Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

Revised May 1, 2006

TRUSTEES' REPORT FOCUSES ATTENTION ON MISGUIDED MEDICARE "45-PERCENT TRIGGER"

by Robert Greenstein, Richard Kogan, Edwin Park, and James Horney

The Social Security and Medicare Trustees report issued May 1 includes an estimate that the portion of Medicare funding that comes from general revenues will exceed 45 percent in 2012. This estimate is likely to be cited by some as an indication of Medicare's growing problems, with the implication being that Medicare's financing problems would be ameliorated if the general-revenue share of Medicare funding were to be reduced.

Such claims or implications, however, would not be accurate. Medicare clearly faces major financing problems — its costs are growing faster than either payroll taxes or the economy, and the Medicare Hospital Insurance Trust Fund is projected to become insolvent in 2018. But these problems are *not* the result of decisions to fund Medicare partly through general revenues (i.e., partly through the income tax), rather than entirely through payroll taxes and premiums charged to beneficiaries. Moreover, reducing the share of Medicare funding that comes from general revenues — and boosting the share that comes from payroll taxes or beneficiary premiums — would do nothing itself to put Medicare on a more sustainable long-term footing.

How Is Medicare Financed?

Medicare Part A, the Hospital Insurance program, covers hospital costs and is financed primarily through payroll taxes. The remainder of Medicare — **Part B**, which covers physician and other outpatient services, and **Part D**, which provides the new drug benefit — is designed to be financed with general revenues, as well as premiums paid by beneficiaries.

The "45-percent measure," established by the 2003 prescription drug law, is essentially an ideologically based measure and has been promoted primarily by individuals and institutions who seek to ensure that increases in progressive taxes, such as the income tax, are not considered even as a small part of any future package of program cuts and revenue increases to help shore up Medicare's finances.

- Under a provision of law enacted as part of the 2003 Medicare prescription drug bill, the annual Medicare Trustees' report is required to include an estimate of the year in which general revenues will account for more than 45 percent of Medicare funding. If the projections in two consecutive trustees' reports indicate that this portion will exceed 45 percent within the next six

years, the President is required to submit legislation to reduce the portion to less than 45 percent. In his latest budget, President Bush has proposed amending this provision to require *automatic cuts* in Medicare every year once the 45-percent point is reached.

- The new Trustees' report projects that the share of Medicare funding coming from general revenues will reach 45 percent in 2012, which is within the six-year window. If next year's report contains a similar estimate, which is likely, it will constitute the second consecutive such estimate. That, in turn, will trigger the requirement for the President to propose legislation (as part of the budget he sends Congress in February 2008) to reduce the general-revenue share of funding for Medicare so it does not exceed 45 percent.

This analysis examines why the 45-percent standard represents an unsound (and inequitable) measure for evaluating Medicare's financial status and for triggering actions by policymakers.

Why the 45-Percent Trigger is Misguided

Medicare faces serious long-term financial problems. Last year, the Medicare trustees projected that the Medicare Hospital Insurance program (Medicare Part A) will become insolvent in 2020. Medicare expenditures are projected to rise rapidly in coming decades as the baby-boom generation retires and health care costs continue to rise. A trigger that would prompt presidential and congressional review of measures to extend the solvency of the Medicare Hospital Insurance program and to address the larger budgetary issues raised by the rising costs of health care — and hence of Medicare — could indeed be useful.

The 45-percent trigger, however, which was added behind closed doors in 2003 in the conference on the Medicare drug law, is not designed to address these challenges.[1] To the contrary, the 45-percent threshold is an arbitrary benchmark laden with ideological overtones and inconsistent with Medicare's basic financing structure.

- By law, both Medicare *physicians'* coverage and the new Medicare drug benefit are *supposed to be* financed by general revenues, as well as beneficiary premiums, rather than by the payroll taxes that finance Medicare *hospital* coverage. The fact that a particular share of Medicare costs is financed by progressive income taxes rather than regressive payroll taxes is not itself a problem, just as it is not inherently problematic that defense, education, homeland security, and medical research are financed by general revenues.

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[1] Additional procedures tied to the 45-percent threshold have recently been proposed. The President's fiscal year 2007 budget proposes *automatic cuts* in Medicare provider payments if the 45-percent threshold is exceeded. In addition, the budget resolution that the Senate passed in March 2006 would institute a new Senate point of order against legislation that would increase the costs of *any* entitlement program if the 45-percent threshold is projected to be exceeded within six years. See Robert Greenstein, Richard Kogan, Edwin Park, and James Horney, "President and Senate Budget Committee Embrace Misguided '45-Percent Trigger,'" Center on Budget and Policy Priorities, revised March 15, 2006.

- That the 45-percent level will be reached in about 2012 is of little significance.[2] The 45-percent threshold would be reached in a relatively few years even if Medicare's fiscal picture were to brighten considerably and Medicare costs rose *much more slowly* than is currently projected.

- Of particular concern, complying with the 45-percent threshold would *rule out certain approaches to strengthening Medicare's finances,* rather than allowing all approaches to be on the table. By and large, the only approaches that could be considered would be those favored by individuals on the right of the political spectrum. As explained below, the 45-percent trigger appears to be designed to rule out scaling back any part of the 2001 and 2003 tax cuts and using some or all of the proceeds to help address even a fraction of Medicare's financing needs as part of a larger Medicare reform package.

Marilyn Moon, a former Social Security and Medicare trustee who is widely regarded as one of the nation's leading Medicare experts, observed in 2004 that the 45-percent calculation "is a measure that actually makes very little sense the more you look into it" and is "a measure that not only is indicating a warning but it essentially limits the options that you have to finding a solution." Moon commented that establishing a trigger that would be pulled when Medicare expenditures reach a certain share of the U.S. economy would represent a much sounder policy.[3]

Moon also noted that Medicare's financing problems are sufficiently large that long-term solutions almost certainly will need to include changes in health care generally, reforms in the Medicare program, *and* additional general revenues. If revenues are not a part of the solution, Moon observed, Medicare cuts will have to be severe. "[The] solution is not going to be an easy one to come up with, and it probably cannot be done and keep a viable Medicare program without tax increases at some point in the future," she said. The 45-percent threshold is designed, however, largely to take general revenue increases off the table, thereby intensifying pressure for cuts in Medicare that ultimately would have to be very steep.

The Misleading Nature of the 45-Percent Threshold

The statutory requirement relating to the 45-percent trigger creates an impression that the 45-percent benchmark is an important measure of Medicare's overall financial health and that 2012 (or whatever new date is contained in the forthcoming trustees' report) is a critical date, after which Medicare's finances will be in substantial danger. That is not the case.

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[2] In directing the trustees to calculate the percentage of Medicare expenditures financed by general revenues, the Medicare drug law requires the percentage be determined in the following manner. The trustees calculate the percentage that total Medicare expenditures minus dedicated revenues (i.e., revenues *other than* general revenues) make up of total Medicare expenditures. Because "total Medicare expenditures minus dedicated revenues" is very similar, but not strictly identical, to "general revenues supporting Medicare," the 45-percent threshold is not strictly based on general revenues. We and others refer to the 45-percent threshold as applying to general revenues for ease of discussion.

Dedicated revenues are defined in the Medicare drug law as Medicare Part A payroll taxes, the portion of income taxes on Social Security benefits that is dedicated by law to the Medicare Part A trust fund, Medicare beneficiary premiums, and "clawback" payments from state Medicaid programs, which finance a portion of the cost of the Medicare drug benefit for low-income beneficiaries who are enrolled in Medicaid.

[3] Citations of statements by Marilyn Moon come from presentations and comments by Moon in two audio-conferences sponsored by the Center on Budget and Policy Priorities on March 23, 2004. Transcripts are available from the Center.

The 45-percent level is an artificial threshold with little substantive merit. By law, Medicare is supposed to be financed in substantial part by general revenues rather than payroll tax revenues.

- Under Medicare's financing structure, the Medicare Hospital Insurance program (Medicare Part A) covers hospital costs and is financed through payroll taxes. The remainder of Medicare — Part B, which covers physician and other outpatient services, and Part D, which provides the new drug benefit — is designed to be financed with premiums paid by beneficiaries and general revenues, rather than regressive payroll tax revenues. That these parts of Medicare are financed with general revenues is no more problematic than that defense, the war on terrorism, and most other parts of the budget are financed by general revenues. Moreover, nothing in Medicare law bars the general fund from paying Part B and Part D benefits if general-revenue financing reaches 45 percent of total Medicare costs. The federal government is required by law to use general revenues to the extent needed to pay Part B and Part D costs that are not covered by beneficiary premiums.

- The 45-percent threshold is certain to be reached in coming years for two reasons. First, Congress and the President specifically elected to fund the new drug benefit with general revenues (and beneficiary premiums), rather than payroll taxes. This decision increased the share of Medicare costs that is financed with general revenues.

- The second reason that the 45-percent threshold is certain to be reached — and that the share of Medicare costs financed by general revenues is projected to continue rising in future years — is that total Medicare expenditures are projected to rise more rapidly than dedicated revenues. The payroll tax — the main source of dedicated revenues — generally grows more slowly than the economy because an increasing portion of income is received in forms not subject to the payroll tax, such as untaxed fringe benefits, capital gains, and dividends. In contrast, Medicare expenditures — whether for hospitalization, outpatient care, or prescription drugs — are projected to grow faster than the economy for the indefinite future.[4] This will cause the share of Medicare costs that is financed by general revenues to rise toward 45 percent and ultimately past it, even if Medicare expenditures grow much more slowly than expected in coming years.

- Adding to these problems with the 45-percent measure, the calculation that the Medicare drug law requires the trustees to make in determining when the 45-percent level will be reached itself is seriously flawed. The trustees are required to treat the interest that the Medicare Part A trust fund earns on the Treasury securities it holds as though this interest income were a subsidy from the general fund. However, it is not, as the box on page 5 explains. This unjustifiable aspect of the 45-percent measure accelerates the date when the 45-percent threshold will be reached by as many as *eight years* and ultimately will necessitate deeper cuts in Medicare if the 45-percent threshold is complied with.

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[4] The growth of Medicare spending is driven both by the growth in the beneficiary population and by increases in the cost of health care per beneficiary. CBO's intermediate assumption is that Medicare spending *per beneficiary* will grow 1 percentage point faster than per capita GDP in coming decades. This is consistent with the Medicare trustees' assumptions, but is slower than the average growth of 2.9 percentage points faster than GDP that Medicare has experienced since 1970 or the 1.9 percentage points faster-than-GDP average observed since 1990. Congressional Budget Office, *The Long-Term Budget Outlook*, December 2005, page 31.

Law Requires Flawed Calculation of When 45-Percent Level is Reached

Adding to the problems that the 45-percent threshold provision poses, the calculation the Medicare drug law requires the trustees to make in determining when the 45 percent threshold will be reached is seriously flawed. In making this calculation, the law requires the trustees to treat the interest earnings that the Medicare Part A trust fund earns on its trust fund balances as though these earnings were a general fund subsidy. Yet these earnings clearly are not a subsidy from the general fund.

The Part A trust fund balances currently total nearly $300 billion, and the Office of Management and Budget projects that these reserves will grow to $395 billion by 2010. These balances are invested in Treasury securities and earn interest. The interest earnings are important; interest is the way in which $1 in payroll taxes that is collected today but intended for future benefits can hold its value until it is eventually needed.

These interest earnings essentially represent dedicated trust fund revenues, rather than a subsidy from the general fund. It is easy to see why. Suppose the Medicare Part A trust fund invested its balances in private financial markets rather than in Treasury securities. Those balances would still accrue earnings. Yet the general fund would not be involved; it would not be making interest payments to the Medicare Part A Trust Fund. The reason that the Medicare trust fund balances are invested in Treasury securities rather than in private financial markets is that this is what federal law requires. That does not make the interest earnings a subsidy from the rest of the government to the trust fund.

Moreover, the general fund would have to pay the same amount of interest even if *no* trust fund balances were invested in Treasury securities. If the general fund of the Treasury did not borrow from the Medicare Part A trust fund to help finance general fund deficits, it would have to borrow the same amount from the public instead and pay interest on it. Borrowing from the Medicare Part A trust fund and paying interest on the borrowed funds does not increase total general fund spending or total general fund interest payments.

Despite this, the provision of the Medicare drug law that established the 45-percent measure requires that the interest which the Part A trust fund earns on its balances be counted as part of the general fund financing that is subject to the 45-percent threshold. While Medicare faces serious fiscal challenges, this dubious treatment of the trust fund's interest income makes Medicare's financing problems appear worse than they are. This misleading accounting maneuver will cause the 45-percent threshold to be hit as much as eight years earlier than otherwise would be the case.

These are among the reasons the 45-percent general-revenue financing threshold contained in the Medicare drug law is unsound. As Marilyn Moon has stated, "general revenue contributions have been in this program since 1965 when it was first passed and are an intended and not a problematic part of the program." It makes no more sense to say that the reliance of Medicare Parts B and D on general revenues is inherently problematic than to say that the reliance of the Pentagon on general revenues is a problem.

To help illustrate the shortcomings with the 45-percent measure, let us suppose that overall Medicare costs grew at the same rate as overall revenues. In that event, the Medicare program would place no additional pressure on the budget as the years passed. There would be no special need to cut future Medicare benefits or increase future taxes. Yet if Medicare costs grew at the same rate as overall revenues, the program's costs would likely be growing more rapidly than payroll tax revenues and more slowly than general revenues. As a result, the 45-percent threshold would still be

breached eventually, since overall Medicare costs would be increasing at a faster pace than dedicated revenues.

If Congress' goal is to establish a measure to trigger review by policymakers when Medicare costs threaten to reach too high a level, a much sounder measure could readily be designed under which a review would be triggered whenever Medicare costs were projected to reach a certain share of the economy or of the federal budget. Such a measure, which would be far more rational, was suggested in 2003, but the designers of the Medicare drug law rejected it.

Staying Within the 45-Percent Level Would Limit Policymakers' Options

As Moon has pointed out, adhering to a goal of holding general-revenue financing below 45 percent of Medicare expenditures will limit policymakers' options. To remain below the 45-percent level will entail cutting Medicare services, raising the premiums and/or other co-payments that beneficiaries are charged, cutting provider payments, and/or shifting more of the burden of financing Medicare from progressive income taxes to regressive payroll taxes (and hence from affluent taxpayers to those with more modest incomes).

- As Medicare expenditures rise over time with the aging of the population and increases in the cost of health care in the United States, the amount of revenues needed to finance Medicare will increase. The 45-percent measure is designed, however, to limit sharply any increases in general revenues.

- The primary revenue-raising measure that could be used to help meet the 45-percent threshold would be to shift more of the financing for Medicare from general revenues — i.e., from the income tax — to increased payroll taxes. Such a change would be regressive. It would shift tax burdens from upper-income individuals to middle-class and working-poor families.

- The alternative to meeting the 45-percent threshold through the regressive step of increasing Medicare payroll taxes would be to increase beneficiary premiums and co-payments or to make ever-deeper cuts over time in Medicare eligibility, the medical services that the program covers, and/or payments to Medicare providers.[5] To stay within the 45-percent threshold, such cuts or beneficiary payment increases eventually would have to reach stunning proportions.

In short, the 45-percent threshold threatens to skew the Medicare debate by ensuring that progressive income taxes are not among the mix of options under consideration to help pay for rising Medicare costs, and consequently by placing the burden of the future growth in Medicare costs on increases in premiums, deductibles, and co-payments or increases in payroll taxes. The only

[5] Meeting the 45-percent threshold also could lead to shifting more financial responsibility for Medicare from the federal government to the states, due to increased "clawback payments" from state Medicaid programs. Under the 2003 Medicare legislation, states are required to finance part of the cost of the Medicare Part D coverage for "dual eligibles" (low-income Medicare beneficiaries who also are eligible for Medicaid) who previously received their drug coverage through the Medicaid program. These payments are scheduled to be reduced from 90 percent of the prescription drug costs that states otherwise would have incurred for the dual eligibles in 2006, to 75 percent of such costs in 2015 and succeeding years. Because the clawback payments count as *dedicated* revenues under the 45-percent calculation, increasing these clawback payments would help meet the 45-percent threshold. For example, the percentage could be frozen at 90 percent in perpetuity or even increased to 95 percent or 100 percent.

revenue-raising options that would be permissible generally are those that have a common element: they largely shield the most affluent Americans while placing more of the burden on people on the low and middle rungs of the income ladder.

The 45-percent provision is essentially an ideological cousin to fiscal policy proposals to erect Pay-As-You-Go rules that apply to expenditures for federal entitlement programs but *exempt* tax cuts from fiscal discipline. Like those budget proposals, the 45-percent provision appears designed in part to protect the tax cuts enacted in 2001 and 2003, which provide very generous tax-cut benefits to the nation's most affluent individuals, from being scaled back even modestly as one element of a larger package to address Medicare's looming deficits as the population ages and medical practice continues to advance.

Conclusion

Policymakers need to begin addressing Medicare's long-term financing problems. The trustees project that the Medicare Hospital Insurance program will become insolvent in 2018, and Medicare expenditures are projected to increase rapidly in coming decades as health care costs continue climbing and the baby-boom generation retires. The artificial 45-percent ceiling for general-fund financing of Medicare does not address these problems in a straightforward or ideologically neutral manner. To the contrary, it is an arbitrary measure that defines the problem in simplistic and ideological terms.

The 45-percent measure also poses the risk of leading policymakers and the public to the misguided belief that Medicare will face a significant financing crisis at the point the 45-percent level is reached, and that holding general-fund financing below 45 percent of Medicare costs is necessary to restore the program's long-term financial health and maintain stability in the budget as a whole. Those beliefs clearly are mistaken. If policymakers cannot even correctly identify and measure Medicare's budgetary problems, the prognosis for their ability to tackle these problems effectively may be bleaker than commonly thought.