Brother, Can You Spare $43 Trillion?

The projected long-term costs of Social Security and Medicare do more than merely boggle the mind. They also threaten the future vitality of our society.

by Richard M. Ebeling, AIER Senior Fellow

Uncle Sam’s budget deficits and accumulated debt are growing by leaps and bounds because of the nearly $2 trillion so far committed to recent bailout and stimulus programs. But the numbers pale in comparison to the vast sums of money the Federal government has promised to spend to cover Social Security and Medicare.

The Treasury Department’s recently issued 2008 Financial Report of the United States Government estimated the total cost of these two unfunded liabilities over the next 75 years. It put the current present value of the country’s commitment to the social welfare programs at almost $43 trillion.

To put this in perspective, the entire Federal budget in fiscal year 2008 was about $3 trillion. The Gross Domestic Product (GDP) of the United States—the market value of all goods and services produced in the nation—last year was around $14 trillion dollars. The federal government would have to have, right now, the equivalent of three years of U.S. GDP that was earning interest to be able to cover its unfunded liability promises projected over the 75-year time horizon.

These two big unfunded promises are Social Security benefits and Medicare payments. Both serve retired workers.

Social Security has been around since the New Deal. It was designed as a pay-as-you-go system in which current workers paid taxes to cover the benefits for those who were retired. Since 1990, both employers and employees have each paid in 6.2 percent of taxable earnings. The self-employed pay 12.4 percent of their taxable earnings.

The problem is that the huge baby boom generation born between 1946 and 1964 is now reaching retirement age. This means there are fewer workers around to pay for more retirees. In the 1960s, there were about four workers paying into the Social Security fund for every one retiree. In 2000, before any of the boomers reached retirement age, that ratio had narrowed to three to one. By 2030, the Treasury’s report estimates there will be only about two workers for every one person eligible for Social Security.

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For most of Social Security’s history, workers and employers have paid in as much money as was paid out to retirees. Since 1990, both employers and employees have each paid in 6.2 percent of taxable earnings. The self-employed pay 12.4 percent of their taxable earnings.

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Inside this report

As tax time fast approaches, accountant Robert J. Sheedy explains the implications of selling collectibles, some of which are hitting record prices. See page 3. How bad is it this recession? AIER Research Associate Alan P. Murray compares the data. See back page.

In our next issue

Economist Walter Cadette writes in the Extra section that Alan Greenspan bears most of the blame for our economic woes.
The Treasury Department estimates that the Social Security Fund will continue to run modest budget surpluses until 2017, only eight years from now. By that time, the oldest of the boomers will be 71—and ever-growing numbers of the 78 million members of this generation will be leaving the workforce and taking Social Security payments.

Twenty-five years from now, as some of the boomers’ children approach retirement age, 20 percent of the population will be over 65, compared to only 12 percent today.

If current eligibility standards remain the same—and that’s a big if—this will require the government to raise taxes or borrow increasing sums on the domestic and foreign financial markets.

Of course, the government also can change eligibility standards, cut benefits, or eliminate Social Security entirely at the stroke of a pen.

There is an enormous sum of money at stake. The 2008 Social Security Trustees Report estimates that Social Security obligations over the next 75 years will create a shortfall with a current present value of $6.6 trillion.

But as large as the government’s unfunded liability may be for Social Security, it pales in comparison to what is committed to Medicare recipients over that same 75-years.

President Lyndon Johnson created Medicare in 1965 to provide health insurance to people 65 and older. The Medicare tax on salaried employees is currently 2.9 percent of earnings, with 1.45 percent withheld from workers’ paychecks and employers paying the other half. As with Social Security, the self-employed pay the full amount, in this case 2.9 percent, out of their earnings.

It has been one of the fastest growing federal expenses since its implementation. It now represents about 16 percent of all federal spending, the third largest item in government expenditure after Social Security and defense.

In 2008, around 45 million Americans received Medicare dollars at a cost of more than $450 billion.

Medicare expenditures are classified under three general headings. Only Part A: Hospital Insurance is financed through the 2.9 percent tax on earnings. Part B: Supplementary Medical Insurance is 75 percent financed from general federal government revenues and 25 percent through beneficiary premiums. Part D: Prescription Drug Benefits is 80 percent financed from general government revenues and 20 percent from state government payments and beneficiary premiums.

According to the 2008 Medicare Trustees’ Report, the 75-year projection of the costs of funding Parts D: Prescription Drug Benefits is 80 percent financed from general government revenues and 20 percent from state government payments and beneficiary premiums.

Continued on page 3

Pensions in the Private Sector

Defined-benefit plans involve a contractual obligation of an employer to pay retired employees a stream of payments based, for example, on their years of service and/or their average final compensation. This promise is a contract, a legal liability for the employer leading to a specific financial liability. Its value, which can be calculated by actuaries, is the present value of the promised future benefit stream, taking into account variables such as life expectancy, wage growth, and turnover. For a large employer, these liabilities can easily reach billions of dollars.

The first pension plans were on a pay-as-you-go basis—an employer’s retirees were simply paid out of general funds. If the employer went out of business, the retirees received no further income. To avoid this unpleasant possibility, employers often established separate trust funds to pay pensions that would not be subject to the claims of creditors in the event of bankruptcy. This was encouraged by the tax code, which permitted employers to deduct their payments into a pension fund (if it qualified by meeting certain requirements), without reporting such payments as income to their employees.

Pay-as-you-go plans are now illegal for private employers (but federal, state and local government plans are exempt from these requirements). The Employee Retirement Income Security Act of 1974 (ERISA) requires private employers sponsoring plans to contribute cash into a separate trust or insurance contract for the exclusive purpose of paying benefits.

The establishment of a defined-benefit plan instantly creates a past-service liability—the present value of the benefits to be paid to retirees on the basis of their employment prior to the establishment of the plan. The same thing happens whenever prospective benefits are increased. Companies usually cannot afford to fully fund past-service liabilities when they are created. Instead they are gradually funded (amortized) over many years. Each year companies are required to pay into a defined-benefit pension fund enough to cover the current-service liability and to amortize any unfunded past-service liability.

Private companies can and do cut back on retiree health benefits. Under the ERISA law of 1975, companies must honor promised pension benefits—but that is all. Accordingly, many private companies have cut back sharply on promises of future retiree health benefits.

—Adapted from the AIER archives
As the economy shows no sign of a turnaround, comparing the data reveals some striking and often unsettling trends.

by Polina Vlasenko, AIER Research Fellow

The current recession, which started in December 2007, has lasted for 14 months, thus far making it the third longest recession in post-war history. For now, at least, it clocks in behind the recessions of 1973-75 and 1981-82, each of which lasted for 16 months. But AIER’s primary leading indicators strongly point to a continued downturn.

With all our indicators, a score below 50 signals likely contraction. This month both the percentage of leaders expanding and the cyclical score remained the same at 17 (two out of twelve) and at 28, respectively. As also was the case last month, only two of the primary leading indicators are appraised as expanding—M1 money supply and the yield curve index. Expansionary monetary policy continues to push these indicators upwards. All other primary leading indicators are appraised as clearly contracting. This picture does not suggest an imminent turnaround.

It is now common to call the current recession the worst post-war recession and to compare it either to the Great Depression or to the recession of 1981-82, which is the deepest post-war recession so far.

In terms of employment, this recession has not been worse than 1981-82. As of January 2009, the national...
unemployment rate was 7.6 percent, which is below the rate that prevailed during 1981-82, when it ranged from 7.6 to 10.8 percent. Initial claims for state unemployment insurance, which reached 583,000 per week in January 2009, are within the range of 435,000-671,000 experienced in 1981-82. However, the labor force is much larger now, so relative to the size of the labor force, initial claims are much smaller now than they were in 1982.

There are some measures by which the current downturn does seem unprecedented. New housing permits have established new lows in the history of the series every month for the past four months. While this sounds alarming, keep in mind that the current sharp fall in housing construction is following a very large boom that lasted to mid-2007. The correction necessarily has to be sizable.

**Primary Leading Indicators**

- **M1 Money Supply (1)** (constant dollars, billions)
- **Ratio of Manufacturing and Trade Sales to Inventories (3)**
- **Yield Curve Index (1)** (cumulative total)
- **Vendor Performance: Slower Deliveries Diffusion Index (3)** (%)
- **Index of Manufacturers’ Supply Prices (3)** (percent)
- **Index of Common Stock Prices (2)** (constant purchasing power)
- **New Orders for Consumer Goods (3)** (constant dollars, billions)
- **Average Workweek in Manufacturing (3)** (hours)
- **New Orders for Core Capital Goods (4)** (constant dollars, billions)
- **Initial Claims for Unemployment Insurance (3)** (1000s, inverted)
- **New Housing Permits (3)** (thousands)
- **3-Month Change in Consumer Debt (4)**

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2. Ratio of Manufacturing and Trade Sales to Inventories
3. Yield Curve Index
4. Vendor Performance: Slower Deliveries Diffusion Index
5. Index of Manufacturers’ Supply Prices
6. Index of Common Stock Prices
7. New Orders for Consumer Goods
8. Average Workweek in Manufacturing
9. New Orders for Core Capital Goods
10. Initial Claims for Unemployment Insurance
11. New Housing Permits
12. 3-Month Change in Consumer Debt
Primary Roughly Coincident Indicators

Our primary roughly coincident indicators reinforce the view of a continued recession. The percentage expanding remains at zero and the cyclical score has fallen from 23 to 15. According to advance estimates, constant-dollar gross domestic product decreased at an annual rate of 3.8 percent in the fourth quarter of 2008, a much faster decrease than the decrease at the rate of 0.5 percent in the previous quarter. A larger quarterly decrease has not been seen since the recession of 1981-82. Overall, however, from the fourth quarter of 2007 to the fourth quarter 2008, GDP decreased by a mere 0.2 percent. Only the mild recession of 2001 produced a smaller annual decrease. In the current recession, the substantial decline in GDP did not take place until four quarters after the peak. For a more detailed comparison of all post-war recessions, see the article on the back page of this issue.

In the face of widespread claims of frozen credit

Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.
In the face of restricted availability of other forms of financing, businesses increasingly are turning to pre-existing credit arrangements with banks. Usually, commercial and industrial loans increase for a few months after the start of a recession as falling sales and profits necessitate increased borrowing.

On average, as the top left chart on page SI-3 shows, in all post-war recessions, not counting the current one, commercial and industrial loans increased for about six months after the peak of the business cycle. The current recession seems unusual because loans have expanded, thus far, for 12 months after the peak. However, comparison of the current recession to another sharp postwar recession, that of 1981-82, reveals a surprisingly similar pattern. Then as now, commercial and industrial loans continued to expand for more than a year into the recession.

It is possible that commercial and industrial loans expand for a longer time when the economy faces a fairly deep recession, which was the case in 1981 and is the case now. In contrast to the deep recession of 1981, commercial and industrial loans thus far have expanded more slowly, possibly because of frozen credit markets.

Another series with a surprising trend is the change in labor cost per unit of manufacturing output. Despite the numerous reports of layoffs, labor cost per unit of output continued to increase through December 2008, the latest month for which data is available. This suggests that cuts in costs (either through layoffs or other forms of labor cost reduction such as furloughs) have not been large enough yet to match the decline in output. This could indicate that firms are reluctant to lay off workers and will do so only when all other cost cutting measures have been exhausted.

On average, in all post-war recessions the labor cost per unit of output continued to increase for about 12 months after the peak of the business cycle, as the top right chart on page SI-3 shows. However, the current increase in labor costs is much larger than average. As with commercial and industrial loans, comparing the current recession to the recession of 1981-82 reveals surprising similarities. Labor costs per unit of output increased substantially in 1981 for about six months following the start of the recession. Both the trend and magnitude of contemporary changes are strikingly similar to those of 1981.

After the initial six months of the recession, however, a substantial difference emerges. The labor cost per unit of output started falling in 1981, presumably because firms began laying off workers to cut labor costs. In the current recession this shift has yet to occur. But firms cannot continue indefinitely to keep up employment in the face of falling output. The adjustment will have to come eventually, and when it does we are likely to see a sizable increase in layoffs.

Firms cannot keep up employment in the face of falling output.
Traditionally, collectibles have been taxed at the highest capital gain rate (28 percent) because of public policy arguments. Supporters of the higher rate justify their position by citing the lack of broader benefits such as innovation, new products, and higher productivity that society receives from collectibles.

Collectibles include gold and silver bullion, works of art, rugs or antiques, metals or gems, stamps or coins, and alcoholic beverages. Some collectibles, notably gold, have enjoyed particularly high prices in the past year, and their sale has specific tax implications.

As with securities, gain (loss) on collectibles owned less than 12 months may be taxed differently than are collectibles owned longer. To determine the tax, start by summarizing (netting) the short-term versus the long-term transactions on Form 1040 Schedule D.

Here are two different scenarios: Net short-term gain only, ordinary tax rates (highest marginal rate). Net long-term gain only, 28 percent maximum tax rate (lower if marginal rate is lower).

Transactions from other investments, which can be taxed at other rates, are also thrown into the mix to determine the overall net short-term gain (loss) and the net long-term gain (loss).

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A, B, and D, at the current present value totals $36.3 trillion above what will be paid into the system as payroll taxes or premium payments.

Adding together the present value of the Social Security system’s unfunded liability of $6.6 trillion to this estimated present value of Medicare’s unfunded liability gives us the grand total of $42.9 trillion.

Since the government clearly does not have that sum of money lying around, it would, then, have to tax and set aside the equivalent to 8.2 percent of America’s annual GDP for the indefinite future to have enough revenue to cover these legislated entitlement costs. Because of the aging of the population, this cost is projected to remain constant despite any expected growth in GDP. The likely shortfalls in Social Security, Medicare, and the financing of Supplemental Medical Insurance are projected in the chart above.

To put this into some type of manageable perspective, the 75-year estimated present value of $43 trillion dollars in these unfunded liabilities represents for the nation’s population of around 305 million a 2009 per capita tax burden of more than $140,000.

From any perspective, it is difficult to comprehend how the federal government will be able to fully finance these unfunded liabilities under existing rules. Judging from past behavior, the most likely government response will be the implementation of minor fixes—raising taxes and premiums, pushing up minimum eligibility ages, imposing more stringent rules for access to certain types of medical care and treatment.

But a larger issue concerns the very vitality of our society. Programs such as Social Security and Medicare could grow to a point where they drain the wealth generated by the productivity of the competitive market. We are rapidly approaching a point when the welfare state may be “eating the seed corn.” Stagnation and social retrogression have threatened every society in history that has followed that path.

**Ask the Expert**

**Taxing Collectibles**

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Net short-term losses will offset net long-term gains and vice versa. If a taxpayer has a net short- or long-term gain in gold, this would be offset to the extent of either a net short- or long-term loss from security transactions.

—Robert J. Sheedy is a senior tax partner at BST Advisors, LLC.

To submit questions for future columns, email asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.
The Recession by the Numbers

The data don’t yet support widespread forecasts of disaster.

by Alan Murray, AIER Research Associate

The current downturn is frequently characterized as the worst since the Great Depression. Yet while it has been underway longer than most since World War II, it hasn’t yet reached the severity of many other downturns and is nowhere close to that of the Great Depression.

The table below compares previous downturns with data for the current recession through December 2008. The most severe current decline is in industrial production. The 7.8 percent drop is steeper than those over three of the last four recessions. But it does not approach the declines of 1973-75 and 1957-58, both of which exceeded 13 percent.

The drop in employment is large in absolute terms and tragic in its impacts on individuals. As a percentage of peak employment, however, it has yet to reach the levels of the majority of post-World-War-II recessions. The same is true for the unemployment rate. Employment statistics, however, lag behind other measures of economic activity, so further deterioration is likely.

Constant-dollar GDP at the end of 2008 was only 0.2 percent below the year before. This may seem puzzling in the face of the 3.8 percent drop in the advance estimate for the final quarter. But the 3.8 percent is an annual rate—the actual percentage point deterioration between the third and fourth quarters was less than 1 percent.

The most unusual aspect of the current recession is the lack of inflation. The consumer price index rose a minuscule 0.1 percent between the end of 2007 and the end of 2008. You have to go back to the Great Depression and the recession of 1948-49 to find downturns in which inflation was more subdued. (The average inflation during 2008, shown in the table below, was 3.8 percent.)

The largely unchanged level of consumer prices was the result of a rise in the first seven months of the year followed by a drop in the last five. Energy prices played a major role in the volatility.

The recent downturn in prices affects appraisals of data on sales and incomes. In current dollars, aggregate personal income fell in each month of the final quarter of 2008. But constant-dollar personal income—income after adjustments for lower prices—rose over the quarter and advanced nearly 1 percent for the year.

Personal consumption expenditures in real terms paint a gloomier picture. They fell 1.3 percent over the year. In contrast, consumption rose during the 1981-82 recession and fell less than 1 percent during the 1973-75 downturn—both relatively severe downturns.

The drop-off in consumer spending is certainly worrisome. But the stability of real income in 2008 suggests that the recession may not be as severe as some have predicted. What remains unknown is the impact of the $787 billion stimulus package recently signed into law.

A Capsule History of Business Recessions

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<th>Duration (Months)</th>
<th>GDP*</th>
<th>Personal Income*</th>
<th>Industrial Production*</th>
<th>Nonagricultural Payroll Employment*</th>
<th>Unemployment Rate Increase</th>
<th>Percent of Industries with Employment Decrease**</th>
<th>Percent 12-Month Inflation Rate†</th>
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<td>(% Chg.)</td>
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na Not available. * Percentage decrease from high month or quarter to low. † Highest monthly figure reached and increase from low to high. ** Percentage of industries that experienced a decrease in employment over a six-month interval. The figure shown is the highest percentage reached during the recession. †† Average 12-month rate of change in the Consumer Price Index during the recession. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, Business Conditions Digest; Business Cycles, Inflation, and Forecasting, Geoffrey H. Moore, 1983.