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MEDICARE "COST CONTAINMENT" PROPOSAL INCLUDES IDEOLOGICALLY LOADED PROVISIONS

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Conferees on the Medicare prescription drug bill are now considering a proposal they term "Medicare cost containment." Although some policymakers and observers appear to have assumed this proposal would trigger measures to contain Medicare drug costs if the new drug benefit turns out to cost more than the Congressional Budget Office has projected, that is not the case; the "cost containment" mechanism under discussion has nothing to do with whether Medicare drug costs (or, for that matter, *total* Medicare costs) exceed projections. Instead, the proposal is designed to limit general-revenue financing of the Medicare program as a whole.

Specifically, the "cost-containment" proposal would establish a policy presumption that general revenues should not finance more than 45 percent of overall Medicare costs. The proposal would require that the second time the Medicare trustees project the general-fund share of Medicare expenditures will exceed 45 percent in any of the next seven years, two events would be triggered automatically:

- the President would be required to submit a legislative proposal, presumably to alter Medicare sufficiently to bring the projected percentage below 45 percent, and

- a new Senate Rule would automatically come into force, barring consideration of any improvements in Medicare benefits or Medicare payments to health care providers unless the extra costs are fully offset, with the only allowable offsets apparently being cuts in Medicare.

Based on current projections of Medicare costs, these events would be triggered starting in about 2010 or 2011 (that is, seven years before the 45 percent level is projected to be reached). They would be triggered every year thereafter unless increasingly radical changes were made in Medicare.

As explained below, the concept of erecting a percentage limit on general fund financing for Medicare is inconsistent with Medicare's basic financing structure. Medicare Part B, which covers physician and outpatient services, and Part D — the new drug benefit — are *supposed to be* financed with general revenues. Only Medicare Part A, which covers hospital costs, is financed with payroll taxes. For this and other reasons, the proposed "cost-containment" proposal is fraught with problems.

This is not to say that a properly designed trigger to force Congressional consideration of the Medicare program and rising Medicare costs would be inappropriate. Recent long-term budget forecasts from GAO, the Brookings Institution, Goldman Sachs, and the Center on Budget and Policy Priorities in partnership with the Concord Coalition and the Committee for

Economic Development all project long-term budget deficits of rather massive proportions. Projected increases in Medicare costs are among the factors that underlie these projections (along with a shrinking revenue base due to tax cuts and expected increases in Social Security costs as the population ages). A cost-containment mechanism that would be triggered when Medicare costs exceed a certain percentage of the economy (or of the federal budget) — and that is neutral with respect to the type of deficit-reducing measures that could be instituted to address such developments — could be a useful part of a larger effort to address the nation's looming long-term fiscal difficulties. Such an effort also could reinstitute the Pay-As-You-Go rule that worked effectively through most of the 1990s, and under which the costs of any entitlement increases — including increases in Medicare — as well as any tax cuts had to be fully offset.

The "cost containment mechanism" now under discussion in the Medicare conference, however, is very different. It would apply whether or not deficits were out of control, and whether Medicare was growing faster or slower than expected. It would set a dubious standard — that general revenues should not finance more than 45 percent of Medicare costs — that favors regressive payroll tax increases and increases in Medicare premiums over progressive revenue-raising measures instituted through the income tax. The proposed mechanism also would limit future Medicare improvements that would increase costs *without* applying similar discipline to future tax cuts (or to increases in other entitlements). It would require the Medicare trustees to produce an analysis of Medicare's financial status each year that would necessarily be inaccurate and misleading. It also would calculate the degree to which Medicare is financed by general-fund subsidies in a manner that is not valid. In each of the areas in which the proposed "cost containment" mechanism is problematic, the proposal reflects a decidedly ideological tilt.

Misguided in Concept

The proposed mechanism would treat general-fund financing beyond the 45-percent level as inappropriate and something that must be avoided. Yet establishing a limit on the percentage of Medicare expenditures that can be financed with general revenues (rather than, for example, creating a trigger that is tied to the percentage that Medicare constitutes of the economy or the federal budget) would contradict the basic principles of Medicare's financing structure. By law, all parts of Medicare except hospital costs are financed by general revenues (and premiums), not by payroll taxes. General revenues are supposed to constitute a substantial share of Medicare financing.

Moreover, as a result of advances in medical practice that are shortening and deemphasizing hospital stays and relying more on outpatient services and drug therapies instead, Medicare costs for physician and outpatient services and prescription drugs — the parts of Medicare that are (or would be) financed by general revenues — are rising faster than Medicare hospitalization costs. This continuing shift in medical practice helps to moderate the growth in Medicare costs and is a positive development. It also causes the proportion of Medicare expenditures that is financed by general revenues to rise. General-revenue financing is projected to reach the 45-percent level sometime in the 2015-2020 period and to rise above that level in subsequent years. The general-revenue percentage of Medicare is likely to rise in all years even if Medicare spending grows more slowly than projected.

For these reasons, erecting an artificial ceiling on general-revenue financing at 45-percent of overall Medicare costs is a misguided way to structure a cost-containment mechanism. Furthermore, such a ceiling would have far-reaching effects. If adhered to, it would ease the burdens of rising Medicare costs on the individual and corporate income tax and those who pay it, since those taxes are deposited in the general fund. Such a ceiling would instead shift more of the burden of paying for Medicare to working-poor and middle-income families that pay the bulk of the payroll taxes and to Medicare beneficiaries, who would stand to have their premiums and co-payments raised. The provision also could affect Medicare providers, who could see their reimbursements reduced substantially in order to help hold general-revenue financing to 45-percent of total Medicare costs.

The design of the trigger consequently appears to reflect an ideological agenda. If one wanted to create a trigger to force action on rising Medicare costs, there are far less ideologically loaded ways to do it.

Moreover, the problems do not end with the concept of establishing a percentage limit on general-fund financing for Medicare. Even if that concept is accepted, a number of other elements of the proposal raise very serious concerns.

- The proposal would treat general-fund financing beyond the 45-percent level as being synonymous with insolvency for all components of Medicare, including Medicare Parts B and D. It would require the production of "official" projections each year that assume that federal law restricts general fund contributions to 45 percent of overall Medicare costs even though that is not the case.

  This treatment of Medicare's finances has no basis in fact. *It makes no more sense to say that reliance on general revenue financing makes Medicare Part B or the new drug benefit insolvent than to say that defense, education, veterans benefits, or military retirement face long-term insolvency because they rely on general revenue financing*.

- Although these insolvency projections would be inaccurate and misleading, they would be given an official imprimatur. They likely would be trumpeted continually by those who favor radical changes in Medicare (and, ultimately, large reductions in Medicare benefits) to scare the public and Medicare beneficiaries into believing the entire program will collapse unless it is sharply altered.

- The new Senate Rule that the proposal would create — under which legislation that increases Medicare costs would be barred — would resurrect in a distorted way the concept underlying the Pay-As-You-Go rule that was in effect through most of the 1990s. But under the version of the "cost containment" proposal that key conferees — including Senate Budget Committee Chairman Don Nickles and reportedly the Administration — are pushing, the resurrected Pay-As-You-Go rule would apply to *Medicare only*. Unlimited tax cuts that have no offsets, as well as expansions of other entitlements, would continue to be allowed.

Reinstating the Pay-As-You-Go rule *budget-wide* makes sense. But singling out Medicare while continuing to allow unlimited tax cuts that are not offset would be inequitable. So would erecting a prohibition that bars the use of any offsets to finance Medicare improvements except for cuts in Medicare itself, another feature of the version of the cost containment proposal that Senator Nickles is advancing.

- The proposal would treat the interest that the Medicare Part A trust fund earns on the Treasury securities it holds as though the interest income were a subsidy from the general fund; the proposal would count the interest income as part of the "general fund financing" that would be capped at 45 percent, rather than as part of the trust fund's dedicated funding. As explained below, this treatment is inconsistent with Medicare's financing structure and is very difficult to justify. This dubious aspect of the proposal would accelerate the date when the 45-percent level is reached by between five and seven years and ultimately would require more radical changes (i.e., deeper cuts) in Medicare to stay within the 45-percent limit.

These issues are examined in more detail starting on page 5.

Proposal Likely to Lead to Radical Changes in Medicare Over Time

Holding general revenue financing to no more than 45 percent of overall Medicare costs (as general-revenue financing would be defined under the proposal) would entail instituting changes in Medicare that would have to become increasingly severe over time. Maintaining the 45-percent level over time would require such measures as:

- Establishing the 45-percent threshold as a legal cap, with across-the-board reductions automatically instituted in provider reimbursement rates and payments for prescription drugs to the degree such reductions are needed to remain under the cap, or with increases automatically instituted in premiums, deductibles, or co-payments. Such reductions in provider payments would eventually risk access to Medicare if providers stopped accepting Medicare patients. Such increases in cost-sharing, which eventually could become very large in order to adhere to the 45-percent limit, could risk access for those who could not afford the payments.

- Converting some or all of Medicare into a voucher system under which Medicare would pay a fixed dollar amount per person to subsidize the purchase of private-sector health insurance that covered those benefits. To avoid exceeding the 45-percent level, the value of the vouchers would have to be capped at a growth rate slower than the growth rate of medical care costs, causing beneficiaries to shoulder an increasing share of these costs over time;

- Gradually increasing the age at which persons would become eligible for benefits under some or all of Medicare, which would result in substantial numbers of people in their mid-to-late 60s becoming uninsured; or

- Gradually and indefinitely raising payroll taxes.

One factor adding to the severity of the cuts that would be needed ultimately to maintain the 45-percent level is that, at the insistence of the pharmaceutical industry, both the House and Senate bills *bar* the federal government from using Medicare's vast purchasing power to negotiate lower prices for drugs than the private health care plans that would administer the drug benefit could secure themselves. There is little question that the federal government could negotiate better prices. Because the legislation would prohibit more effective cost containment in the new drug benefit, the proposed "cost containment" trigger mechanism would likely lead to deeper reductions in Medicare benefits over time.

Problems in the Design of the Mechanism

The remainder of this analysis examines four key issues in the design of the proposal — apart from the general-revenue financing limit — that warrant attention and raise major concerns.

1. Reaching the Arbitrary 45 Percent Target Does *Not* Make Medicare Insolvent

Under the proposal, when the Medicare trustees prepare the annual trigger report, they would include an "official" presentation of Medicare finances that lumps all parts of Medicare together with Medicare Part A and assumes that general-fund financing can not exceed the arbitrary 45-percent limit.

Such a presentation would have no basis in fact. Under current law — and even under this proposal — the general fund is *not* prohibited from paying Part B and Part D benefits when general-fund financing exceeds 45 percent. Yet the Trustees would be required to pretend such a prohibition existed for purposes of determining when *all* of Medicare would become "insolvent" and for calculating the program's "unfunded liability."

Such a presentation would make Medicare's "unfunded liability" look perhaps *three or four times* as large as it actually is. The actuaries might speak of *tens of trillions of dollars* of unfunded liabilities in Medicare. This type of bogus accounting would likely lead to years of scare messages that all of Medicare will collapse unless radical changes are made in it.

There is no need for such artificial accounting, which is unrelated to the proposed trigger. Even if one agreed to a trigger that would be pulled when general-fund financing is projected to reach 45 percent of total program costs, a projection that the 45-percent threshold will be hit would *not* mean that Medicare would be insolvent and unable to pay full benefits; it would only mean that the arbitrary benchmark would be reached. The proposed requirement that the Medicare trustees issue insolvency and unfunded liability projections based on the arbitrary 45-percent limit seems to be ideologically motivated.

If the proposed trigger is included in the conference agreement, the requirement that the Trustees issue a calculation of Medicare's financial status each year based on these inappropriate assumptions should be dropped.

2. The Pay-As-You-Go Rule Should Not be Imposed Solely on Medicare Benefits

In addition to triggering a presidential recommendation for legislation to alter Medicare, a Trustees' projection that general-fund financing will reach 45 percent of total program costs also would trigger the automatic reinstitution of a version of the Pay-As-You-Go rule. At this stage of the negotiations, two competing proposals regarding how this rule would work are under consideration. Under the more sensible approach (which is advocated by Senator Max Baucus), the Pay-As-You-Go rule would be triggered budget-wide, so that no new tax cuts, legislation increasing Medicare costs, or legislation increasing the cost of any other entitlement could be enacted unless it were fully offset. The Senate could waive this Rule only by a three-fifths vote.

But under the alternative approach being pushed by the Senate Budget Committee chairman Don Nickles and apparently the Administration, the Pay-As-You-Go rule would be reinstated *for Medicare benefits only*. Unlimited additional tax cuts would continue to be allowed without being subject to the Pay-As-You-Go rule. As a consequence, the nation's long-term fiscal problems — which stem from the imbalance between revenues and expenditures — could continue to worsen.

If a Pay-As-You-Go rule is to be reinstated, it should be done across-the-board. It is inequitable to reinstate Pay-As-You-Go for Medicare benefits only, while allowing additional, unlimited tax cuts for the well-off or additional increases in other entitlement programs.

The rising cost of Medicare should not be thought of as a problem in isolation from the rest of the budget. Increases in Medicare expenditures would not present a budgetary problem if other costs were naturally declining or revenue growth were especially robust. Growing Medicare costs are a problem because the overall budget is projected to run unsustainably large deficits for the foreseeable future, especially after the baby boomers retire — a problem that will be caused by the combination of large and growing tax cuts, rapid growth in health care costs, and the retirement of the baby boom generation. If a Pay-As-You-Go provision is to be reinstituted, it consequently should apply to all entitlement and tax legislation as it did in the 1990s, not solely to Medicare.

Moreover, the Pay-As-You-Go rule that worked successfully through most of the last decade allowed increases in entitlement programs to be enacted if they were fully paid for by offsetting reductions in any other entitlement program or by revenue increases. Under the new proposal, by contrast, legislation improving Medicare coverage or benefits would not be allowed even if it were fully offset by other entitlement reductions or revenue increases. Medicare improvements would be barred, even if made in response to medical research or the development of new medical procedures or treatments that improve health or save lives, unless financed by cuts elsewhere in Medicare.

3. Trust Fund Interest Earnings Should Not Be Considered a "General Revenue Subsidy"

The proposal would treat the interest earnings on the balances in the Part A trust fund as a general fund subsidy that is part of the general-fund financing that would be subject to the 45-percent threshold. Yet these earnings are *not* a subsidy from the general fund.

The Part A trust fund balances currently total about $250 billion, and CBO projects them to grow to almost $550 billion by 2013. These balances are invested in Treasury securities and earn interest. The interest earnings are essential; 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 represent "dedicated revenues," rather than a subsidy from the general fund. It is easy to see why this is so. 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. The balances are invested in Treasury securities rather than in private financial markets because that is what federal law requires. That does not make the interest earnings a subsidy given to the trust fund from the rest of the government.

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 Part A trust fund to help finance general fund deficits and debt, it would have to borrow the same amount from the public instead and would have to pay interest on it. Borrowing from the Part A trust fund (and paying interest on the borrowed funds) does *not* increase total general fund spending.

Despite this, under the proposed trigger, the interest that the Part A trust fund earns on its balances would be counted as part of the general fund financing that would be subject to the 45-percent threshold. Medicare surely faces serious fiscal challenges in future decades. But this dubious accounting of the trust fund's interest income would make Medicare's financing hole look more dire than it truly is. Furthermore, this accounting maneuver would cause the 45-percent threshold to be hit between five and seven years earlier than it otherwise would be reached, and ultimately would necessitate more drastic changes in Medicare to hold general-fund financing to 45 percent of total Medicare costs.

If the trigger proposal is pursued, this indefensible treatment of the trust fund's interest earnings as though they were a troublesome and unaffordable subsidy from the general fund should be dropped.

4. Rules for Considering Legislative Proposals Developed in Response to the 45-Percent Trigger

A final key issue involves the procedures governing Senate floor consideration of the Medicare legislation that the President would submit, or the Finance Committee would report, in response to a projection that the 45-percent level would be reached. After the Medicare trustees issued a projection for the second time that the 45-percent level would be reached within the next seven years, the President would have to include a recommendation in his budget and submit legislative language within 15 days after that. The committees of jurisdiction, such as the Senate Finance Committee, would have to report the President's legislation or some variation of it by June 30. There is disagreement among conferees regarding the rules that then should govern the consideration of this legislation on the Senate floor.

As noted above, there appears to be no way to prevent general-fund financing from exceeding 45 percent of total Medicare costs on a long-term basis other than through radical changes in Medicare that would be highly controversial and represent unprecedented changes in the program. It is important that such proposals be considered carefully and fully debated. Such changes would be large and affect millions of Americans. They would best be made on a bipartisan basis.

During negotiations on the cost containment mechanism, some Republican negotiators have proposed that such legislation be exempt from full Senate debate, with the time for debate circumscribed and the potential for a filibuster eliminated. This would be a mistake. One positive aspect of the threat of a filibuster is that it provides strong incentives for policymakers to reach bipartisan compromise on controversial legislation. By contrast, legislation that is exempt from filibuster can be pushed through the Senate on a narrow party-line basis. That would not be a healthy way to make sweeping changes in a program as consequential as Medicare and would likely lead to bitterness, recriminations, and years of effort to reverse the changes. A filibuster-proof procedure might be appropriate in the face of an immediate crisis. But the 45-percent threshold related to general-revenue financing that the "cost containment" proposal would establish is arbitrary, and no immediate insolvency crisis actually would threaten.

A provision to limit debate on legislation produced in response to a report that the 45-percent threshold would be reached does not appear in the current draft of the cost containment proposal being discussed by Senate conferees. Senator Nickles reportedly called for such a provision last week, however, and according to some reports, House conferees and the Administration are advocating such a provision.