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ELEMENT OF MEDICARE TRUSTEES' REPORT COULD SPELL TROUBLE FOR BENEFICIARIES IN FUTURE YEARS

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The report that the Social Security and Medicare trustees issued March 23 on the state of Medicare's finances contains a "finding" that may draw considerable attention. The Medicare drug law enacted in 2003 requires the trustees to estimate in each of their annual reports the point at which general revenues will finance at least 45 percent of Medicare costs. Once the trustees estimate in two successive reports that this 45-percent level will be reached within the next six years, the President is required to include a proposal in his next budget — and to submit legislation within 15 days of the budget's release — to alter Medicare so the 45-percent threshold will not be exceeded. The Congressional committees with jurisdiction over Medicare must then report the President's proposal or other Medicare legislation by June 30.

This year's trustees' report, like last year's, projected that the 45-percent level will be reached in 2012.[1] If this projection remains unchanged in subsequent trustees' reports, the trigger date (i.e., the date on which two consecutive reports project that the 45-percent level will be reached within the coming six years[2]) will come two years from now when the trustees issue their 2007 report.

Ensuring that policymakers begin to address Medicare's long-term financing problems soon is important. Last year, the trustees projected that the Medicare Hospital Insurance program will become insolvent in 2019, and 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 address the larger budgetary issues raised by the rising costs of health care — and hence of public health insurance programs such as Medicare — could be useful.

The 45-percent trigger established by the Medicare drug law, however, is *not* designed to address these challenges. To the contrary, the 45-percent threshold is an arbitrary benchmark laden with ideological overtones and inconsistent with Medicare's basic financing structure. That the 45-percent level will be reached soon is of little significance. Indeed, the 45-percent threshold will be reached even if Medicare costs rise much more *slowly* than is now projected.

Moreover, complying with the 45-percent threshold would *rule out* certain approaches to strengthening Medicare's finances, rather than allow all approaches to be on the table. By and

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1 See "2005 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," March 23, 2005, pages 31 and 32.

2 Technically, the trigger date is the date on which two consecutive trustees' reports project that the 45-percent level will be reached within a seven-year period that includes the current year and the six subsequent years.

large, the only approaches that could be considered would be those favored by individuals on the right of the political spectrum. As this analysis explains, the 45-percent trigger seems designed more to rule out scaling back any part of the 2001 and 2003 tax cuts and using the proceeds to help address even a fraction of Medicare's financing needs than to address Medicare's solvency problems forthrightly.

Marilyn Moon, a former Social Security and Medicare trustee who is widely regarded as one of the nation's leading Medicare experts observed last year 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 Medicare, *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, however, is designed largely to take general revenue increases off the table, thereby intensifying pressure for cuts in Medicare that ultimately would have to be very deep.

Background: The 45-Percent Provision and the Problems It Poses

As a result of a provision added behind closed doors in the conference on the Medicare drug legislation, the Medicare trustees now are required to include in their annual reports a projection of the year in which general revenues will start to finance at least 45 percent of overall Medicare expenditures.[4] Once two consecutive annual trustees' reports show this 45-percent level will be reached within the next six years, the trustees are required to issue a warning that triggers Presidential and Congressional action. This year's trustees' report projects that general revenues will cover more than 45 percent of total Medicare expenditures starting in 2012.

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[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.

[4] In directing the trustees to calculate the percentage of Medicare expenditures financed by general revenues, the Medicare drug law requires the percentage in the following manner. The trustees calculate the percentage that total Medicare expenditures minus dedicated revenues (i.e., minus 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 will finance a portion of the cost of the Medicare drug benefit for low-income beneficiaries who are enrolled in Medicaid.

Under New Senate Budget, 45-percent Threshold Would be Reached Five Years Sooner

During debate on the congressional budget plan for 2006, the Senate approved an amendment calling for the repeal of a provision of law that treats a portion of Social Security benefits as taxable income, and dedicates the income taxes raised by that treatment to the Medicare Hospital Insurance (Part A) trust fund. New data from the Medicare actuaries show that, if Congress enacts such a change in tax law on a permanent basis, the Medicare HI trust fund will become insolvent in 2016 rather than 2020. In addition, the 75-year shortfall in that trust fund will increase by one-eighth, or $1.1 trillion in present value.*

Moreover, since these income-tax receipts are considered dedicated rather than general revenue financing for Medicare, eliminating these tax receipts would mean that the share of Medicare costs covered by general revenues (rather than by dedicated receipts) would necessarily rise and the 45 percent threshold would be hit sooner. Based on estimates in this year's Medicare trustees' report, we calculate that the date would be accelerated *five years*, from 2012 to 2007.

* See Center on Budget and Policy Priorities, "With Bunning Amendment, Senate Budget Would Move Up Medicare Insolvency By Four Years And Increase Deficits By More Than $200 Billion," March 25, 2005.

The statutory requirement relating to the 45-percent trigger may create an impression that this 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. Yet that is not the case.

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 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, education, veterans' benefits, Medicaid, the war on terrorism, or most other parts of the budget are financed by general revenues.

  In addition, nothing in Medicare law bars the general fund from paying Part B and Part D benefits if general-fund financing reaches 45 percent of total Medicare costs. The federal government is required by law to use general revenues to the full 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

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

Adding to the problems that the 45-percent threshold provision poses, the calculation that the Medicare drug law requires the trustees to make in determining when the 45 percent threshold will be reached is 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 savings were a general fund subsidy. Yet these earnings are *not* a subsidy from the general fund.

The Part A trust fund balances currently total about $275 billion, and the Office of Management and Budget projects that these reserves will grow to $365 billion by 2010. 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 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 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 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 the Part A trust fund earns on its balances be counted as part of the general fund financing subject to the 45-percent threshold. Medicare faces serious fiscal challenges in future decades. But this dubious accounting of the trust fund's interest income will make Medicare's financing problems look worse than they are. This misleading accounting maneuver will cause the 45-percent threshold to be hit as much as eight years earlier than it otherwise would be reached. This maneuver also will necessitate more drastic changes in Medicare if the 45-percent threshold is adhered to.

decision increased the share of Medicare costs that are 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. 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 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 is itself 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. It is not, as the box on page 4 explains. This unjustifiable aspect of the 45-percent measure accelerates the date when the 45-percent threshold will be reached by as much as eight years and ultimately will necessitate deeper cuts in Medicare if the 45-percent threshold is complied with.

These are among the reasons that the 45-percent general-revenue financing threshold built into the Medicare drug law is not rational. 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, education, or veterans benefits on general revenues is a problem. Moon also has noted that "the 45 percent measure … is a very convoluted measure and has a lot of problems that will give you also a lot of false positives in terms of indicating a crisis."

To help illustrate the shortcomings with the 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 be breached since overall Medicare costs would be increasing at a faster pace than dedicated revenues.

As another example, suppose Congress enacted increases in premiums for the Medicare physician and prescription drug programs (Medicare Parts B and D) in response to the 45-percent threshold. That would increase the amount of dedicated financing for Medicare and could bring the program into compliance with the 45-percent threshold. But for every additional dollar of premiums Medicare received, the program would receive one *fewer* dollar of general revenues. (This is how the financing of Medicare Parts B and D is structured.) Total Medicare financing would be unchanged, and the Medicare Hospital Insurance trust fund would gain no additional years of solvency. In other words, nothing would have been accomplished for Medicare. The sole effects of substituting dedicated revenues for general revenues would be that more revenue would be raised through regressive measures, and potential pressure to scale back the 2001 and 2003 cuts in the progressive income tax would be lessened.

If Congress' goal was to establish a measure to trigger review by policymakers when Medicare costs threatened to reach too high a level, a measure could have been designed to trigger such a review when Medicare costs were projected to reach a certain share of the economy or of the federal budget. Such measures, which would have been far more rational, were suggested in 2003. But the designers of the Medicare drug law rejected them.

Staying Within 45-Percent Level Would Limit Options Available to Policymakers

As Moon has pointed out, adhering to a goal of holding general-revenue financing below 45 percent of Medicare expenditures will limit the options available to policymakers. To remain below the 45-percent level will entail cutting Medicare services, raising beneficiary premiums and/or other co-payments, 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 to limit sharply any increases in *general* revenues. If general revenues cannot exceed 45 percent of total Medicare costs, Medicare will face artificially induced financing crises that become deeper with each passing year. Moreover, the only way that the 45-percent threshold could be met — other than through the regressive step of increasing Medicare payroll taxes and shifting a steadily increasing share of the burden of financing Medicare physician or drug costs from the income tax to higher payroll taxes — would be through ever-deeper cuts over time in Medicare eligibility, the medical services that the program covers, or payments to Medicare providers, or through continuing increases in beneficiary premiums and co-payments. To stay within the 45-percent threshold, such cuts or beneficiary payment increases would eventually have to reach stunning proportions.

- As just noted, the primary revenue-raising measure that could be used to help meet the 45-percent threshold would be to increase payroll taxes and convert part of the financing for either Medicare physician services or the new Medicare drug benefit from general revenues — i.e., from the income tax — to increased payroll taxes. Such a change would be regressive, shifting tax burdens from upper-income individuals to middle-class families and the working poor.

In short, the 45-percent threshold appears designed to skew the Medicare debate by ensuring that progressive income taxes are not used to help pay for rising Medicare costs and, in so doing, by making the burden of future increases in Medicare costs (other than increases averted through program cuts) fall on increases in premiums, deductibles, and co-payments or increases in payroll taxes. The revenue-raising options that would be allowed all have one common element: they shield affluent Americans and pass more of the cost to those lower on the income spectrum.

The 45-percent provision should be viewed as an ideological cousin to fiscal policy proposals to erect pay-as-you-go rules that apply to expenditures for federal 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 extremely generous tax-cut benefits to the nation's highest-income individuals, from being scaled back even modestly to help contribute to the financing of anticipated increases in Medicare costs as the population ages.

Conclusion

It is important for policymakers to begin addressing Medicare's long-term financing problems. The Trustees project that the Medicare Hospital Insurance program will become insolvent in 2020, and Medicare expenditures are projected to rise rapidly in coming decades as health care costs continue to increase and the baby-boom generation retires.

But the 45-percent threshold for general-fund financing of Medicare does not address these problems in a straightforward or ideologically neutral manner. 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 a mistaken belief that Medicare will face a significant financing crisis at the point when the 45-percent level is reached and that holding general-fund financing below the 45-percent of Medicare costs is necessary to restore Medicare's long-term financial health or to maintain overall fiscal stability.