2004

Status of the Social Security and Medicare Programs

A SUMMARY OF THE 2004 ANNUAL REPORTS

Social Security and Medicare
Boards of Trustees

Hypertext versions of the Social Security and Medicare Trustees Reports as well as this document are available on the Internet at the following addresses:

Social Security (OASDI):	**www.socialsecurity.gov/OACT/TR/TR04/index.html**
Medicare (HI and SMI):	**www.cms.hhs.gov/publications/trusteesreport/**
Summary:	**www.socialsecurity.gov/OACT/TRSUM/trsummary.html**

Other information about Social Security benefits and services is available at **www.socialsecurity.gov** or by calling toll-free **1-800-772-1213**.

Other information about Medicare benefits and services is available at **www.cms.hhs.gov** or by calling toll-free **1-800-633-4227**.

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 2004 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 cash surpluses will soon begin to decline and then turn into rapidly growing cash deficits toward the end of the next decade as the baby-boom generation retires. The financial outlook for the Medicare Hospital Insurance (HI) Trust Fund that pays hospital benefits has deteriorated significantly from last year, with annual cash flow deficits beginning this year and expected to grow rapidly after 2010 as baby boomers begin to retire. The growing annual cash deficits in both programs will lead to exhaustion in trust fund reserves for HI in 2019 and for Social Security in 2042. 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 transfers and premium charges. As the reserves in Social Security and HI are drawn down and SMI general revenue financing requirements continue to grow, the pressure on the Federal budget will intensify. We do not believe the currently projected long run growth rates of Social Security and Medicare are sustainable under current financing arrangements.

Social Security

The annual cost of Social Security benefits represents 4.3 percent of Gross Domestic Product (GDP) today and is projected to rise to 6.6 percent of GDP in 2078. The projected 75-year actuarial deficit in the combined Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds is 1.89 percent of taxable payroll, down slightly from 1.92 percent in last year's report. The program 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 2018 and will be sufficient to finance only 73 percent of scheduled annual benefits by 2042, 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 in payroll taxes of 15 percent 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 the sustainability of the system beyond 2078 would require even 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 essentially the same demographic challenge, 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 are currently 2.7 percent of GDP, or about 60 percent of Social Security's, they are now projected to surpass Social Security expenditures in 2024 and reach almost 14 percent of GDP in 2078, more than twice the percent for Social Security in that year.

The projected 75-year actuarial deficit in the Hospital Insurance (HI) Trust Fund is now 3.12 percent of taxable payroll, up significantly from 2.40 percent in last year's report mainly due to higher actual and projected hospital expenditures, as well as lower actual and projected taxable payroll, and new Medicare legislation. The fund now 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 has moved forward significantly to 2019, from 2026 in last year's report, and projected HI tax income falls short of outlays beginning this year, as compared to 2013 in last year's report. HI could be brought into actuarial balance over the next 75 years by an immediate 108 percent increase in program income or an immediate 48 percent reduction in program outlays (or some combination of the two). However, as with Social Security, adjustments of far greater magnitude would be necessary to the extent changes are delayed or phased in gradually, and continuation of the program after 2078 would require substantial changes.

Part B of the Supplementary Medical Insurance (SMI) Trust Fund, which pays doctors' bills and other outpatient expenses, and the new 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 sets financing each year to meet next year's expected costs. However, this automatic provision will result in a rapidly growing *amount of general revenue financing—projected to rise from 0.9 percent of GDP today to 6.2 percent in 2078—as well as substantial increases over time in beneficiary premium charges.*

Conclusion

Though highly challenging, the financial difficulties facing Social Security and Medicare are not insurmountable. But we must take action to address them in a timely manner. The sooner they are addressed the more varied and less disruptive can be their solutions. The problem of finding ways to allow older Americans access to high quality medical care is daunting and likely to demand frequent legislative adjustments in the future, as it has since Medicare was first enacted. With informed public discussion and creative thinking that relates the principles underlying these programs to the economic and demographic realities, as well as 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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and Managing Trustee

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Thomas R. Saving,
Trustee

A SUMMARY OF THE 2004 ANNUAL SOCIAL SECURITY AND MEDICARE TRUST FUND REPORTS

Who Are the Trustees? There are six Trustees: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, the Commissioner of Social Security and two members appointed by the President and confirmed by the Senate to represent the public. The Public Trustees are John L. Palmer, University Professor at Syracuse University's Maxwell School of Citizenship and Public Affairs, 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-negotiable 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 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 effective this year, Part D, which provides a new prescription drug benefit that begins in 2006. 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 2003? In December 2003, 39.4 million people were receiving OASI benefits, 7.6 million were receiving DI benefits, and 41 million were covered under Medicare. Trust fund operations, in billions of dollars, are shown below (totals may not add due to rounding).

	OASI	DI	HI	SMI
Assets (end of 2002)	$1,217.5	$160.5	$234.8	$34.3
Income during 2003	543.8	88.1	175.8	115.8
Outgo during 2003	406.0	73.1	154.6	126.1
Net increase in assets	137.8	15.0	21.2	-10.3
Assets (end of 2003)	1,355.3	175.4	256.0	24.0

What Are the Major Changes in the Outlook for the Trust Funds Since Last Year? The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 introduced the most sweeping changes to Medicare since the program began in 1965. The new prescription drug benefit will bring Medicare more in line with modern insurance coverage and medical practice. Together with other provisions of the Act, it will add greatly to the overall cost of SMI, however, and will increase the proportion of total Medicare costs financed from Federal general fund revenues. Also, lower than anticipated tax income and higher than anticipated expenditures, combined with provisions of the new law affecting HI, caused significant deterioration in HI's financial outlook this year. The outlook for Social Security did not change appreciably.

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 and by the self employed (154 million for OASDI and 158 million for HI in 2003). The self employed are charged the equivalent of the combined employer and employee tax rates. The payroll tax rates are set by law and for OASDI apply to earnings up to an annual maximum that rises as average wages increase (it is $87,900 in 2004). HI taxes are paid on total earnings. The tax rates (in percent) for 2004 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 ($66.60 in 2004 for Part B; Part D premiums begin in 2006). Part D also will receive 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. 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 2003 is shown in the table below (totals may not add due to rounding).

Source *(in billions)*	OASI	DI	HI	SMI
Payroll taxes	$456.1	$77.4	$149.2	—
General fund revenue	—	—	0.5	$86.4
Interest earnings.	75.2	9.7	15.0	2.0
Beneficiary premiums	—	—	1.6	27.4
Taxes on benefits.	12.5	0.9	8.3	—
Other	*	—	1.1	*
Total.	543.8	88.1	175.8	115.8

* Less than $50 million.

What Were the Administrative Expenses in 2003? Administrative expenses, as a percentage of total expenditures, were:

	OASI	DI	HI	SMI
Administrative expenses 2003. . .	0.6	2.7	1.6	1.8

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.

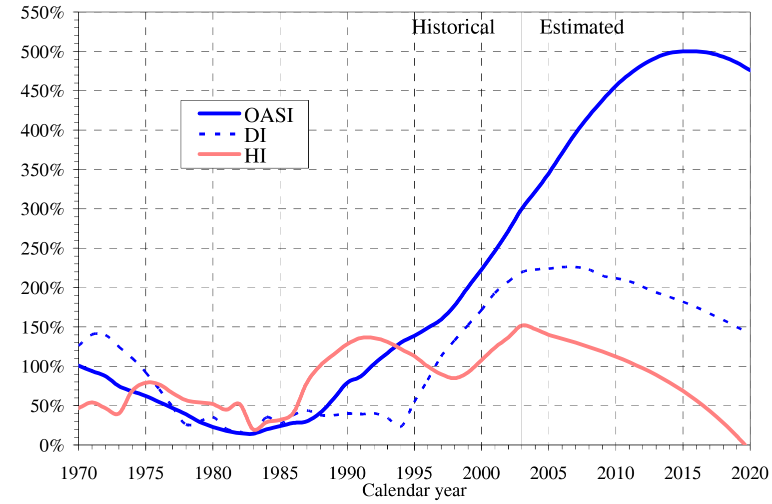
Because the future is inherently uncertain, three alternative sets of economic and demographic assumptions are used to show a range of possibilities. The intermediate assumptions (alternative II) reflect the Trustees' best estimate of future experience. The low-cost alternative I is more optimistic for 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 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.

What is the Short-Range Outlook (2004-2013) for the Trust Funds? For the short range, we measure the adequacy of the OASI, DI, and HI Trust Funds 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 the beginning of a year at least equal to projected benefit payments for that 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 are over the 100 percent level through the year 2013. The HI fund does not meet the short-range test of financial adequacy because its assets fall below the 100-percent level in 2012. Chart A shows these trust fund ratios under the intermediate assumptions through 2020.

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 that are automatically adjusted each year to meet expected costs. Thus, under current law both SMI accounts are fully financed throughout the 75-year projection period no matter what the costs may be.

The table below 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 Part B and for the new Part D account. 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

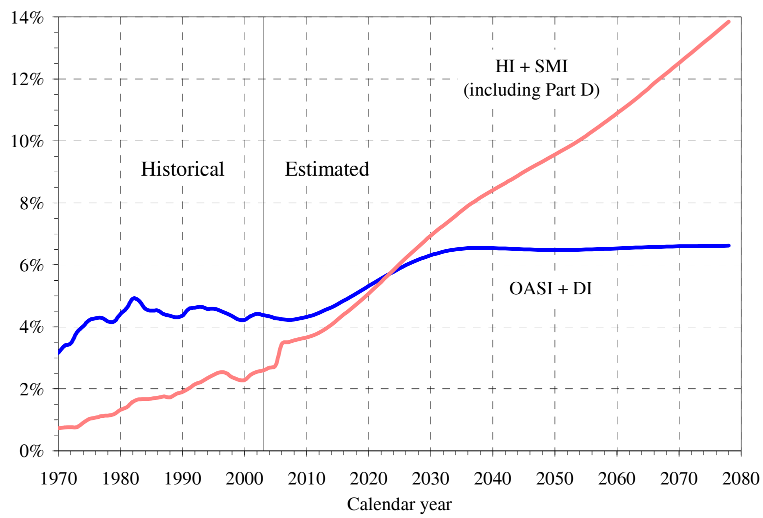
(In billions—totals may not add due to rounding)

	Income					Expenditures					Change in fund		
				SMI					SMI				
Year	OASI	DI	HI	B	D	OASI	DI	HI	B	D	OASI	DI	HI
2004	$563	$91	$181	$133	$3	$422	$79	$174	$135	$3	$141	$12	$8
2005	604	97	196	155	12	434	84	188	147	4	170	13	8
2006	636	102	206	160	86	449	89	201	157	85	187	13	5
2007	675	107	217	167	94	469	95	213	166	93	207	12	4
2008	718	113	228	178	103	492	102	225	176	102	225	11	3
2009	760	118	240	188	112	521	110	239	186	111	239	8	1
2010	806	124	251	199	122	554	116	253	196	121	252	8	-2
2011	856	130	264	211	133	590	122	269	208	131	266	8	-5
2012	904	136	278	225	147	630	130	286	221	146	274	6	-8
2013	953	142	290	243	164	674	138	305	238	162	280	4	-14

What is the Long-Range (2004-2078) Outlook for Social Security and Medicare Costs? 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. Thereafter, Social Security costs grow slowly due primarily to projected increasing life expectancy. Medicare costs continue to grow rapidly due to expected increases in the use and cost of health care. In particular, continuing development and use of new technology is expected to 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.

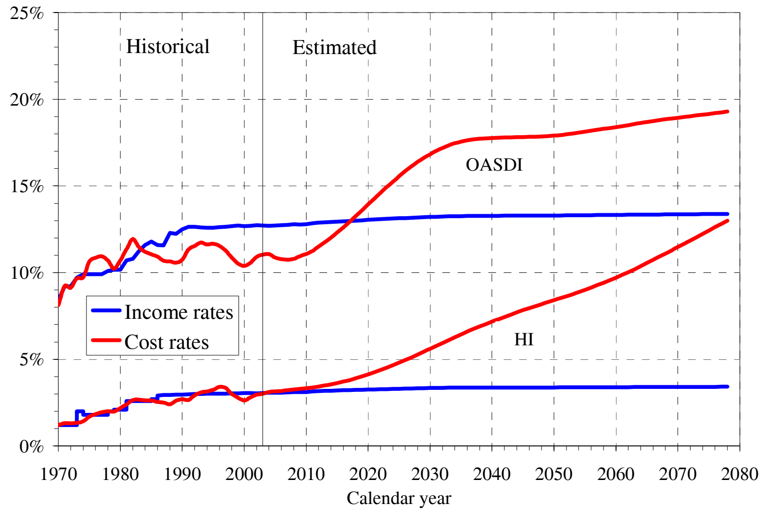
Thus, a good way to view the projected cost of Social Security and Medicare is in relation to gross domestic product (GDP), the most frequently used measure of the total U.S. economy (Chart B below). Social Security outgo amounted to 4.3 percent of GDP in 2003 and is projected to increase by just over one-half to 6.6 percent of GDP in 2078. Medicare's cost was smaller in 2003, 2.6 percent of GDP, but is projected to grow more than fivefold to 13.8 percent of GDP in 2078, when it will be more than twice Social Security's.

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 their primary source of income is the payroll tax, it is customary to compare their income and cost rates as a percentage of taxable payroll, as in Chart C. Note that the income rate lines do not rise significantly 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, primarily because a greater proportion of beneficiaries will become 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 that could be added to the current law income rate for each of the next 75 years, or subtracted from the cost rate for each year, to bring the funds into actuarial balance. However, such uniform changes, while adequate for this period as a whole, would close less than one-third of the gap for 2078 between the annual income and cost rates for OASDI and HI shown in Chart C.

ACTUARIAL DEFICIT OF THE OASI, DI, AND HI TRUST FUNDS
(As a percentage of taxable payroll)

	OASI	DI	OASDI	HI
Actuarial Deficit	1.56	0.33	1.89	3.12

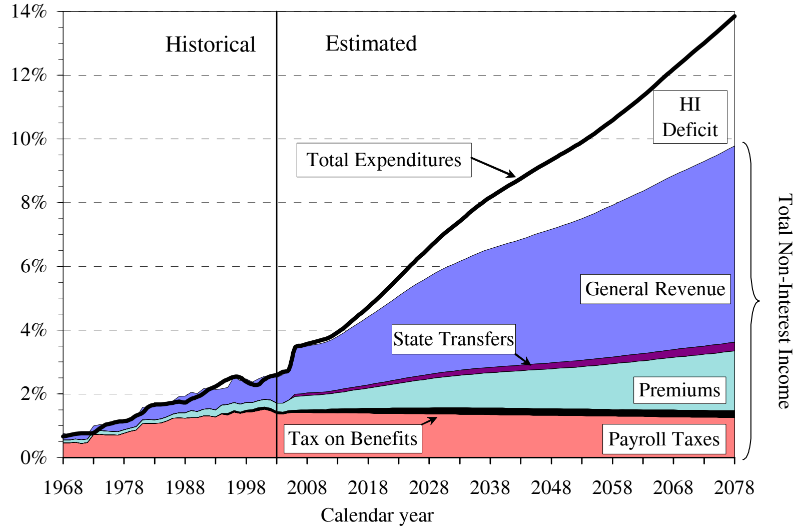
What Are Key Dates in Long-Range OASI, DI, and HI Financing?
When costs exceed tax income (shown in Chart C), use of trust fund assets occurs in stages. For HI the process begins in 2004, when interest earnings will have to be used to help pay benefits. Beginning in 2010 assets will have to be redeemed each year until the trust fund is exhausted in 2019. At that time, tax income is estimated to be sufficient to pay 81 percent of HI costs—and by 2078 only 26 percent. OASDI first needs to utilize interest in 2018 and to begin redeeming assets in 2028. OASDI assets are projected to be exhausted in 2042, when tax income would cover 73 percent of costs—and by 2078 only 68 percent. 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	2008	2018	2004
First year outgo exceeds income including interest	2029	2017	2028	2010
Year trust fund assets are exhausted	2044	2029	2042	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 shown in Chart B and shows Medicare costs rising to 13.8 percent of GDP by 2078. Revenues from taxes are expected to remain just over 1.4 percent of GDP, while general fund revenue contributions are projected to rise from 0.9 percent in 2004 to 6.2 percent in 2078, and beneficiary premiums from 0.3 to 1.9 percent of GDP. Thus, revenues from taxes will fall substantially as a share of total non-interest Medicare income (from 55 percent to 15 percent) while general fund revenues will rise (from 34 to 63 percent), as will premiums (from 11 percent to 19 percent). The gap between total non-interest income and expenditures steadily widens due to growing annual HI deficits, which reach 4 percent of GDP by 2078. The new Medicare law requires a determination in future reports of whether the difference between total outlays and earmarked revenues (the first four layers in Chart D) exceed 45 percent of total Medicare outlays within the first 7 years. This threshold is now expected to be reached in 2012.

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

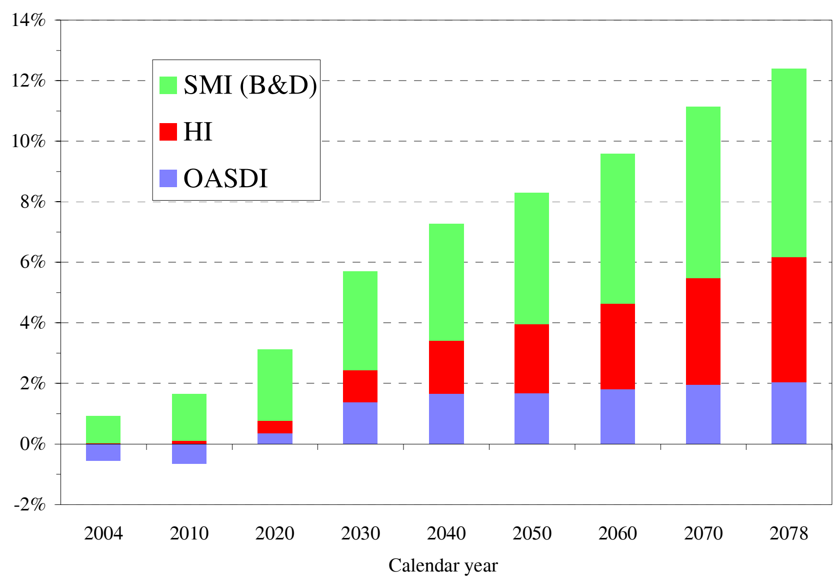


Why is Reform to Improve the Medicare and Social Security Financial Imbalance Needed? Public concern about the financial status of Medicare and Social Security tends to focus exclusively on the HI and OASDI Trust Fund exhaustion dates when benefits scheduled under current law can no longer be paid in full. But there are more immediate and fundamental reasons why Medicare and Social Security financing reform is needed: namely, the two programs together will place rapidly mounting draws on Federal general fund revenues long before trust fund exhaustion, and their financing in the long term is far more problematic than suggested by the 75-year actuarial deficits for HI and OASDI.

The rapidly 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 and Part D. The initial negative amounts for OASDI in 2004 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. Conversely, the positive amounts for OASDI and HI initially represent payments the Treasury must make to the funds to supplement tax income to help pay benefits in the years leading up to exhaustion of these trust funds, then their widening financing gap thereafter.

The Social Security tax income surplus in 2004 is projected 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. This combined shortfall is projected to grow each year—such that by 2018 net revenue flows from the general fund to the trust funds will total $577 billion, or 2.6 percent of GDP. Since 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 these trust funds must be financed by increased taxation, increased Federal borrowing and debt, and/or 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 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 understood. There is a big increase in the shortfall of dedicated payroll tax and premium income in the 2010 to 2030 period as the "baby-boom" generation reaches retirement age, but this shortfall continues to grow rapidly after that point due to expected faster-than-GDP growth in health care costs and to the increasing life expectancy of beneficiaries. In 2003, the combined annual cost of HI, SMI and OASDI was about 7 percent of GDP, or two-fifths of total Federal revenues. It is projected to more than double to 15 percent of GDP by 2040 and then to rise further to 20 percent of GDP in 2078, at which time it would exceed total Federal revenues at their historic share of 19 percent of GDP. We do not believe such a long-term rate of growth for the two programs can be sustained.

In summary, the projections for Medicare and Social Security under current law manifest mounting draws on Federal general fund revenues, exhaustion of trust funds beginning in 15 years (for HI) that would not permit full payment of currently scheduled benefits, and unsustainable long-term growth in costs. The sooner these problems are addressed, the more varied and less disruptive will be their solutions.

A MESSAGE FROM THE PUBLIC TRUSTEES

These are the fourth annual Trustees Reports in which we have participated since beginning our terms as Public Trustees in late 2000. As Public Trustees we strive 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 numerous assumptions that must be made, we believe the projections in these reports provide the most reliable indication available of the financial outlook under current law for Medicare and Social Security.

2003 Experience and Outlook

This year's reports show little change in OASDI's projected financial status from last year's, as the program continues to face serious financial shortfalls. The sizeable annual tax income surpluses the Social Security funds have experienced in recent years continued in 2003, with non-interest (tax) income exceeding outgo in the combined Social Security (OASDI) Trust Fund by $68 billion. But these surpluses are projected in these reports to peak in 2008. They will then begin a decline that will accelerate as the baby-boom generation retires and turn into rapidly growing annual tax income deficits beginning in 2018. The result is the exhaustion of OASDI fund reserves in 2042, at which time annual tax revenues will be sufficient to pay only 73 percent of scheduled benefits. In just 20 years, OASDI will go from providing annual surplus revenue to the Treasury equal to 7 percent of Federal income taxes to requiring a transfer from the Treasury—to redeem the bonds that comprise the trust fund reserves—equal to more than 6 percent of Federal income taxes (projected at their historical share of GDP).

In contrast to Social Security, the projected financial status of Medicare has taken a major turn for the worse since last year's reports. As a result, the financing problems facing Medicare are now projected to occur sooner and to eventually be much larger and more difficult to solve than those of Social Security. There has been a significant deterioration in the financial outlook for Medicare Part A Hospital Insurance (HI) in both the near and longer term due to lower projected payroll tax income, higher projected expenditures for inpatient hospital care, and increased expenditures resulting from the major Medicare legislation enacted late last year. Although tax income exceeded outgo by $6 billion in the HI Trust Fund in 2003, its annual expenditures are expected to exceed non-interest income beginning this year, and tax income deficits will grow each year—as soon will the necessary cash payments from the Treasury to redeem the bonds *that comprise its reserves—until HI fund reserves are exhausted in 2019. The financial outlook for Medicare Supplementary Medical Insurance (SMI) has undergone an even more dramatic change than has that for HI since last year's Trustees Reports, since the new Medicare Part D prescription drug provisions combine with higher projected costs for Part B to greatly accelerate the overall projected rate of growth of SMI (which is composed of Parts B and D). This new SMI growth path, and the higher HI cost projection, raise serious doubt about the sustainability of Medicare under current financing arrangements.*

More on Medicare's Financing Problems

The projected depletion of HI Trust Fund reserves in 2019 is a full 7 years earlier than in last year's Trustee Reports. But another problematic milestone for HI's finances occurs much sooner. In contrast to last year, the HI Trust Fund now fails to meet even the Trustees short-run test of financial adequacy, since its projected reserves fall below the next year's projected expenditures in less than 10 years—in 2012. This year the HI Trust Fund will require only a small cash transfer from Treasury, as interest income on its reserves begins to be used to help cover annual expenses. These transfers will grow rapidly, however, to reach the equivalent of 3.5 percent of Federal income taxes by the year of trust fund exhaustion in 2019. In 2020, once HI Trust Fund reserves are depleted, annual tax income to the fund will be sufficient to cover only about 80 percent of projected annual costs; and the annual deficits grow so rapidly thereafter that, by the end of the 75-year projection period (2078), only about 25 percent of expected HI costs can be covered by projected tax income. The inadequacy of current HI financing arrangements to fund the hospital insurance benefits promised in the law is clear, and the need for legislative action is pressing.

Medicare Part B and the new Part D prescription drug benefit that becomes effective in 2006 are both financed primarily (roughly 75 percent) by annual transfers to the SMI Trust Fund from general revenues, with separate beneficiary premiums for each part providing most of the remainder of their funding. The Part B and Part D general revenue transfer and premium amounts are reestablished each year to match expected costs for the following year. Part B costs have grown steadily faster than the economy in the past and are now projected to increase from their 2003 level of 1.1 percent of Gross Domestic Product (GDP) to over 2 percent within 20 years and then to almost 5 percent of GDP by 2078. (Moreover, these cost projections are probably too low in the near term because cur-

rent law provides for large negative physician payment updates for several years after 2005 that are politically unrealistic.) The new Part D prescription drug account costs are expected to be 0.7 percent of GDP in 2006, but to grow even faster than Part B costs, to over 1.5 percent of GDP in 20 years and about 3.4 percent by 2078. Thus, the overall costs of SMI are projected to rise from 1.1 percent of GDP to 3.8 percent in 2025 and then more than double again to well over 8 percent of GDP in 2078.

The automatic annual adjustment of general revenue and premium amounts in current law for Part B and Part D means that SMI financing is always projected to be sufficient to meet costs. This financing arrangement, however, places rapidly growing demands on beneficiaries' and government's overall finances. Consider that in 2003, SMI general revenue financing amounted to just under 9 percent of Federal income taxes; but it is projected to amount to nearly 14 percent of Federal income taxes in 2010, to nearly 29 percent by 2030 and to just over 50 percent in 2078, if these taxes remain the same share of the nation's economy as they have for the past several decades. For beneficiaries, the availability of SMI greatly reduces the costs that they would otherwise face for health care. But the financial burden for most SMI beneficiaries will nevertheless grow rapidly. Whereas in 2003 Part B premiums and coinsurance for a typical Medicare beneficiary amounted to 15 percent of the average Social Security benefit, the same expenses for Parts B and D combined for beneficiaries in the future are expected to exceed 35 percent by 2010, 50 percent by 2030 and 80 percent by 2078. Moreover, as individual beneficiaries grow older in retirement, SMI premiums and coinsurance will increase each year as a percentage of the average Social Security benefit, since the rate of increase in health care costs is expected to be much greater than the general rate of inflation used to make annual cost- of-living adjustments to Social Security benefits.

The conundrum of Medicare financing is even more perplexing because Americans are taking advantage of continuing medical advances in diagnostic and treatment capabilities and living longer and more productive lives. But the result of these (very happy) trends, unfortunately, is a rate of growth of medical costs that will continue to far outstrip that of the economy. As Public Trustees we are compelled to point out the inadequacy of the Medicare financing arrangements in current law to meet the projected cost of the benefits promised by law.

Conclusion

The HI Trust Fund fails the Trustees' test of short-range financial adequacy, and legislative action to remedy this situation will be required shortly. Moreover, the need for the HI Trust Fund to begin using interest and, therefore, require a general revenue transfer to cover expenditures this year is only the tip of the iceberg of the additional demands that the Medicare and Social Security trust funds soon will be placing on Federal general revenues to fund both their rapidly growing tax income shortfalls and the necessary general revenue transfers for SMI. The dramatic increase in the projected costs of Medicare in this year's report, including the provisions of the 2003 legislation, should increase the urgency for the search for ways to provide good health care to aged Americans at a cost that can be borne by both taxpayers and beneficiaries. Medicare's costs are now projected to surpass those of Social Security by 2024 and to continue to grow much faster thereafter. Although Social Security's financing problem is serious, it did not worsen over the past year and is far more manageable than Medicare's. We believe that continued national dialogue about, and timely action on, financial reform of Medicare and Social Security are imperative.

John L. Palmer,
Trustee

Thomas R. Saving,
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