



Medicare's Bad News: Is Anyone Listening?

By Joseph Antos

Medicare is in serious fiscal trouble, but no one seems to be paying attention. The Medicare trustees recently issued their annual report, and the news is not good. If current trends continue, Medicare's Hospital Insurance (HI) trust fund will be depleted in 2019. To make good on the health care benefits promised to Americans, future generations face a tax bill of \$85 trillion (measured in today's dollars). That makes the mortgage bailout, which is unlikely to cost more than \$1 trillion, look like chicken feed. Why are we ignoring a calamity that will affect every American? What can we do to avoid fiscal disaster?

The financial news lately has been bleak. The collapse of the subprime mortgage market is in all the newspapers, with virtually daily coverage since the beginning of the year. Undoubtedly, this will remain a topic of anxious conversation around every water cooler in America for months to come, and with good reason. Staggering losses are predicted—as much as \$1 trillion, according to a leading investment bank.¹

In the last week of March, the Medicare trustees issued their annual report on Medicare's financial outlook, and the news is ominous.² Medicare spending is projected to exceed its dedicated sources of revenue, accumulating to an \$85.6 trillion shortfall (measured in present value terms).³ This represents an unprecedented catastrophe. However, after a day or two of perfunctory reporting, Medicare's problems have dropped out of sight until this time next year.

The increase in Medicare's shortfall since 2007 was more than \$10 trillion—ten times the size of the expected mortgage market losses.⁴ Yet, it is ho-hum, business as usual for Medicare.

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Why the Message Doesn't Get Through

The difference in the public reaction to these two serious financial problems is instructive. It reveals three major problems with the way Medicare's bad news is communicated and perceived:

- The Medicare crisis fails to connect on a visceral level with the public and the press.
- The trust fund concept in Medicare instills a misleading sense of confidence in the program's financing.
- No simple, easily understood number adequately captures the magnitude of Medicare's financing crisis.

Failure to Engage the Public's Imagination.

There is immediacy to the mortgage mess that generates empathy even among those not directly involved. We can imagine how we would feel if we were unable to continue to make payments on the McMansion that has become overnight an overpriced liability. Even people who do not have a subprime mortgage and are not directly involved in the meltdown can identify with the second part of that statement—living in

a suddenly devalued home. To the man on the street, this crisis is real.

The Medicare financing problem is eighty times larger and, for that reason, must be attended to very soon—a point the trustees have been making for years. But this does not have the same immediacy as the mortgage crisis. The average person has difficulty imagining how the Medicare crisis will affect him. The trust fund numbers are just numbers—gigantic numbers in the tens of trillions of dollars, numbers at the limits of imagination. Those numbers do not convey concretely what could happen to an individual or to his children or grandchildren in terms of lost opportunities, poor health care, or a reduced standard of living.

Although the trustees' report provides valuable information about Medicare financing, it is a 236-page reference book and not a broadside that can fire the imagination of the press or the public. Other, more user-friendly studies are needed to convey the seriousness of Medicare's financing troubles to a broad audience. One might, for example, translate the trustees' complicated financial statistics into an illustration of how much benefits would have to fall for the average Medicare enrollee in 2030 absent a major reform. But even such an example could be misconstrued as a remote problem affecting the incomes of doctors, hospitals, or nursing homes, rather than a more personal threat to an individual's health and well-being.

In addition, Medicare's funding crisis will only become more acute in the future—and not that far into the future. In the near term, the growing financial pressure is measured in seemingly small percentage increases, and the growth rates do not look as dangerous as they actually are. Even in 2011, the year when the first wave of baby boomers turns sixty-five, Medicare enrollment is projected to increase 2.3 percent from the year before—not the tidal wave that some might imagine.⁵ Program spending will increase by about 6.3 percent in that year, again not that different from recent growth rates.⁶ Although such increases may appear manageable, they accumulate over time to create a calamitous mismatch between demands on Medicare funding and the resources to finance the program.

Misplaced Trust in Trust Funds. For many people, the term “trust fund” conjures up an image of financial stability and permanence. That is precisely what the New Dealers had in mind in 1939 when they relabeled the Social Security reserve fund a trust fund.⁷ The new term conveyed a

perception that a worker's “contributions” (a misnomer—they are taxes) were safely held in his “account” until needed to pay for his retirement. This bit of spin doctoring undoubtedly helped build the public's confidence at a time of great economic and political uncertainty.

It is not surprising that the trust fund terminology, by now long-established and familiar (if not fully understood by the public), was adopted at Medicare's creation in 1965. It is likely that most people are only dimly aware of the program's trust funds, except when they are mentioned in the annual newspaper stories reporting their future depletion. Nonetheless, trust fund accounting can give observers a misleading sense that any financing crisis is far off. To focus on the kind of confusion that trust fund accounting can sow, consider the end-of-year balance in the Medicare trust funds.⁸ According to the trustees' report, Medicare's trust funds had a combined balance of nearly \$370 billion at the end of 2007.⁹ That is nowhere near the \$2.2 trillion trust fund balance of the Social Security trust funds, but it is certainly nothing to sneeze at.

Or is it? The assets in the trust funds are not in a bank account, ready to be withdrawn when Medicare gets into trouble. They are not invested in negotiable financial securities.¹⁰ They spend no time sitting in some vault at the Treasury Department. Instead, each dollar that is not spent by Medicare to pay for the health care of current beneficiaries is immediately lent to the Treasury and used to finance the ongoing operations of the government. The special Treasury bonds that the trust funds hold cannot be cashed in when Medicare needs the money since we did not actually save those surplus funds in the first place. If the program's revenue fell short of the program's costs, additional funds would have to be raised by cutting back on other government spending, increasing taxes, or (the old-fashioned way) deficit spending.

Although the amount held in Medicare's trust funds is not the same as cash on hand, the projected sharp decline in that amount is an indication of a worsening financial situation for the program. According to the trustees, Medicare's HI trust fund, which accounts for financial transactions under Part A for inpatient hospital and other services, will be exhausted by 2019 if current trends continue. This is a serious problem demanding corrective action, as the trustees have said, but even this dire prediction only tells part of the story.

No Simple Number. How big is Medicare's fiscal crisis? Perhaps surprisingly, that is a difficult question to answer

clearly. Other than giving the impression that the problem is “big,” the report includes no single number that provides an intuitive sense of the seriousness of the problem. Big compared with what? When should we worry, or is it already too late?

The trustees’ report offers a wealth of data, enough to induce sensory overload, but little nontechnical information on what it all means. One can examine detailed actuarial projections of revenue inflows and spending outflows year-by-year through 2082. One can contemplate a raft of “ultimate assumptions”; consider the relationship between the “income rate” and the “cost rate”; and ponder the interpretation of “dedicated revenue,” “general revenue contributions,” and “unfunded obligations” (either “through the infinite horizon” or “from program inception through 2082”). These *are* useful measures, but they are not easy to understand.

The one seemingly clear statistic in the report—the HI projected insolvency date of 2019—is misinterpreted by many people. The casual reader might think that is the date when Medicare will no longer be able to pay its bills, essentially ending the program. Not at all: 2019 is the date when Medicare will no longer pay *in full* its share of the hospital bills and other charges for services covered under HI. In 2020, Medicare would be able to pay a substantial portion of its hospital bills even without new legislation because payroll taxes would continue to be collected and available to defray partially the cost of services. The HI trust fund could, in theory, run short of funds. That is because this part of Medicare is financed by sources of revenue (mainly payroll taxes) that are projected to grow more slowly than HI outlays, assuming current trends and policies continue.

But there is another Medicare trust fund. The Supplementary Medical Insurance (SMI) trust fund accounts for financial transactions under Part B for outpatient services and under Part D for prescription drugs. Unlike HI, the SMI trust fund was deliberately designed so that it can never run out of money.

Although the SMI trust fund cannot become insolvent, the fund is not a fiscal perpetual motion machine. Parts B and D receive a quarter of their revenue from premiums paid by enrollees. The remainder is from general revenue, essentially income taxes, and by law the trust fund may draw as much general revenue as it needs to cover its costs. Under this arrangement, the SMI trust fund is always in balance, but that tells us nothing of interest. The trustees project that spending under Parts B and D will continue to grow rapidly,

gobbling up more resources and exerting increasing pressure on the economy.

The trustees report two statistics that measure the combined fiscal impact of HI and SMI. Both statistics account for the flow of general revenue into Medicare, reasoning that greater inflows to Medicare reduce the money available to finance other federal programs and priorities. One statistic estimates the total amount of general revenue projected to be transferred into Medicare over the long term. The result is an incomprehensibly large number. If Medicare is to pay all of its bills over the next seventy-five years, \$36 trillion in general taxes, measured in today’s dollars, must be transferred to the trust funds. About \$85 trillion is required to fully finance Medicare indefinitely. Except for providing fodder for debate, this calculation has not generated much pressure on policymakers to address Medicare’s financial crisis.

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The Medicare Modernization Act of 2003 created a “trigger” mechanism requiring policymakers to act if the projected flow of general revenue into Medicare rose above 45 percent of program spending in two successive trustees’ reports. The trigger formula is a confusing mouthful. The ratio of general revenue income to total Medicare spending is not a number that evokes an image of certain disaster. The level chosen for the standard, 45 percent, seems arbitrary—why not 46 percent? The arithmetic is not compelling, even to many policy experts.

Once the trigger is pulled, the required actions are far from exciting. The president must propose reforms within fifteen days of submitting his budget in early February. The Congress must consider them on an expedited basis, but it is not required to enact anything. Regrettably, this is also business as usual for Medicare.

Triggering Reform

Even a weak trigger could promote useful political debate leading to legislation—but only if all sides rose above politics and took the fiscal problem seriously. The Democrats, in charge of the congressional agenda, have

paid just enough attention to the trigger to ridicule it. Republicans, who have little more than a bully pulpit, have, unsurprisingly, failed to generate interest in Medicare reform during an election year.

Although there is little chance that Congress will enact major Medicare legislation this year, the White House could have used the trigger mechanism to establish principles for future reforms. Instead, the White House proposal confined itself to small adjustments to the program intended to lower the general revenue/spending ratio below 45 percent. That would only recock the trigger for a future president.

The president's proposal, embodied in the Medicare Funding Warning Response Act of 2008, presents three important policy themes:

- “Value-based” health care, which calls for development in Medicare of a variety of promising ideas, including electronic health records, better information on price and quality, and pay for performance
- Medical liability reform, which would help lower health care costs in general
- Income-related Part D premiums, which would increase Medicare revenue

These themes fall short of a coherent vision of Medicare reform. Improving Medicare's information and payment systems makes sense, but it is only a start on building efficiency into a system that is fundamentally broken. The act would allow such improvements to be embarked upon only if the actuary were to estimate that money would be saved, indicating an appropriate lack of confidence that such steps could produce immediate cost reductions. Not surprisingly, the Congressional Budget Office (CBO) has scored this provision as producing no savings.¹¹

Steps to make the liability system work better for patients are highly desirable but would reduce Medicare spending by only \$4.8 billion over ten years, according to the CBO. Requiring higher income beneficiaries to pay higher Part D premiums would have a greater impact on Medicare finances, increasing revenue by \$12.1 billion over the decade. There are good reasons to support this proposal, but raising revenue does nothing to address the fundamental problem—runaway Medicare spending.

Structural reform—not merely tinkering around the edges of the current program—is needed. One such

reform, premium support, would convert Medicare into a system similar to the Federal Employees Health Benefit Program. Beneficiaries would receive a subsidy based on a good basic benefit package, and they would be free to choose from among competing health plans. Individuals who prefer more expensive insurance options would pay the additional premium themselves. A premium support plan would require all plans (including traditional Medicare) to compete on the same basis.

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Such a reform would realign the financial incentives of the program to encourage better performance by health care providers and more informed choices by beneficiaries. Fundamental restructuring is needed to promote real competition and offer beneficiaries realistic health plan choices. We need to replace Medicare's culture of entitlement, which distorts the decisions of patients and providers alike, with a culture of individual responsibility and efficient delivery of care.

Conclusion

Unlike the mortgage crunch, Medicare's fiscal crisis does not seem real to most people. Medicare seems to be functioning adequately now, the trustees' estimates are difficult to truly understand, and the average American is more worried about gasoline prices than about the uncertain promise of government health benefits in old age. No wonder politicians have been unwilling to take the kinds of actions necessary to reform the program—the next election is always just around the corner, and without a palpable sense of crisis, the public would not back such policies.

The trustees' report clearly demonstrates that it will soon be difficult to ignore Medicare's problems. If recent trends in spending per beneficiary continue, the influx of the baby boomers will rapidly drive up program spending. Left unchecked, Medicare will drain money from the budget, making it increasingly difficult for Congress to find the means to fund other urgent policy priorities.

Notes

1. Goldman Sachs estimates that the U.S. financial system would eventually realize a \$1.2 trillion loss associated with the implosion of the mortgage market. Goldman Sachs, “U.S. Daily: Leveraged Losses—Still Out There (Tilton),” March 24, 2008.

2. Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2008 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (March 25, 2008), available at www.cms.hhs.gov/ReportsTrustFunds (accessed April 10, 2008).

3. The shortfall is the difference between Medicare’s expenditures and revenue specifically dedicated to the program, summed over all future years and discounted to the present. Sources of dedicated revenue include the Medicare payroll tax, the tax on Social Security benefits, premiums, and transfers from state programs to Medicare. To compute Medicare’s financial shortfall, add the unfunded obligations through the infinite horizon for Medicare Part A (*2008 Annual Report*, table III.B10) to the general revenue contributions through the infinite horizon for Part B (*2008 Annual Report*, table II.C15) and for Part D (*2008 Annual Report*, table III.C23).

4. The 2007 trustees’ report estimated that the shortfall in Medicare’s dedicated revenue was \$74.3 trillion over the infinite horizon.

5. Author’s calculation, based on *2008 Annual Report*, table III.A3.

6. Author’s calculation, based on *2008 Annual Report*, table III.A1.

7. During a hearing before the Senate Finance Committee in 1939, Social Security board chairman Arthur Altmeyer stated

that the reserve account was renamed a trust fund “to allay the unwarranted fears of some people who thought Uncle Sam was embezzling the money.” (*Social Security Act Amendments: Hearings before the Senate Finance Committee*, HR 6635, 76th Cong., 1st sess., 1939.)

8. A more detailed explanation of the mechanics and meaning of Medicare’s trust funds can be found in Joseph Antos, “Crisis du Jour or the Real Thing?” *Health Policy Outlook* no. 7 (May 2006), available at www.aei.org/publication24319/.

9. The Hospital Insurance trust fund had a balance of \$326 billion and the Supplementary Medical Insurance trust fund (which includes the new drug benefit) had a balance of \$42.9 billion at the end of 2007. See *Social Security and Medicare Boards of Trustees, Status of the Social Security and Medicare Programs: A Summary of the 2008 Annual Reports* (March 25, 2008), available at www.ssa.gov/OACT/TRSUM/trsummary.html (accessed April 10, 2008).

10. Note that the Social Security trust funds included a mix of marketable and nonmarketable Treasury securities for roughly the program’s first three decades. Currently, both the Social Security and Medicare trust funds are invested only in special obligation bonds of the Treasury—essentially IOUs from the Treasury to itself. See Larry DeWitt, “The Social Security Trust Funds and the Federal Budget” (research note 20, Social Security Administration, Baltimore, March 4, 2005, updated June 18, 2007), available at www.ssa.gov/history/BudgetTreatment.html (accessed April 10, 2008).

11. Peter R. Orszag, “Cost Estimate for H.R. 5480, Medicare Funding Warning Response Act of 2008,” letter to Representative John M. Spratt Jr., March 12, 2008, available at www.cbo.gov/ftpdocs/90xx/doc9050/hr5480.pdf (accessed April 10, 2008).

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