Trustees have made this determination in two consecutive reports, a “Medicare funding warning” is triggered.

Why is Reform to Improve the Social Security and Medicare Financial Imbalances Needed? Concern about the long-range financial outlook for Medicare and Social Security often focuses on the exhaustion dates for the HI and OASDI Trust Funds—the time when projected finances under current law would be insufficient to pay the full amount of scheduled benefits. A more immediate issue is the growing burden that the programs will place on the Federal budget well before the trust funds are exhausted.

The Federal general fund revenues that would be needed to finance currently scheduled benefits for Social Security and Medicare are shown in Chart E for selected years during the 2007-81 projection period. The total draw on general fund revenues (as a percentage of GDP) has three components: the gaps between tax income and the cost of scheduled benefits for the OASDI and HI programs, as well as the general fund revenue requirements to finance SMI’s Parts B and D (75 percent of expenditures).

Chart E– Projected OASDI and HI Tax Income Shortfall plus the 75-Percent General Fund Revenue Contribution to SMI
(Percentage of GDP)



The initial negative amounts shown for OASDI indicate that tax income exceeds outgo (which occurs during 2007-16) and represent net revenues

to the Treasury that result in the issuance of Treasury bonds to the trust funds. Those OASDI net revenues are more than offset by the Medicare general revenue requirements under current law. For instance, in 2007 the Social Security tax income surplus (\$85 billion) is estimated to be significantly smaller than the statutory Medicare Part B and Part D general revenue transfers, resulting in an overall cash requirement of \$100 billion (0.7 percent of GDP) from the general fund of the Treasury.

The combined difference grows each year, so that by 2018, net revenue flows from the general fund will total \$545 billion (2.3 percent of GDP). The positive amounts that begin in 2017 for OASDI, and in 2007 for HI, initially represent payments the Treasury must make to the trust funds when assets are redeemed to help pay benefits in years prior to exhaustion of the funds. Note that neither the redemption of trust fund bonds, nor interest paid on those bonds, provides any new net income to the Treasury, which must finance redemptions and interest payments through some combination of increased taxation, reductions in other government spending, or additional borrowing from the public.

Chart E shows that the difference between outgo and dedicated payroll tax and premium income will grow rapidly in the 2010-30 period as the baby-boom generation reaches retirement age. Beyond 2030, the difference continues to increase nearly as rapidly due primarily to health care costs that grow faster than GDP. After the trust fund exhaustion dates (2041 for OASDI, 2019 for HI), the increasing positive amounts for OASDI and HI depict the excess of scheduled benefits over projected program income. When the statutory SMI general fund revenue requirements are added in, the projected combined Social Security and Medicare general fund revenues needed in 2081 equal 10.1 percent of GDP. A similar burden today would require nearly all Federal income tax revenues, which amounted to 10.8 percent of GDP in 2006.

To put these magnitudes into historical perspective, in 2006 the combined annual cost of HI, SMI, and OASDI amounted to 40 percent of total Federal revenues, or about 7 percent of GDP. That cost (as a percentage of GDP) is projected to double by 2042, and then to increase further to nearly 18 percent of GDP in 2081. It is noteworthy that over the past four decades, the average amount of total Federal revenues as a percentage of GDP has also been 18 percent, and has never exceeded 21 percent in a given year. Assuming the continued need to fund a wide range of other government functions, the projected 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 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 seventh annual Trustees Reports issued since our initial appointments as Public Trustees by President Clinton and subsequent reappointments by President Bush. They are also the last to be issued on our watch, since our second terms will end later this year. Our goal as Public Trustees has been to work in a nonpartisan way to ensure the integrity of the process by which the reports are prepared and the objectivity and credibility of the information they contain. We believe the role of the Public Trustees is important and urge the President to nominate, and the Senate to confirm, our successors as soon as possible, so that they can participate fully in the process leading up to next year's reports.

The projections in the reports are based on a number of underlying assumptions. While any projections are inherently uncertain, we believe the Trustees' intermediate ones, which are the basis for our following discussion, provide the most reliable available picture of the financial outlook under current law for Social Security and Medicare. This outlook continues to be highly problematic.

Social Security

This year's OASDI report shows little deviation from last year's in the intermediate projections for Social Security. There has been a slight improvement in the outlook for the combined trust funds throughout the 75-year projection period, due to the positive effects of updates in program data and minor changes in methods and assumptions that more than offset the negative consequences of extending the valuation period by one year. As a result, the date of trust fund exhaustion has moved from 2040 back to 2041, the actuarial deficit for the 75-year projection period has declined from 2.02 to 1.95 percent of taxable payroll, and the end-year (now 2081) annual deficit is lower (5.20 percent of taxable payroll for 2081, compared with last year's 5.38 percent for 2080). Despite the improvement, the projected costs of scheduled benefits as a percentage of GDP remain the same as described in last year's report, rising from a 2007 level of 4.3 to 6.2 in 2030 and to 6.3 in 2080. Again, the projected cost of scheduled future benefits is far greater than projected revenues. In consequence, Social Security poses a significant challenge to Federal government finances.

The difference between the costs of currently scheduled benefits and tax revenues for the Social Security program over the 75-year projection period provides a summary measure of the magnitude of this challenge.

This difference is projected to total \$6.8 trillion in present value, or about 1 percent of the present value of GDP over the same period. While current trust fund reserves provide the authority to cover the first \$2.0 trillion of this funding shortfall before being depleted, Treasury must still come up with this amount in future cash as the special issue Treasury securities that make up trust fund reserves are redeemed. Because the deficits for Social Security continue to increase beyond the 75-year horizon, the magnitude of the fiscal problem over the very long run is much greater than the 75-year picture conveys.

Thus, the fundamentals remain the same this year as for all the years of our tenure as Public Trustees. 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 10 years, become rapidly growing deficits that must be covered with cash from the General Fund of the Treasury until trust fund reserves are exhausted a few decades later. At that time (2041), current law would no longer require Treasury to cover the annual trust fund deficits, and annual trust fund tax revenues would be sufficient to pay only 75 percent of currently scheduled Social Security benefits. Additional revenues initially equivalent to 13 percent of Federal income tax revenues (projected at their historical average share of GDP over the past four decades) and growing over time—would be necessary to fill this gap.

As we have noted in our past two years' Messages, demographic change is the major force shaping the financial outlook for Social Security, and only highly unlikely deviations in actual experience from the Trustee's intermediate assumptions for 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. Were the economy to expand as rapidly in future decades as in past ones, the financial outlook for Social Security would improve somewhat, though not nearly enough to eliminate its long-term deficit. But the marked slowdown in the growth of the labor force over the next several decades virtually precludes this.

Medicare

The outlook for Social Security presents a fiscal challenge that pales in comparison to that posed by Medicare. The big news in this year's report is the triggering of the "Medicare funding warning." While the warning is new, it simply reflects the same dire financial outlook for the program

we have been reporting for years and which was exacerbated by the recent addition of the Part D prescription drug benefit.

Projected Medicare costs are even more sensitive to population aging than Social Security's. But they are also projected to grow faster than those of Social Security over the entire projection period for a far more important second reason: the expectation that per capita health care costs will continue to grow faster than per capita GDP in the future, as they have in the past. As a result, this year's report—as did last year's—projects overall Medicare expenditures to increase from their 2007 level of 3.2 percent of GDP to 6.5 percent by 2030, and to 11.3 percent by the end of the 75-year period. In the absence of reform that greatly restrains these cost increases, taxes on the working age population and out-of-pocket payments by beneficiaries will both have to rise far faster than incomes in the decades ahead.

The Medicare program's Hospital Insurance (HI) component is inadequately financed over the next 10 years, is already running an annual deficit in tax income relative to expenditures, and is expected to exhaust its Trust Fund reserves in 2019. By then, annual revenues to the Trust Fund (generated primarily by Medicare's 2.9 percent payroll tax) would cover less than 80 percent of projected costs. The gap between projected costs and revenues grows so rapidly thereafter that projected revenues are less than 40 percent of projected costs by 2050, and less than 30 percent by the end of the 75-year projection period. The present value difference between projected expenditures and dedicated revenues for the 75-year horizon for just the HI component of Medicare is \$11.6 trillion, 70 percent higher than the analogous \$6.8 trillion measure of the budgetary challenge represented by OASDI as noted above.

The Supplementary Medical Insurance (SMI) component of Medicare—which covers outpatient services (Part B) and prescription drugs (Part D)—never experiences a shortfall between projected costs and revenues, since under current law, beneficiary premium income and general revenue transfers to the SMI trust fund are assumed to increase each year to match expected costs. But per capita expenditures for this program component, as for HI, are projected to grow in line with per capita health care costs over the long run. Thus, SMI trust fund revenues from premiums and general revenue transfers are expected to account for a growing share of beneficiary incomes and Federal general revenues over time. The level of general revenue transfers in excess of their current share of total Federal revenues amounts to \$13.2 trillion over the next 75 years, and is an appropriate measure of the additional burden projected SMI expenditures

will place on Federal finances during this period. Thus, if program costs grow as currently projected, the total additional burden that would be imposed on Federal finances by Medicare (HI plus SMI) over the 75-year projection period would be \$24.8 trillion. This is more than five times the current outstanding Federal (publicly-held) debt and amounts to 3.4 percent of projected GDP over the same period.

On a cash-flow basis, last year's general revenue transfers to Medicare were equivalent to 12.3 percent of Federal income tax revenues. To fully fund currently projected Medicare costs would require—in addition to currently dedicated sources of income from payroll taxes, premiums and the like—the equivalent in such transfers of nearly double this percentage of Federal income tax revenues (again, projected at their historical average share of GDP over the past four decades) within 15 years and more than triple in 25 years. Such transfers would require that over the next 25 years either Federal spending on government programs other than Social Security and Medicare fall by almost 25 percent, or that income tax revenues increase by more than 25 percent from their historical shares of GDP.

We should note that long-term projections of Medicare costs are subject to more sources of unexpected variation than are those for Social Security. In addition to the uncertainty inherent in the economic and demographic assumptions used in common with the Social Security projections, factors specific to health care—such as the rate of scientific breakthroughs, the frequency of the development of new “blockbuster” drugs, the possibility of new diseases or wide reoccurrence of older ones, the development of new medical treatment techniques, and the preferences of the population for particular kinds of care—introduce further uncertainty into the future course of Medicare costs. The most important Medicare-specific assumption embodied in the Trustees' long-term projections is that health care cost inflation, which has historically exceeded the growth in GDP on a per capita basis by more than two percentage points annually, will gradually decline over the 75-year projection period until it simply equals GDP growth at the period's end. This assumption seems reasonable, since per capita expenditures on health care cannot grow faster than per capita GDP indefinitely without all other forms of consumption trending to zero. Our citizenry has demonstrated a strong propensity over the past half-century to increase the share of income spent on health care, and there is, as yet, no clear evidence of when, or even how, this trend might abate. But if it does not do so soon, then the bleak fiscal picture portrayed in these reports will be bleaker still. Thus, along with

the overall imperative to reform Medicare funding comes an urgent need for better understanding of the factors contributing to the growth of health care spending and how these factors might be moderated in the future. We encourage further work on this important issue.

Conclusion

Social Security and Medicare both present daunting fiscal challenges, though Social Security's is far more manageable analytically and dollar-wise. Their fiscal problems are driven by inexorable demographic change and, in the case of Medicare, relentless increases in health care costs, and are not likely to be greatly ameliorated by economic growth or mere tinkering with program financing. Prudence dictates action sooner rather than later to address these fiscal challenges.

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Trustee*

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