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 March 15, 2006

PRESIDENT AND SENATE BUDGET COMMITTEE EMBRACE MISGUIDED "45-PERCENT TRIGGER"

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

Both the President and the Senate Budget Committee have embraced the notion that increases in the share of Medicare expenditures that are funded by general revenues are problematic and should be limited. The President's fiscal year 2007 budget calls for Medicare to be subject to automatic cuts in any year in which more than 45-percent of Medicare expenditures are financed by general revenues. This would alter a current provision of law, enacted as part of the 2003 Medicare prescription drug bill, that requires the President to propose legislation to reduce the portion of Medicare funding coming from general revenues to no more than 45 percent if projections indicate the portion will rise above that within the next six years. In addition, the budget plan that the Senate Budget Committee approved March 9 would establish a new Senate prohibition against legislation that would increase expenditures for *any* entitlement program (not just Medicare) if the general-revenue share of Medicare funding is projected to exceed 45 percent.

The President's proposal would make an already misguided law more ill-advised. It would lead to cuts in Medicare virtually every year and, as explained below, would likely make it *harder* rather than easier for future Presidents and Congresses to agree on a comprehensive and equitable plan to address Medicare's long-term financing problems.

The Senate Budget Committee plan similarly endorses the misguided idea that an increase in the percentage of Medicare funding that comes from general revenues — rather than dedicated revenues — itself represents a problem and that reducing this percentage would represent an important improvement in the outlook for Medicare and the federal budget. The Senate Budget Committee provision also suffers from another flaw: it is one-sided. It imposes stricter fiscal discipline on legislation to strengthen any entitlement program — including programs that serve the neediest Americans, veterans, or people with severe disabilities — but imposes *no* discipline on the passage of new deficit-increasing tax cuts, including tax cuts for the nation's wealthiest individuals and largest corporations.

Why the 45-Percent Trigger is Misguided

Medicare faces serious long-term financial problems. Last year, the Social Security and Medicare trustees projected that the Medicare Hospital Insurance (Medicare Part A) 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 to address the larger budgetary issues raised by the rising costs of health care — and hence of 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. By law, 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 payroll taxes. That a particular share of Medicare costs are financed by progressive income taxes rather than by regressive payroll taxes is not itself a problem, just as it is not inherently problematic that defense, education, or space exploration are financed by general revenues. That the 45-percent level will be reached soon (the trustees last year projected that it will be reached in 2012) also is of little significance. The 45-percent threshold will be reached in a relatively few years even if Medicare costs rise *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 allow 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 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 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, 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 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.[1]

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. As noted, however, the 45-percent threshold 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.

The President's proposal, which would institute automatic reductions in payments to Medicare providers if the 45-percent threshold is exceeded, would strengthen the position of those policymakers and ideological forces who oppose considering an increase in general-revenue funding

[1] 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.

as a part of any future Medicare reform plan. By blocking action on a more comprehensive and equitable approach to Medicare reform, these policymakers would be able to ensure that significant cuts in Medicare would be implemented without general revenues being among the mix of options being used.

In the first year that it would be applied, the automatic cut would equal a four-tenths of one percent reduction in payments to Medicare providers. Additional automatic cuts of four-tenths of one percent would be instituted in each succeeding year as long as the share of Medicare costs financed with general revenues continued to exceed 45 percent, as it necessarily would under Medicare's financing structure. Since an additional cut of four-tenths of one percent every year would not suffice to reduce the share of general-revenue funding below 45 percent, the cuts would continue indefinitely and grow steadily deeper over time. Robert D. Reischauer, President of the Urban Institute and vice chair of the Medicare Payments Advisory Commission (Congress' official advisory body on Medicare payments), and a former Director of the Congressional Budget Office, has described the President's proposal as a "perpetual cutting machine."[2]

The Senate Budget Committee proposal would not institute automatic cuts in Medicare but is troubling nevertheless, as it lends support to the notion that increases in the general-revenue share of Medicare financing (rather than the dedicated-revenue share) are inherently bad and should be avoided — and that it is more important to keep the general-revenue share of Medicare funding below 45 percent than to focus on the share of the budget or the U.S. economy that Medicare costs constitute. This misguided approach could deflect attention from Medicare's real problems. It also could make it harder to reach agreement on appropriate ways to deal with those problems, since it would effectively rule out balanced Medicare packages that include some increased general-revenue funding alongside changes in Medicare and the overall U.S. health care system.

Background: The-45-Percent Threshold and the New Proposals

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 each of their annual reports on the program's finances an estimate of the year in which general revenues will finance at least 45 percent of overall Medicare expenditures. By law, Medicare Hospital Insurance is financed primarily by payroll taxes, while Medicare physician's coverage and the new Medicare drug benefit are financed primarily by a combination of general revenues and beneficiary premiums.[3]

Once the trustees estimate in two successive reports that the 45-percent level will be reached by the sixth year after the year in which the report is issued, the President is required to include a proposal in his next budget — and to submit legislation within 15 days of the budget's release — that is supposed to alter Medicare so the 45-percent threshold will not be exceeded.[4] Congressional

---

[2] Urban Institute 17th Annual Roundtable on the President's Budget and the Economy, February 8, 2006, http://www.urban.org/url.cfm?ID=900931.

[3] Beneficiary copayments cover part of the costs of services provided by all three parts of Medicare.

[4] 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

committees with jurisdiction over Medicare must then report the President's proposal or other Medicare legislation by June 30.

The proposal included in the President's budget for fiscal year 2007 would alter the current provision of law by "requiring an automatic reduction" in Medicare if the 45 percent threshold is exceeded. The reduction would begin as a four-tenths of one percent reduction in all payments to providers in the year the threshold is exceeded, and would grow by four-tenths of a percent every year thereafter that the 45-percent threshold continued to be exceeded.[5] The Administration has not provided further details about the proposal.[6]

The 2005 trustees' report, like the previous year's report, projected that the 45-percent level will be reached in 2012. 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) will come a year from now (in March 2007) when the trustees issue their 2007 report. The President would then be required to include in his budget for fiscal year 2009 (which will be submitted in February 2008) a proposal to reduce the general-revenue share of Medicare funding below 45 percent. Under the new proposal that the President's budget includes, if such legislation is not enacted and the share exceeds 45 percent in 2012, automatic reductions in Medicare payments will be triggered at that time.

As explained below, the share of Medicare expenditures covered by general revenues almost certainly will exceed 45 percent within a few years, and the automatic cuts proposed by the President would not keep the general-revenue financing share below 45 percent. As a result, additional automatic cuts in Medicare payments would be made every year. In 25 years, Medicare payments would be nearly 10 percent lower than they would be under current law. Arbitrarily reducing all payments to Medicare providers by 10 percent likely would mean that the level and quality of care

---

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.

Some observers mistakenly believe that the "general-revenue share" of Medicare financing will increase when the parts of Medicare that are funded by general revenues (physician services and prescriptions drugs) grow faster than the part of Medicare that is funded by payroll taxes (hospital services). As defined in the 2003 prescription drug legislation, however, the "general-revenue share" of Medicare funding increases whenever total Medicare expenditures grow faster than dedicated revenues. Under this definition, the "general-revenue share" of Medicare actually increases *more rapidly* if Medicare expenditures for hospital services grow faster than expenditures for physician services and prescription drugs. That is because increases in Medicare costs for drugs and physicians services lead to increases in beneficiary premiums, which are counted as dedicated revenues, while increases in Medicare hospital insurance costs do not, because Medicare hospital insurance does not charge premiums. (Under the 2003 legislation, an increase in dedicated revenues reduces the amount of "general-revenue funding," because "general-revenue funding" is defined as total Medicare expenditures minus dedicated revenues.)

[5] *Analytical Perspectives* volume of the *Fiscal Year 2007 Budget of the U.S. Government*, February 6, 2006, page 211.

[6] In a press briefing, HHS Secretary Leavitt said the details would be marked out with Congress. See Department of Health and Human Services Secretary Michael Leavitt, press briefing on the President's budget, February 6, 2007, http://www.hhs.gov/budget/brief.html .

provided to Medicare beneficiaries would fall significantly behind that received by people in the private health care system. It also could mean that large numbers of doctors and hospitals eventually would stop participating in the Medicare program.

The provision included in the budget resolution that the Senate Budget Committee approved March 9 on a party-line vote also is tied to the 45-percent threshold. This provision would establish a new prohibition in the Senate against consideration of legislation that would increase entitlement costs (for any entitlement program, not just for Medicare) unless the increases are paid for in the same bill through reductions in other entitlement programs or increases in revenues. This prohibition would take effect once the Budget Committee Chairman has determined two years in a row that the general-revenue share of Medicare funding will exceed 45-percent within the next six years. Based on current projections, the chairman would make this determination in March 2007. The Chairman would presumably rely on the findings of the Social Security and Medicare Trustees in making his determination.

This new Senate rule could make it harder to enact legislation that would increase the costs of any entitlement program (since it would take 60 votes on the Senate floor to override the new prohibition), although legislation increasing entitlement costs already is prohibited in the Senate unless the increases are paid for or the annual budget resolution assumes the increase in expenditures. The new rule is flawed in two fundamental respects.

First, it represents an endorsement of the importance of the 45-percent threshold as a key measure of Medicare's financial soundness and as a way to keep Medicare from placing too much pressure on the rest of the budget, despite the fact that the 45-percent threshold is seriously deficient in both respects. Second, it uses the 45-percent threshold to further tighten the budget constraints on legislation to improve any entitlement program (including programs for people who are poor, veterans, or severely disabled) while imposing no constraints on new tax cuts, including new tax breaks for the well-off and powerful corporations that engage high-paid lobbyists.

The 45-Percent Threshold is Misguided and Misleading

The existing statutory requirement relating to the 45-percent trigger, and the Administration's and Budget Committee's new proposals, may create 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. But 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 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, 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 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.[7] 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 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. It is not, as the box on page 7 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 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, education, or veterans benefits on general revenues is a problem.

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

[7] 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 significantly 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 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 that is 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.

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 on Medicare of substituting dedicated revenues for general revenues would be that more of the revenue supporting the program would be raised through regressive measures and that potential pressure to scale back the 2001 and 2003 cuts in the progressive income tax to help ease Medicare's long-term financing problems would be lessened.

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 easily 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. The designers of the Medicare drug law rejected it.

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

As Marilyn 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.

- 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, shifting tax burdens from upper-income individuals to middle-class families and the working poor.

- The only ways that the 45-percent threshold could be met *other than* through the regressive step of increasing Medicare payroll taxes would be through increases in beneficiary premiums and co-payments that grow much larger over time or through ever-deeper cuts over time in Medicare eligibility, the medical services that the program covers, and/or payments to Medicare providers. 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 thus by placing the burden of future increases in Medicare costs (other than increases averted through cuts in Medicare eligibility, benefits, or payments to providers) squarely on increases in premiums, deductibles, and co-payments, or on increases in payroll taxes. The revenue-raising options that would be allowed generally have one common element: they largely shield the most affluent Americans and place more of the burden on people on the low and middle

rungs of the income ladder. (An exception to this would be increases in Medicare premiums that apply only or primarily to Medicare beneficiaries with higher incomes.)

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

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 rise and the baby-boom generation retires. But the 45-percent threshold for general-fund financing of Medicare and the automatic cuts proposed by the President do not address these problems in a straightforward or ideologically neutral manner. The 45-percent measure is an arbitrary measure that defines the problem in simplistic and ideological terms. It 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 to long-term financial health and maintain stability for the budget as a whole.