



Social Security and Medicare: Trying to Tackle Two 800-pound Gorillas

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While many people worry about the billions of dollars spent bailing out banks, auto makers and other sectors, looming shortfalls in Medicare and Social Security are what could ultimately sink efforts to revive the sagging U.S. economy.

As 78 million baby boomers begin to retire, funding for the government's two primary old-age security plans grows increasingly precarious -- even as the equity collapse that has taken a toll on private retirement savings and employment is creating additional drag on the nation's two major entitlement programs.

A report released earlier this week by trustees of the Social Security and Medicare trust funds shows that Medicare payments are expected to surpass the program's surplus in 2017, two years earlier than projected last year. The surplus in the Social Security trust fund is now forecast to run out in 2037, four years ahead of last year's estimates.

According to [Kent Smetters](#), a Wharton insurance and risk management professor, shortfalls in Medicare and Social Security total between \$80 trillion and \$120 trillion, and are rising at a rate of \$2 trillion annually. By comparison, he says, the value of all tangible property in the U.S. -- homes, buildings, land, autos and personal property -- is \$50 trillion. "The few trillion thrown at the banks looks like chump change compared to that," says Wharton health care management professor [Mark Pauly](#).

At their current rate of growth, the two benefit programs will inevitably lead to a drain on the federal budget along with higher tax rates and borrowing costs, predicts Pauly. And while the Wall Street bailout and other government programs recently approved are a one-time expense, Medicare and Social Security obligations roll on year after year, he adds.

[Olivia Mitchell](#), a Wharton insurance and risk management professor, raises additional concerns about the Social Security system, which she says has experienced a "triple whammy" in the past year. First, Social Security recipients in January received the largest cost of living increase -- 5.8% -- in 25 years. At the same time, the prolonged recession has led to a decline in payroll tax revenue. Finally, more unemployed older workers losing their jobs in the recession are likely to opt to receive Social Security benefits to replace their paychecks.

Medicare on Life Support?

While the strain on Social Security is daunting, Medicare makes up the biggest portion of the problem, accounting for an estimated 80% of the combined shortfall. If Medicare were a corporation, states Pauly, "it would be bankrupt many times over."

The trustees report shows that the Medicare hospital program could be brought into actuarial balance over the next 75 years by changes equivalent to an immediate 134% increase in the payroll tax -- from a rate of 2.9% to 6.78% -- or an immediate 53% reduction in program outlays.

The current debate over health care reform in the United States has ignored the problems with Medicare and is focused on finding ways to cover the uninsured and on controlling costs for those under age 65 in the private market, Pauly says.

He has doubts about the effectiveness of a coalition formed by six trade groups, including the American



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Medical Association and organizations representing hospitals and drug manufacturers, to rein in health care costs. The group is pledging to reduce spending by \$2 trillion over 10 years to help provide medical insurance for those without coverage. Critics contend the group is motivated by a desire to influence potential regulation and maintain a voice in health care reform. "They are just repackaging a set of ideas for lowering costs, like greater use of information technology, that have already been talked about a great deal although not generally proven to be effective," says Pauly. The pledge "is better than nothing, but not really noble and not, in any case, binding" on the trade groups.

Any cost reduction that works in the private insurance market will also benefit Medicare. However, Pauly cautions that the health program's trustees are already assuming a growth rate for Medicare spending in the long run that is lower than the 5.5% growth -- reduced from 7% -- promised by the coalition. "It would postpone the day of doom for Medicare but not avoid it," says Pauly. "This is a political statement, not a serious economic proposal."

In his book, *Markets Without Magic: How Competition Might Save Medicare*, Pauly lays out a solution to make Medicare sustainable over the long term that is based on a voucher system. The plan would rely on market competition to provide basic health coverage for the elderly, while also allowing individuals to make choices about what they are willing to pay for varying levels of additional care.

Pauly argues that elected officials do not currently have the political spine to rein in doctors and medical spending to make Medicare sustainable, which means they will wind up rationing medical care in a haphazard fashion when the system simply runs out of money. The United States, he says, is not likely to introduce the kind of policies that are part of the British system where, for example, a patient who is 80 may not receive expensive treatments for kidney failure because of his or her age. In the United States, he says, rationing will be less direct. "The budget will be constrained, and [health care consumers] will have to take what they can get for a set amount of money."

Financing Half a Heart

According to Smetters, true cost containment must address the question of the value of extending human life. "We really haven't made that tough decision," he says. And while he notes that the problems in Social Security could be corrected with a change in benefit levels or a delay in the retirement age, Medicare costs are more difficult to get under control because they are rooted in a simple dollar amount. For example, the system -- in an effort to trim costs -- cannot decide to finance only part of a patient's heart operation.

The Obama administration, according to Smetters, seems to be focusing on overall reform of the national health care system with the hope that driving cost savings and efficiencies in the broader health care market will improve the financial outlook for Medicare. Smetters notes, however, that two-thirds of all health care spending is by the government, and he suggests that it may be Medicare that drives up costs in the private system. Meanwhile, government reimbursement is key to establishing medical treatment without regard to the costs and benefits of a certain procedure or treatment, he says.

An unexpected wild card in all these discussions has been the financial crisis, which seems to have temporarily postponed debate on the long-term financial viability of the nation's entitlement programs. At the moment, Smetters says, a sharp discussion about entitlement program shortfalls might make the buyers of government debt nervous -- just when they are needed to support interventions to aid the economy.

But delaying the discussion for now may push the debate out even further in the future as Obama comes closer to the next presidential campaign. "He's not going to take the issue on just before an election," says Smetters, adding that "every year we kick the can down the road, the present value of the shortfall in Medicare and Social Security increases."

Smetters prefers a market-oriented medical system that would make better use of health savings accounts or other methods that would encourage private saving for medical needs later in life. "The private system is not perfect," he acknowledges, adding that private insurers should be able to communicate better through standard information technology, just as other industries, including finance, have done. However, he points out that ultimately, medicine is a labor-intensive industry in which specialists are paid top dollar

because the supply of trained professionals is constrained. "The training is challenging, but think about what it takes to become a PhD in a lot of other areas," he suggests. "It's all about supply and demand, and the AMA [American Medical Association] plays a role in restricting the supply of specialists."

Reliance on Employers

Wharton legal studies and business ethics professor [Arnold Rosoff](#) favors the notion of universal health coverage, but cautions that the system could never cover the costs of all the care citizens might want. He says a universal system should provide an adequate level of coverage, then rely on private insurance to offer additional care. "No matter how health care reform plays out, there's no way that we won't have a substantial private health insurance market in the United States."

Rosoff notes that private insurers are already moving toward more consumer-driven plans for employees that cover catastrophic events, but less routine care. Employers "are probably doing this to save on premiums, but what they say to employees is that they are putting the responsibility back on people to use health care resources [wisely]. It's really just a smokescreen."

The recession may also have additional implications for the health care system as patients put off routine visits and preventive care to save money, but wind up needing more expensive care in the future, according to Rosoff. Fan Zhou, a University of Pennsylvania student conducting research under Rosoff's guidance, is exploring relationships between economic downturns and health outcomes. Zhou says the United States offers a good test case of the link between economic conditions and health because the nation's health care system relies heavily on employers. "I think that tie and that uniqueness will lead to negative health outcomes for individuals" in recessionary times.

Another aspect of the relationship between recessions and health care lies in the political arena, according to Zhou. "In times of recession, when people aren't getting health care, is when you see a push for reform. This is also when it is hardest to make that happen because the tax base is diminished."

The result of the government's stress tests for the banking system may give politicians more confidence to push for health care reform because they are less concerned about the frailty of the financial system than they were in prior months, suggests Rosoff.

The health care reform debate may go in a number of directions, but he expects the Obama Administration to gradually expand Medicare to people under age 65. That coverage, he says, could be paid for in a number of ways, including employer-paid premiums. "Politically and practically, no one wants to come in and displace the private health insurance market with a government plan. They're not going to sweep away the private sector and replace it with a single payer."

The government may, however, want to allow participation in Medicare plans by small employers and the self-employed who often find it difficult to secure affordable coverage because they do not have a large subscriber population.

Rosoff acknowledges that the existence of an expanded Medicare program might encourage more employers to dump coverage for their workers. At the same time, the government program might result in subsidized coverage that puts private health insurers at a disadvantage. He says it will be difficult to structure the plan to address those concerns. Personally, Rosoff favors a larger government role in health care. "In my mind, if we can get there in the next five to 10 years, it could erode the private market and move more toward a government program. I don't necessarily see that as a bad thing."

As for Social Security, Mitchell says there is no easy fix. According to the trustees' report, Social Security tax income will begin to fall short of outlays in 2016, but will be enough to finance 76% of scheduled annual benefits in 2037, when the trust fund is projected to be exhausted. The trustees report goes on to state that Social Security could be brought into actuarial balance over the next 75 years with an immediate 16% increase in the payroll tax, from 12.4% to 14.4%, or an immediate reduction in benefits of 13%, or some combination of the two.

Mitchell points out that proposals to develop private security accounts are likely to fall flat as a result of the stock market decline. And while the Obama Administration is interested in improving financial literacy to encourage successful saving and investing, it will take years for that to have an impact on

individual portfolios. "A good economy could lead to a rebound in revenues for the Social Security system if people get good jobs and pay payroll taxes again," Mitchell says. "But that may well take a couple years. There's nothing rosy on the immediate horizon."

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