

The Truth About Social Security and Medicare

Interview with Henry Aaron

Social security and Medicare present entirely different challenges, says this authority. But you would not know that to listen to Alan Greenspan's comments last winter. He said both programs would have to be cut. In contrast, future social security obligations can be accommodated without serious changes, this noted economist argues. The growth of Medicare obligations is much faster and will indeed require serious attention.

Q Alan Greenspan, the chairman of the Federal Reserve, said two months ago that both social security and Medicare benefits had to be reduced in light of future federal budget pressures. On the one hand, he refused to entertain the possibility that taxes should be raised. But, on the other hand—and what I wanted to discuss specifically—he focused on both social security and Medi-

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care as the primary programs to be trimmed. What was your immediate response to these remarks?

A. My immediate response is that there are two distinct problems here, perhaps three, and they should not be combined. Social security and Medicare, although they are both titles of the Social Security Act, present problems that are radically different from each other. Social security is a financing issue—and perhaps a structural design issue for those who would like to change it—that is relatively self-contained. Medicare is one part of the complex private-public system by which we pay for health care in the United States. The problems that Medicare confronts are similar to those that will confront private health insurance, which is largely paid for as a fringe benefit in the workplace. Medicare’s problems are also related to those of Medicaid, the federal and state program for the poor. That means that these problems pose challenges for states and localities as well as for the federal budget. What is called the Medicare problem extends to how we design the entire system of how we deliver and pay for health care, and how, I believe, we eventually decide to ration it. Social security is a far narrower and more tractable issue.

Q You think we should not combine the two and talk about it as one problem.

A. It is a real mistake to do so because it suggests that somehow what we are talking about is just a financial problem, just about spending money through the federal government. The pension problem—social security—entails issues of financing and possible structural changes. But that problem is almost completely separate from the question of how we organize the financing and delivery of health care in the United States. These are quite different problems that will call for quite different interventions.

Q Alan Greenspan did lump the two together. Let us take social security first. He seemed to claim that the only way to deal

with social security is to reduce future benefits. You do not agree, I know.

A. The social security system does face a projected long-term deficit over the next seventy-five years, and the sooner our elected officials act to close it, the better. In this case the price of pensions has gone up for American workers—per worker—for a couple of reasons. The most important is that the benefit package is becoming more costly because people are living longer and therefore receiving benefits for more years. In addition, as long as we rely mostly on a pay-as-you-go system of financing, the tax cost on workers has to rise when the ratio of the elderly to active workers increases. In the end, we could decide to cover these additional costs either by raising taxes or by cutting pension benefits. As a practical matter, my guess is that we are going to do what we have done in the past when confronted with similar problems—we will do some of both. What I hope is that in dealing with this projected financial shortfall, we do not lose sight of the more central structural issue, which is the importance of continuing to have at the core of retirement income a benefit system that protects workers and their families from the financial market and other economic risks to which privatization would expose them.

Q. How big is the social security deficit projected to be over seventy-five years?

A. According to the 2003 Trustees' Report's actuarial projections, outlays come to exceed tax revenues of social security in 2017. But the surpluses earned in the interim have been and will be invested in government bonds. So the outlays will not exceed total income of the social security system, including interest earnings on the government bonds that it holds, until 2027. In fact, social security reserves will grow by about \$1 trillion between 2017 and 2027.

Q. And at that point what begins to happen?

A. After 2027 the reserves begin to be depleted and are projected to be exhausted in 2042. At that point, revenues coming into the system are projected to be sufficient to cover about 75 percent of the benefits promised under current law.

Q These are under fairly modest assumptions about economic growth.

A. The actuaries do a very careful job of setting a whole set of key assumptions. One of these is the rate of economic growth. They have lately revised upward their assumed rate of growth. The currently assumed growth rate is slower than the rate that the U.S. economy is now enjoying, but it is faster than the actual rate the U.S. economy achieved during the 1970s and 1980s. If we continue to have a very bullish performance—that is, very high productivity growth—there is little doubt that the actuaries would gradually increase their assumed rate of productivity increase. That change by itself would increase revenues more than outlays and defer the year in which reserves are exhausted by several years.

Q Let us try to make it clear to readers what we mean by the trust fund's being still positive in 2017. What is that trust fund?

A. Social security over its history has collected revenues—payroll taxes, earmarked income taxes, and small additional transfers from the general fund—that exceed total outlays for benefits and for administration. Currently reserves are about \$1.6 trillion. Virtually all those reserves are held in the form of special Treasury bonds that are about the best investment one could have. They are even better than Treasury bonds that insurance companies and banks hold in their reserves. They bear the average interest rate on outstanding Treasury securities with a maturity of four years or more, but they have a feature that no other bond has, which is an unlimited put at par, if the trust fund has occasion to sell the bonds to the Treasury.

Q. When people say that in 2017, if projections hold, social security's managers are going to start dipping into that trust fund, what do they mean?

A. That is incorrect. In 2017 outlays come to exceed tax revenues, but the social security system is projected to remain in surplus for another decade. That is, total trust fund reserves are projected to con-

tinue to increase for an additional decade. Consider an analogy. Suppose a family is spending a bit more than it is earning, but it is also receiving income from savings that it has accumulated. Its total spending would be less than its income, the sum of its earnings plus its dividend and interest checks. So its net worth, like that of the social security system, keeps going up.

Q. What concerns people is that, after 2017, this trust fund is still a liability of the federal government.

A. That is correct. It is a liability of the federal government. It is something that the federal government—in effect, the nation as a whole—owes to potential beneficiaries of social security—the retired, the disabled, and survivors. But if one takes other activities of government as given, the accumulation of these reserves in social security does in fact add to national saving. The current fiscal problem of the nation lies elsewhere—in operations of government outside social security, which is hugely in deficit, in significant measure because of tax cuts enacted in the past three years. Currently, social security is running cash-flow surpluses. It makes little sense to bewail current fiscal shortfalls on a part of the budget, social security, that is collecting more in revenues than it is spending, while defending tax cuts that enlarge the deficit in the rest of government operations.

Q What will happen to the federal budget when these bonds have to be paid back?

A. At that point, the federal government would either have to issue debt in other forms—it could borrow directly from the public and then the debt would be owed by the Treasury directly to the general public rather than to social security—or it could raise taxes or cut spending. Those are the options always available to the federal government to cover outlays it needs to make.

Q. Do you happen to know what the outlays will be as a percentage of GDP [gross domestic product] down the road—how much they will rise as baby boomers retire?

A. The current cost of social security is 4.3 percentage points of

GDP. By 2050, costs will rise to 6.7 percent of GDP, an increase of 2.4 percent of GDP. Over the rest of the seventy-five-year period used for social security projections, costs will grow by an additional 0.3 percent of GDP.

Q. Even if we do not reduce benefits?

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Q This is why, on the face of it, the alarm concerning social security seems to be overdone.

A. Between 1965 and 1983, the cost of social security rose from 2.5 to 4.9 percent of GDP, an increase of 2.4 percentage points of GDP. The nation accommodated that shift quite easily. I will bet that few readers realize that the cost of social security increased as much over that eighteen-year period as it is projected to do in the next forty-six years. And I will also bet that few readers realize that with all the talk about entitlements, the cost of social security as a share of output has actually fallen in the past two decades. Now there were other things going on that made it easier for the nation to accommodate the increase from 1965 to 1983—in particular, declines in defense spending were occurring as a share of GDP. But a 2.4-percentage-point shift spread over forty-six years is about as far from meriting designation as a crisis as one could get. It is a modest and gradual shift to which the nation can accommodate. That accommodation does not mean that one should ignore the financial shortfall or the additional costs, and it may well mean that some curtailment in benefits below those promised in current law is called for or that some very modest increase in earmarked taxes is necessary. However one responds, it is not a big deal. But the sooner we deal with it, the better.

Q. What would you recommend?

A. On the revenue side, the payroll tax reaches less far up into the earnings distribution than it has done at some times in the past. One could increase the maximum earnings subject to tax modestly.

Q. What is the maximum income subject to payroll tax now?

A. It is \$87,900 and increases at the same rate as average earnings. But let me return to your last question. Another change in the system is merited. The system is also not quite universal. State and local government employees in four states remain outside the system. That exemption, as it turns out, is not really fair. In the early years of social security, for reasons that are entirely justifiable, successive presidents of both parties and successive Congresses decided to pay the elderly, disabled, and survivors far larger benefits than the taxes paid on their behalf justified. Where did the money for those benefits come from? Well, it came from diverting into current benefit payments payroll taxes levied on then-active workers—thus, the so-called pay-as-you-go system. But that meant that we did not accumulate in reserves the money necessary to pay the benefits of the then-active workers. The resulting hole in the trust fund arose from the relatively generous benefit paid to early retirees who had been hit by the depression. Whether one thinks that early generosity was right or wrong, it cannot be undone. These are reserves that are not there now because they were paid out. They are analogous to the national debt, and, in my view, they should be the responsibility of all Americans generally. What does this have to do with the state and local workers who are now outside the system? The problem is that they are not bearing their fair share of this debt-like national obligation, and they should. Bringing them into the social security system would also entitle them to some valuable benefits from which they are now excluded. It is time to make social security genuinely universal.

Q. Including all state and local workers?

A. Yes, including state and local government employees. We all should pay a part of the trust fund gap. How we pay for it is a matter of judgment. Relying on higher income taxes to pay them would be fair. My Brookings colleague Peter Orszag and MIT professor Peter Diamond suggest that a payroll surtax on earnings above the current ceiling would be a good way to pay for it. Here is the main point. If it were not for this gap, social security would face essentially no financial gap over the next seventy-five years.

Q. On the benefit side, if we should not be able to agree to raise

taxes sufficiently to close the gap, do you have some ideas to accomplish this?

A. Yes. As it happens, increasing longevity is equivalent to a sort of do-it-yourself increase in total lifetime benefits. The lifetime value of benefits increases because we live longer. It is appropriate that at least some part of this increased benefit cost be offset by either increasing the age at which people can claim full benefits or directly lowering the benefit formula. Congress actually did that in 1983 when it increased the full benefits age from sixty-five to sixty-seven starting in 2000. That change will be spread out over the next couple of decades. And that amounts to a benefit reduction of about 14 percent. If Congress had not done that, the current projected long-term deficit would be larger than it is.

Q. Do you think there is still some room to raise that?

A. I do. It needs to be done gradually, and ample notice needs to be given to workers about when it is coming. That is for two reasons. First of all, as individuals, we make long-term plans about when we are going to retire. And, secondly, how social security is modified has profound implications for the design of private pensions, and they, too, would need to be changed.

Q. The criticism of that, as you well know, is that it falls harder on those who do physical labor than those who do not.

A. It does. And the accompanying change that many of us have advocated for a very long time is relaxed standards for eligibility for disability insurance before the age at which full benefits would be payable.

Q. Are there any other benefit reductions that you think might make sense?

A. Another area that has become somewhat controversial concerns the number of years of earnings that are counted in computing average benefits. Currently the highest thirty-five years of earnings are counted in determining each worker's average earnings, which in turn determine that worker's benefits. If one adds two or three years to

the number counted, by definition those are years that are lower than the highest thirty-five. That change would modestly lower the average earnings and, hence, average benefits. It is a defensible change on the grounds that most people do have working careers longer than thirty-five years. One variant of this would be to increase the denominator used in computing average earnings from thirty-five to thirty-seven or thirty-eight, but include all of a worker's earnings in the numerator, even if the worker had thirty-nine or more years of earnings credits.

Q. In sum, then, before we get on to Medicare, when somebody like Alan Greenspan says, "We have to cut social security and, of course, Medicare. We cannot raise taxes," what do you think? Is this an ideological statement? It often comes across in the press as if it is an economic inevitability of some kind, but it is not.

A. Greenspan achieved a real standing on social security by chairing one of the few successful presidential commissions in 1983. However, he also indicated support for various privatization proposals. In so doing, he has identified himself, clearly, with a particular position on the question of social security reform, and one has to recognize that public statements such as those he has recently made before Congress are rooted in the same particular point of view. That is not the only way of technically dealing with social security's long-term deficit. As I have said, one can cut benefits, but one can also modestly raise payroll taxes and also recognize that the nation as a whole, in effect, owes the social security system something for the very generous benefits that were paid to early retirees.

Q Let us move on to Medicare. As you have said, the most important point is that the future Medicare deficit poses an entirely different kind of problem.

A. It is hugely different in size. From the standpoint of the federal budget, increased social security spending will claim a little more than two additional percentage points of GDP if the system remains as it is. But the combined projected increase in spending on Medicare

and Medicaid together will increase federal spending by approximately six percentage points of GDP out to 2040. So the budgetary impact of rising health care spending under current law dwarfs the additional pension costs in social security.

Q. And after 2040, Medicare and Medicaid keep going up, whereas social security goes up only very slowly.

A. Let's face it, long-term projections of per capita medical spending are pure guesswork. But we know that historically, per capita Medicare spending has risen at an annual rate of 2-2½ percent a year faster than average wages. The projections I just cited assume that growth slows to just 1 percent a year faster than wages. It is not clear, given the pace of scientific advance, why growth of per capita spending will slow. Were the much higher, historical rate of increase to persist, we would be looking at an impact on the budget larger than the six percentage points I mentioned. And, since the cost of health care would not be confined to Medicare and Medicaid, we would be looking at an increase in the proportion of employee compensation that would have to go to pay for health care that would begin seriously to squeeze other forms of consumption. The squeeze could occur because employers paid these costs and could not afford to boost cash wages or other fringe benefits much, or it could occur because employees themselves had to directly pay an increased share of their incomes for health care. But in either case, what we are talking about is a very, very large increase in projected spending that leaves the projections of social security in a shadow.

Q If we go beyond 2040, projections are what percentage of GDP?

A. In 2004 federal Medicare and Medicaid spending combined is 4.1 percent of GDP and social security is 4.3 percent. In 2040, given official projections and counting in the recently enacted prescription drug benefit, Medicare and Medicaid combined are projected to represent 10.4 percent of GDP, compared to 6.6 for social security. Go twenty years further into the future, which admittedly is guess-

work, Medicare and Medicaid spending reaches 13.3 percent of GDP, social security at 6.8. In other words, Medicare and Medicaid combined would grow to about twice the size of social security, if one extends these projections to 2060 and the 1 percent-faster-than-wages assumption holds. My own view is that this is a perfect example of economist Herbert Stein's law, which is, if something cannot possibly happen, it will not happen. These increases, in all likelihood, would trigger changes in payment policy by the federal government

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and in the private sector that would somewhat retard that increase of the share of GDP going to health care. Some increase is going to occur—a large increase is going to occur because medical technology is producing some medical wonders. But the pushback from changed policies is likely to be powerful.

Q. It seems clear from this is that tax increases are not going to close the Medicare gap. Something else has to close this gap.

A. Tax increases will contribute to closing the gap. My own view, in the end, is that they may account for a far larger part of closing the gap than the current political debate indicates. Let me state why I say that. It is more a detached political intuition than it is a personal preference. Let us look at the components of the fiscal gap that is going to be opening up. On the one hand, we have social security. Now, the simple fact is that you have to search long and hard to find a member of either party who is willing to embrace the principle of cutting benefits at all. When Greenspan made his statement, Republicans were as quick as Democrats to condemn the idea that benefits should be cut. The president himself said that one of his principles was that we are not going to cut benefits for anybody near retirement. Let us assume we cut them some. Maybe you could shave so-

cial security a little bit, and let us assume, on the high side, you could cut one percentage point of GDP out of social security. Medicaid is highly uneven and, in many states, extremely parsimonious—it is the safety net for the poorest Americans. So I suspect that when we belly up to our own consciences, we are not going to cut Medicaid significantly at all. Back to Medicare, even though there has been a lot of talk about how these costs are going up, what did Congress do last year? It raised benefits and added very significantly to Medicare spending through the prescription drug program for the elderly. Even now, Medicare has very high cost sharing, no stop-loss limits, and poor coverage of long-term care. On the other hand, there is ample room to increase cost sharing on relatively well-to-do Medicare beneficiaries. On balance, we will be lucky if we can hold Medicare costs to the projections that underlie this ten percentage points of GDP gap in 2040.

Next comes interest on the debt, where my projections understate the problem because borrowing costs may increase, a possibility that the projections excluded. Next, there is discretionary spending, which includes defense and everything else government does. The “everything else that government does” currently amounts to a little over three percentage points of GDP. National defense, I think most people agree, should be determined on what our security requirements impose upon us. So where are the potential cuts? There will be some savings; we will find ways of shaving outlays. We at the Brookings Institution just put out a study that showed how a number of cuts could be made in government spending over the next ten years. But, in the end, if we are to close this longer-term gap, we will have to raise taxes rather significantly for the sake of the nation’s economic and political health.

Q The bigger questions then are (1) is this system crying out for radical reform—the entire way we deliver health care in the United States? And (2) is radical reform a practical reality?

A. We in the United States do spend dramatically more on health

care per capita than do the citizens of any other country, including the most developed nations, including Canada. We buy something for the extra money we spend, and we spend a lot of money that buys zero- or low-benefit care. So I would expect over time to see various economies and efficiencies implemented with respect to the U.S. health care system. However, it would be very hard to demonstrate that the main source of the increase in U.S. spending has been an increase in the proportion of outlays that are wasted or used inefficiently. The primary source that is driving up spending is not waste, fraud, and abuse, it is the technical and scientific imagination of doctors and scientists who are producing new procedures, medications, and forms of care. To a lesser extent, costs are rising and will rise because we are getting older. One should not, in my view, hope that scientists become less imaginative or less creative. One should hope that they are even more so. Technological advance is a source of enormous improvement in life prospects and living standards for the mass of humanity. It will not come for free—technological advance never comes for free. Some people naively express surprise that technological advance has not lowered health care spending. The record of technological advance in other fields is consistent. It tends to lower price and raise total spending.

Q. Price per unit, but total spending increases because we want more of it.

A. Yes, that is dramatically true in the case of computation, but it is equally true with respect to air travel, the automobile, and entertainment.

Q. Just to make that clear to readers, the price of a computer has fallen greatly, but total spending on computers has risen. That contrasts with the situation regarding technological advances in medicine. They improve medicine but do not reduce how much we pay.

A. Exactly. There are a couple of studies that have been done, very careful studies, of the treatment of particular conditions—not randomly selected, I have to acknowledge—that suggest that that is just what has happened in the case of health care. In particular, in the case of treating heart attacks and mental illness, very careful studies suggest that the properly measured price achieving a given outcome has gone down, but the amount we spend on treatment has gone up

enormously. We are getting better results because we are getting greatly improved outcomes by spending more money.

Q. But, of course, when you look at most outcome measures of health in Europe, they are better than America's and yet they spend much less on health care as a proportion of GDP.

A. As the founding father of U.S. health economics, Victor Fuchs, emphasized long ago, health depends mostly on factors other than health care, including income, the environment, and personal behaviors. But even if one focuses on health care systems, the U.S. system is not top-ranked. The World Health Organization ranks health systems, and the winner is France. The United States comes in thirty-seventh, just behind Costa Rica and just ahead of Slovenia.

Despite these rankings, I suspect that most Americans would choose, if seriously ill, to receive their care here, but the truth is that for routine care, many—particularly those who have few contacts or personal resources, and especially the uninsured—might do better under the health systems of other nations.

Q. That care might also be preventive, so you do not need the fancy care.

A. That is right.

Q In sum, when people talk about \$14 trillion in future social security and Medicare liabilities, a startling and alarming number, is that a fair representation of our current problem?

A. It is misleading. Once one begins to throw around very large numbers representing total costs summed over periods approaching a century or even in perpetuity, it is important to focus on what period of time it is meant to encompass. Currently annual GDP in the United States exceeds \$11 trillion. If it grows in nominal terms at 5 percent annually, total GDP over the next seventy-five years will approach \$9 quadrillion, and annual GDP will be more than \$400 trillion in seventy-five years. Even if one limits oneself to the present value of GDP, the seventy-five-year sum is close to \$500 trillion. When people talk about liabilities of \$10 trillion, they are talking about

amounts that will be spread out over a very long period of time so that the proper base against which to compare them is not current income or current national debt, but the accumulated amount of income over an extended period of time. This fact does not mean that the fiscal challenge is unimportant, but it is manageable. The challenge is primarily political. It will be hard to form a consensus to act to bring the revenue and expenditure sides of social security, and of the federal budget as a whole, into balance.

Q. Then what metric should we use to think about the size of the social security gap?

A. The most useful way to measure the long-term social security gap is the way that the official projections are presented. Expenditures and revenues are presented as a percent of taxable payroll. Over seventy-five years, the projected gap is equal to about 1.9 percent of taxable payroll. The long-term expenditures exceed the revenues by 1.9 percent of wages—or 12 percent of benefits. In other words, we project both the numerator and the denominator of the equations, not just the future outlays. This is a way of putting things in proper context.