



## The Official Future of Medicare— An Unofficial Review

By Robert B. Helms

*The five trustees of the Medicare program recently released their annual report on the financial condition of the program. The report incorporates new information about how the Medicare Modernization Act enacted last December will affect the future cost of the program. As usual, the report was largely ignored, even though the trustees gave a stronger warning than in past years that the program faces serious financial problems that will begin to affect the federal budget this year. This review examines the new information presented by the trustees and explains why trust fund accounting may be misleading the debate and delaying the serious and timely reform of Medicare called for by the trustees.*

The recently released annual report on the financial condition of Medicare warned that the hospital insurance (HI) trust fund would run out of money in 2019. That was seven years sooner than they had predicted in last year's report. Did anyone notice?

Again this year the entire report and even this finding were greeted with a big yawn. As in past years, the skeptics tell us the Medicare trustees are crying wolf. They have been predicting disaster for years, but nothing bad ever happens. And besides, the skeptics argue, this is a rich country, so we will be able to fix the program if the need ever arises. They insist we should expand Medicare spending by making the drug benefit more generous and extending Medicare eligibility to more people, secure in the knowledge that younger workers will always be there to pay the bills. These political pollyannas could not be more wrong.

This year's report, which contains new information about the future financial condition of the program and the effects of the new Medicare Modernization Act (MMA), deserves a more careful look than past reports have received. This review

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will examine why the trustees have changed their tune and now give a stronger warning on Medicare's fate and the need for reform. But, will the trustees' report motivate policymakers to seek a solution? Are the trustees still too optimistic? Should their warning be even stronger?

### Election Year Politics

Last year was indeed a busy one for anyone who follows the details of Medicare. The final passage of MMA was anything but certain as both houses of Congress debated, compromised, and rewrote the proposed legislation. But in the end, Congress passed and the president signed a law to add a prescription drug benefit to Medicare and to make numerous changes to the program.

Instead of calming the political waters, the passage of MMA seems to have intensified the noisy debate. Both political parties have attempted to establish a rhetorical base on Medicare issues as they head into the presidential and congressional races. The president and the Republicans praise the act for making prescription drugs available and more affordable to the elderly. Democrats complain that the benefits are

inadequate and that the cost savings for the elderly will be too small.

While this noisy debate about who should steer the Medicare ship has been raging on the main deck, no one seems to have noticed the rather loud warning of icebergs ahead that was sent up on March 23, 2004, from the radar room. The radar room is manned by a group of actuaries, economists, and other analysts who have been firing off such warnings for several years now. In 2004, however, the warnings have grown even louder because it appears that the MMA is steering us into extremely dangerous waters. Still, the debate on the main deck continues to drown out the message from below.

## The Medicare Trustees' Report

The warning, of course, was the release of the annual trustees' report on the financial condition of Medicare.<sup>1</sup> The report is compiled by the actuaries from the Centers for Medicare and Medicaid Services (CMS) and signed by Medicare's five trustees—the secretaries of the treasury, labor, and health and human services, and two public trustees. The annual report is required by law and as such constitutes the government's official report on the future of Medicare. The chief Medicare actuary certifies that the report is based on "sound principles of actuarial practice," and that the assumptions are reasonable. The two public trustees state that they believe the projections "provide the most reliable indication available of the financial outlook under current law for Medicare and Social Security."<sup>2</sup> The report gives three sets of projections based on a collection of low, intermediate, and high-cost assumptions, all of which become more uncertain as the length of time of the projection is increased.<sup>3</sup> The following discussion considers the intermediate projections only.

While reports in past years have consistently warned that Medicare faces severe financial problems in the future, this year's report is notable for the strength of its warnings and sense of urgency in its call for corrective action. As the two public trustees put it, "the projected financial status of Medicare has taken a major turn for the worse since last year's reports."<sup>4</sup>

What exactly does the report say? On the very last page of the report, the chief actuary warns of a new level of uncertainty simply because we lack program experience with drug benefits to gauge how many seniors will enroll and how being in the program will affect their utilization of prescription drugs. The report uses reasonable actuarial

assumptions based on available experience in other programs to make their projections of expenditures and revenues. This caveat suggests that discrepancies between the cost projections of CMS and the Congressional Budget Office (CBO) deserve much less attention than they have been receiving. Ultimately, there is no way to know how Medicare beneficiaries will respond until we have had more experience with this new benefit.<sup>5</sup>

Despite its 215-page bulk and detailed discussion of assumptions, the 2004 Trustees' Report has some alarming but simple messages about the future of Medicare. The first is that the combined parts of the program (Part A covering hospital care, Part B covering physician care, and Part D covering drugs<sup>6</sup>) will likely place an unsustainable financial burden on the federal budget. As the report states:

*The interrelationship between the Medicare program and the Federal Budget is an important topic. . . . [The transfers from general revenues to the Part B trust fund] represent a large and growing requirement for the Federal Budget.<sup>7</sup>*

*Total Medicare expenditures were 2.6 percent of the Gross Domestic Product (GDP) in 2003. In 2006, with the implementation of the new prescription drug benefit, total expenditures are estimated to be 3.4 percent of GDP and to increase rapidly to 7.7 percent by 2035.<sup>8</sup>*

Program spending equal to 7.7 percent of GDP in 2035 is equivalent to \$880 billion today. That is about as much as the federal government will spend this year on defense, homeland security, housing, education, the environment, and transportation—in fact, all discretionary programs. Medicare spending of that magnitude would threaten to crowd out those other policy priorities or require substantial tax increases to accommodate all of those functions.

This new emphasis on the future financial burden on the federal budget and the economy is a direct result of a campaign by the public trustees, John Palmer and Tom Saving. It highlights three financial problems: the better known problem with Part A, the more obscure problem in Part B, and the additional financial problems that can be expected from the new Part D.

**Medicare Part A.** The first problem is the unfunded liabilities for Part A, the hospital benefit funded through

payroll taxes paid into the HI trust fund. Since this trust fund is financed primarily by payroll taxes that are set by current law, the actuaries can project a definite future date for its exhaustion. This year's report projects that the fund will be exhausted in the year 2019, seven years earlier than in last year's report. That means that Medicare will be unable to pay for all the inpatient services used by Medicare beneficiaries in that year.

The new drug benefit is not in Part A, so it plays no direct role in the earlier exhaustion of that fund. The actuaries have strived to dispel this common misconception by explaining the seven-year change: two years are due to higher payment rates to rural hospitals and Medicare Advantage plans; two years are due to lower payroll taxes and higher expenditures than were projected last year; one and one-half years are due to higher hospital input cost factors; one year is due to new information that Medicare Advantage enrollees are not as healthy as earlier data suggested; and one-half year is due to new information that certain specialty hospitals (e.g., rehabilitation facilities) are also more expensive than previously assumed.

Beginning in 2019, the projected annual revenue is lower than the projected annual expenditures. According to the current forecast for that year, the dedicated tax revenue from payroll taxes and taxes on Social Security benefits paid by some high-income seniors will cover only 81 percent of Part A costs. Since expenditures are expected to increase at a much faster rate than dedicated tax revenues, this percentage is projected to decline to only 26 percent by 2078.<sup>9</sup>

However, one of the most alarming messages from both the actuaries and the public trustees is that the present system of financing Part A will begin to affect the federal budget in a profound way beginning *this year*. This year, 2004, is the first year that Medicare Part A expenditures will exceed revenues, not including interest income on the present assets of the HI trust fund. Between this year and 2010, "interest earnings will have to be used to help pay benefits."<sup>10</sup>

Relying on interest income does not mean that the government has a new source of income to finance Medicare. Interest income attributed to Medicare is an expense for the Treasury, so this becomes a budget transfer from one part of the government to another. No taxpayer is actually paying more taxes to the government. The interest income in one year becomes an additional asset to the trust fund the next year, but not a net increase in total government assets.

In 2010, expenditures are projected to exceed income, including interest income. This means that after 2010 the Treasury Department will have to start liquidating the assets that it holds in the HI trust fund in order to transfer enough funds to Medicare to pay the yearly claims. The accumulated assets are projected to be depleted by 2019, after which the program will not receive enough annual income to pay for the expected claims.

What are these assets held by Medicare? In past years when Part A revenues exceeded expenditures, the federal government took the excess funds and used them for other purposes. In exchange for the funds, the Treasury Department issues special issue bonds that are sold only to the trust funds.<sup>11</sup> At a future date when Medicare needs additional funds to pay for benefits, it can redeem the bonds in exchange for cash. To carry out this transaction, the Treasury must reduce other government expenditures, raise taxes, or increase its borrowing from the public (increase the deficit or reduce the surplus). When such redemption of assets becomes necessary, it takes away the flexibility of the government to use discretionary funds for other purposes or to reduce borrowing. This begins to happen this year but continues to exert an increasing influence on the budget some fifteen years before the fund is depleted. The public trustees' summarize this situation as follows:

*This year [2004] the HI Trust Fund will require only a small cash transfer from Treasury, as interest income on its reserves begins to be used to help cover annual expenses. These transfers will grow rapidly, however, to reach the equivalent of 3.5 percent of Federal income taxes by the year of trust fund exhaustion in 2019. . . . The inadequacy of current HI financing arrangements to fund the hospital insurance benefits promised in the law is clear, and the need for legislative action is pressing.*<sup>12</sup>

It makes absolutely no difference what you call the net asset redemptions that will begin in 2004 and continue until 2019—the effect is to reduce the Treasury's ability to spend that money for non-Medicare purposes.

**Medicare Part B.** The federal budget is also strained by the use of general revenue funding to pay for 75 percent of the cost of Part B, the fastest growing part of Medicare. Medicare law specifies that the Part B premium paid by

enrollees be set to cover 25 percent of the expected cost. The rest is drawn from general revenues. In a technical sense, the Part B trust fund is fully funded, but only because it has an unlimited draw on general revenues. In fact, all entitlement programs have an unlimited draw on general revenues. But economist Jagadeesh Gokhale recently reminded us that “no one—not even Congress—can spend the same dollar multiple times.”<sup>13</sup>

The public trustees make the point in the following way:

*Consider that in 2003, SMI [Supplementary Medical Insurance, i.e., Part B] general revenue financing amounted to just under 9 percent of Federal income taxes; but it is projected to amount to nearly 14 percent of Federal income taxes in 2010, [and] to nearly 29 percent by 2030.*<sup>14</sup>

Higher future costs of physician care will also have an effect on beneficiary premiums, set each year to cover 25 percent of the expected costs. Buried in an appendix table is the actuaries’ projection that the Part B monthly premium, currently at \$66.60, will have to be increased to \$78.10 in 2005—a 17.3 percent increase. This sizeable increase was due primarily to a change in the law to increase physician payments.

**Medicare Part D.** The trustees report also presents the actuaries’ best estimates of the future effect of the new Medicare drug benefit, Part D, scheduled to begin in 2006. Part D will have its own separate trust fund, but it will operate in a similar manner to the present Part B trust fund. In other words, premiums will be calculated to cover 25 percent of the expected cost of the program, and the remainder will be paid out of general revenues. Therefore, Part D adds to the unfunded liabilities of Medicare and exacerbates the present budget shortfall. The actuaries estimate that expenditures for the drug benefit will grow at an average annual rate of 9.7 percent between 2007 and 2013, so the cost of the benefit will increase from \$93 billion in 2007 to \$162 billion in 2013. The 75 percent draw on general revenues will grow from approximately \$70 billion in 2007 to \$123 billion in 2013, while the average monthly premium will increase from \$37.23 in 2006 to \$60.78 in 2013.<sup>15</sup> If these estimates prove overly optimistic, as many analysts are predicting, then the drain on general revenues and pressure on beneficiary premiums will be even larger.

## An Unofficial Assessment

The annual Trustees Report is largely a technical volume, and is not easy reading for anyone who is not an actuary or a Medicare expert. Still, the actuaries and the public trustees have taken several steps to make the report more accessible to the public. The report begins with a one-page summary of the highlights, followed by a twenty-one-page overview containing four tables of basic data and five charts illustrating the major findings.<sup>16</sup> Four of the charts are especially alarming because they plot the actuaries’ projections of expenses and revenues for the full seventy-five-year period. Since expenditures grow at a much faster rate than current law tax receipts, the yearly deficits increase rapidly. However, those inclined to think that such long-range projections are a fruitless exercise can just cover up the last fifty to sixty years on the charts and look at what the actuaries are projecting for the next two decades. Even if one does that, the charts are still alarming because they show how precipitously the program’s finances deteriorate by the early 2020s, when large numbers of baby boomers will be eligible for Medicare.

The results of the report are also nicely presented in a readable form in the thirteen-page document prepared jointly for the trustees by the actuaries for Medicare and Social Security, although it is not to be found on the Medicare website. It is available, however, on the Social Security website.<sup>17</sup> This shorter statement covers both the Medicare and the Social Security programs, and so it allows one to easily see why the trustees are saying the Medicare program faces the more immediate problem.<sup>18</sup>

At the end of the trustees’ summary document are four unnumbered pages containing “A Message from the Public Trustees.”<sup>19</sup> It is not easy to find, but it is highly recommended as the place to start to get a clear statement of the condition of the Medicare program. By design, the public trustees are less constrained in what they can say about the program. For example, they present the following analysis of the future financial burden on Part B beneficiaries:

*Whereas in 2003 Part B premiums and coinsurance for a typical Medicare beneficiary amounted to 15 percent of the average Social Security benefit, the same expenses for Parts B and D combined for beneficiaries in the future are expected to exceed 35 percent by 2010, 50 percent by 2030, and 80 percent by 2078.*<sup>20</sup>

Meanwhile, since premiums cover only 25 percent of expected expenditures, the burden on the general budget is three times the direct burden on those paying premiums. The public trustees' bottom line is: "As Public Trustees we are compelled to point out the inadequacy of the Medicare financing arrangements in current law to meet the projected cost of the benefits promised by law."<sup>21</sup>

The actuaries have also responded to the public trustees and other critics by changing several of the technical assumptions and providing a more thorough discussion of the effects of alternative assumptions. This year's report provides a new analysis of the relationship between the Social Security and Medicare trust funds and the federal budget.<sup>22</sup> For the more technically minded, Appendix D presents the preliminary analysis of the uncertainty of Part B estimates using stochastic techniques. The analysis reaches the interesting conclusion that future Part B costs could vary substantially from the intermediate projection but that the current way of setting yearly premiums and general fund contributions should continue to work even if costs go up more than presently expected. If your one-year projection is off, you can make up the difference the next year.

Based on the analysis by the actuaries, the trustees have presented a clear message that Medicare is headed for trouble if it stays on its present course. Deciding to take action will now be up to the policymakers, all of whom are politicians. Politicians generally have a very short-term perspective on issues, and therefore they see little reason to take action on a difficult problem until there is a clear crisis. Therefore, it is unlikely that Congress will do anything substantial to change the financial situation of Medicare until there is an immediate danger of defaulting on promised benefits. Because most of the attention is paid only to the Part A trust fund, politicians assume that this crucial crisis point will not occur until 2019. This, they reason, is hardly worth worrying about in this election year.

The real danger for the future of Medicare is that the Congress, when it finally begins to look for solutions, will continue to look for easy answers rather than fundamental reform. Two examples of trust fund manipulation come to mind. In 1983, the Social Security (OASDI) trust fund was faced with immediate insolvency. To continue to pay benefits, the Social Security trust fund borrowed \$17.5 billion from the disability (DI) and hospital insurance (HI) trust funds that were collecting more

than they were spending at that time. Following the Social Security reform legislation in 1983, these loans were repaid in 1985 and 1986.<sup>23</sup> Since the Social Security trust fund is currently projected to add to its accumulated assets until 2018, and exhaust its assets in 2042, it would be possible for HI to borrow from OASDI for several years after 2019, but such borrowing would in turn hasten the time when Social Security would run out of assets. Regardless of which assets are being redeemed, the Treasury still draws the money to pay for current benefits from the usual sources—increases in taxes, reductions in other spending, or increased borrowing from the public.

Another example of trust fund manipulation occurred in 1997 when Congress shifted a large part of the cost of the home health care benefit from Part A to Part B. The CBO estimated that these transfers would amount to \$40 billion between 1998 and 2002 and \$173.6 billion between 1998 and 2007. While relieving the Part A trust fund of some costs, it unloaded the financial burden onto beneficiaries who had to pay 25 percent of the cost through added premiums and onto general revenue financing that paid 75 percent of the cost.<sup>24</sup>

While the trustees have tried to be more forthcoming about the financial future of Medicare, many claim that their projections are overly optimistic. One of the primary criticisms of the actuaries is about their assumption that future health care expenditures will grow at only 1 percent over the growth rate of GDP. Over the last three decades, Medicare spending has grown at approximately 3 percent above GDP growth.<sup>25</sup> Cutting growth in health care spending to the 1 percent excess rate assumed by the actuaries would require a major restructuring of our health care system, especially our strong demand for new and expensive medical technologies.

The 2004 Trustees Report breaks new ground by emphasizing the growing effects of the program's unfunded liabilities that begin already this year to impact the federal budget. Will this be enough to change policymakers' minds? We can only wait and see. Meanwhile, the actuaries and the trustees have done their best to clear the fog.

The Medicare ship is not the *Titanic*. It is not going to suddenly sink from a catastrophic event. Modern actuarial radar can allow us to plan ahead for real dangers, but the Medicare ship is large and may respond sluggishly to a change in course. The sooner we set a new course, the safer the passengers on the ship will be.

## Notes

1. 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, March 23, 2004, hereafter referred to as "Report." Available at [www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf](http://www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf).

2. John L. Palmer and Thomas R. Saving, "A Message from the Public Trustees," *Status of the Social Security and Medicare Programs: A Summary of the 2004 Annual Reports*, unnumbered pp. 11–14, hereafter referred to as "Message." The full publication is referred to as "Summary." It is available at [www.ssa.gov/OACT/TRSUM/trsummary.html](http://www.ssa.gov/OACT/TRSUM/trsummary.html).

3. Report, p. 5.

4. Message, unnumbered p. 11.

5. For a recent discussion of this controversy, see Joseph Antos, "Don't Ask, Don't Tell," *AEI Health Policy Outlook*, March–April 2004, [www.aei.org/publication20021](http://www.aei.org/publication20021).

6. There is a Part C for the Medicare Advantage program, but it does not have a separate trust fund, and the costs of the program are allocated to the other funds.

7. Report, p. 9.

8. Report, p. 2.

9. Summary, p. 7.

10. Summary, p. 7.

11. Report, Table II.B4. Since this is a transfer from one government agency to another, it requires only an accounting entry that creates a liability for the Treasury and an asset for Medicare. The HI trust fund assets are really a promise by the Treasury to redeem the special issue bonds when Medicare needs the funds to pay for benefits. By federal law (PL 103-296,

1994) the Treasury is required to print out paper instruments for the OASDI trust funds. These pieces of paper are stored in Parkersburg, West Virginia. In the one aspect of Medicare that may claim an ounce of efficiency, there is no such waste of paper and file cabinet storage space for the Medicare trust fund assets.

12. Message, unnumbered p. 2.

13. Jagadeesh Gokhale, "Medicare Math," *Wall Street Journal*, April 15, 2004.

14. Message, unnumbered p. 3. As required by law, the trustees' reports almost always extend such projections out for seventy-five years, but to save ink and the readers' time, such projections have been avoided here.

15. Report, Table I.G1.

16. Report, pp. 1–21.

17. See [www.ssa.gov/OACT/TRSUM/trsummary.html](http://www.ssa.gov/OACT/TRSUM/trsummary.html).

18. Summary, pp. 8–10.

19. Message.

20. Message, unnumbered p. 3.

21. Message, unnumbered p. 3.

22. Report, Appendix E. For an expanded analysis, see [www.treas.gov/offices/economic-policy/reports/budget\\_trust\\_fund\\_3\\_23.pdf](http://www.treas.gov/offices/economic-policy/reports/budget_trust_fund_3_23.pdf).

23. 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Table 18, p. 54.

24. The increase in Part B premiums due to the shift of home health services was phased in over seven years. In 2004 and thereafter, beneficiaries paid 25 percent of the cost of the shifted services.

25. CBO, *The Long-Term Budget Outlook*, December 2003, Box 1-2.