

Medicare Finances: Findings of the 2007 Trustees Report

By Paul N. Van de Water

Summary

Each year Medicare's Board of Trustees issues a report that describes the financial condition of the Medicare program in the near term and over the next 75 years. Similar to recent trustees reports, the 2007 report projects that Medicare's Hospital Insurance Trust Fund will be depleted in 2019, at which time scheduled income will cover 79 percent of expenditures. For the first time, the trustees have issued a "Medicare funding warning," which means that more than 45 percent of Medicare will be financed by general (non-dedicated) revenues within the next seven years.

Looking at these projections, some observers contend that Medicare must be fundamentally restructured in order to put the program—and the overall federal budget—on a sound fiscal course. Others point out that Medicare spending has grown at about the same rate as spending for private health insurance and argue that it is impossible to limit spending on Medicare without also slowing the growth of private health care costs or abandoning equal access to care for the aged and disabled.

How is Medicare financed?

Medicare helps pay medical expenses for 37 million Americans age 65 and older and 7 million persons with disabilities. The program's financial affairs are handled through two trust funds, the Hospital Insurance (HI, or Medicare Part A) Trust Fund and the Supplementary Medical Insurance (SMI) Trust Fund. The SMI trust fund consists of two separate accounts—one for Part B of Medicare (which pays for physician and other outpatient health services) and one for Part D (which pays for outpatient prescription drugs). A Board of Trustees oversees the management and investment of the trust funds and issues an annual report on their financial status. Table 1 summarizes the major features of the programs.

Part A of Medicare is funded primarily by payroll taxes on wages and self-employment income. Workers and employers each pay 1.45 percent of wages, for a total of 2.9 percent. Unlike Social Security taxes, which are not imposed on earnings above a set level, Medicare taxes are collected on workers' entire earnings. Payroll tax revenue will provide 86 percent of the income of the HI program in 2007. Interest earned on the investments of the trust funds (8 percent of the total) and income taxes on a portion of Social Security benefits (5 percent) make up most of the balance.

Paul N. Van de Water is Vice President for Health Policy at the National Academy of Social Insurance. Unless otherwise indicated, data in this brief come from the 2007 Medicare trustees report.

Table 1
Medicare Coverage and Financing

Program Details	Hospital Insurance (HI) Trust Fund	Supplementary Medical Insurance (SMI) Trust Fund
Services Covered	Inpatient hospital, skilled nursing facilities, hospice, home health	Part B: Physicians, outpatient hospital, lab tests, medical supplies, home health. Part D: Outpatient prescription drugs
Major Funding Sources	Payroll taxes paid by workers and employers; interest earned on trust fund reserves; income taxes on part of Social Security benefits paid by upper income beneficiaries	Monthly premiums paid by beneficiaries; general revenues, which are made up largely of federal income taxes; payments from states for low-income beneficiaries eligible for Medicaid
Percent of Medicare Spending in 2007	48 percent	Part B: 41 percent Part D: 11 percent

Beneficiaries enrolled in Parts B and D of Medicare pay monthly premiums that are usually deducted from their Social Security benefits. These premiums cover about a quarter of the cost of supplementary medical insurance. The premium for Part B is \$93.50 a month in 2007. The premium for Part D, the new prescription drug benefit, averages about \$22 a month. The premium amounts grow each year at roughly the same rate as the increase in the cost of the programs. Beginning in 2007, beneficiaries with incomes above \$80,000 a year pay an additional income-related Part B premium. The remaining cost of Parts B and D is financed by general revenues, which come mostly from income taxes paid by taxpayers of all ages.

Medicare beneficiaries are responsible for paying part of the cost of their care, in the form of deductibles and coinsurance for covered health services. Beneficiaries are also liable for the cost of health services not covered by Medicare, which include routine dental care, eyeglasses, hearing aids, and most long-term care.

What is Medicare's financial situation?

The Hospital Insurance Trust Fund is projected to run surpluses for the next few years but is not adequately financed beyond then. According to the trustees' best-guess (or "intermediate") assumptions, the HI trust fund will receive income of \$224 billion in 2007 and pay out \$208 billion in benefits and administrative expenses, leaving a surplus of \$15 billion for the year. At the end of the year, the trust fund will hold \$321 billion in assets. Income will continue to exceed expenditures through 2011. After that, current income and trust fund reserves will be sufficient to pay hospital insurance benefits until 2019, when the reserves are projected to be depleted. At that point, if no changes are made, scheduled HI income will cover 79 percent of estimated expenditures.

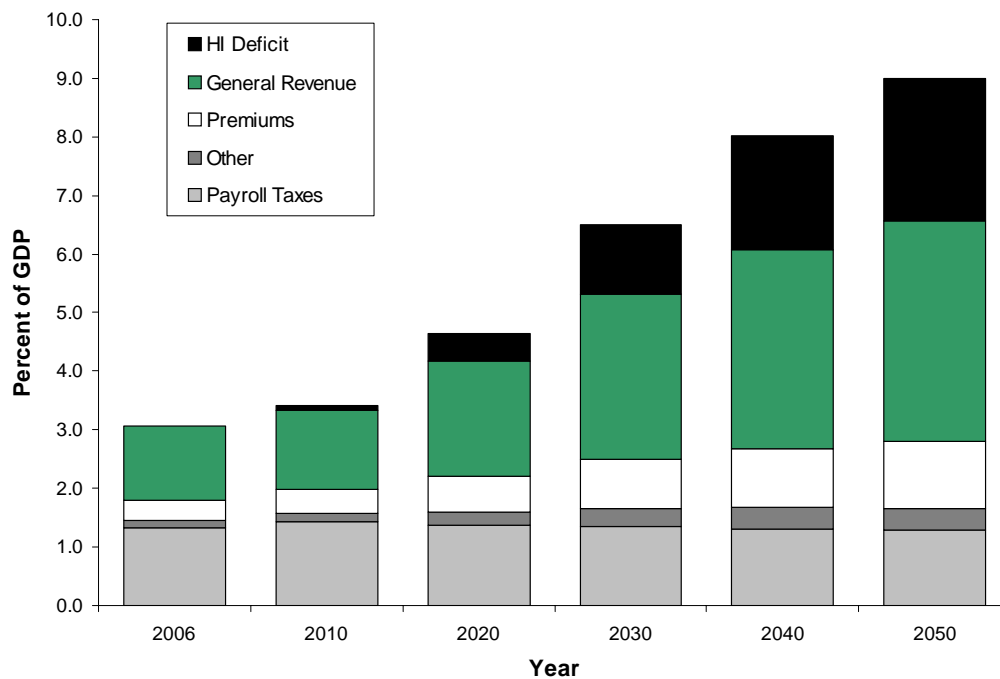
The Supplementary Medical Insurance Trust Fund is always adequately financed because beneficiary premiums and general revenue contributions are set annually to cover the expected costs of Parts B and D for the coming year. However, the rapid rate of growth in program costs will place increasing demands on both beneficiaries (to pay the premiums) and taxpayers (to provide the general revenues). The SMI trust fund will have income of \$238 billion in 2007 and expenditures of \$230 billion.

What are the long-range trends in Medicare costs?

The trustees report includes projections of Medicare’s income and expenditures over the next 75 years. There are several ways of making comparisons over such a long period of time, and here we examine two of them.

Medicare Income and Expenditures as a Percent of GDP. One way to express the growth in the total Medicare program is as a percentage of the gross domestic product (GDP), which is the total value of all goods and services produced in the United States. This measure shows how much of society’s current resources are devoted to Medicare and allows one to assess the combined costs of HI and SMI. Under the trustees’ intermediate assumptions, total Medicare expenditures will grow from 3.1 percent of GDP in 2006 to 4.6 percent of GDP in 2020 and 9.0 percent of GDP in 2050, as shown by the height of the bars in Figure 1. The components of the bars show the projected sources of financing and HI’s financial shortfall. Payroll taxes will remain relatively constant as a share of GDP, while the other sources of financing will all increase. The HI deficit will grow from 0.5 percent of GDP in 2020 to 2.4 percent of GDP in 2050 and average 1.6 percent of GDP over the next 75 years.

Figure 1.
Medicare Non-Interest Financing by Source as a Percent of GDP



Source: Board of Trustees 2007.

HI Income and Expenditures as a Percent of Taxable Payroll. The long-range estimates for the Hospital Insurance program are also often expressed as a percentage of the total earnings on which people pay Hospital Insurance payroll taxes (“taxable payroll”). Over the next 75 years, using the trustees’ intermediate assumptions, HI income will average 3.40 percent of taxable payroll, while costs will average 6.95 percent of taxable payroll, leaving a deficit of 3.55 percent of payroll over the 75 years. This means, for example, that an immediate increase in the HI payroll tax of 1.78 percentage points each for workers and employers (an increase from 1.45 percent to 3.23 percent) would close this projected deficit.

How confident can we be in these projections?

The financial projections for Medicare depend on assumptions about future birth rates, longevity, productivity, growth in health care costs, and other variables that are surrounded by considerable uncertainty. The estimates are particularly sensitive to the assumed rate of growth of health care costs relative to the rate of growth of the economy. To illustrate this uncertainty, the trustees show projections under high-cost and low-cost assumptions, as well as under the intermediate assumptions.

Trustees reports have been projecting impending HI insolvency for more than 35 years, yet benefits have always been paid because the Congress has taken steps to make sure that they are. Over the past 18 reports, changes in the law, the economy, and programmatic factors have moved the projected year of insolvency as early as 1999 and as late as 2030 (see Table 2). Despite the uncertainty of the projections, however, Medicare spending is almost certain to absorb a growing share of the economy in the years ahead.

Who receives Medicare? How much does Medicare spend per person?

In 2007, some 44 million people, or 1 out of every 7 Americans, will be enrolled in one or more parts of Medicare. Most Medicare beneficiaries live in families with modest incomes. In 2003, half of Medicare’s non-institutionalized beneficiaries had annual family incomes of \$20,000 or less. Only 13 percent had income greater than \$50,000 (MCBS Project 2006).

Table 2.
Historical Projections of HI Trust Fund Insolvency

Year of Trustees Report	Projected Year of Insolvency	Year of Trustees Report	Projected Year of Insolvency	Year of Trustees Report	Projected Year of Insolvency
1990	2003	1996	2001	2002	2030
1991	2005	1997	2001	2003	2026
1992	2002	1998	2008	2004	2019
1993	1999	1999	2015	2005	2020
1994	2001	2000	2025	2006	2018
1995	2002	2001	2029	2007	2019

Source: Board of Trustees (various years).

Medicare spending is highly concentrated in a small group of people who have large medical needs. In 2003, 52 percent of beneficiaries incurred less than \$1,000 each in Medicare costs and accounted for only 2 percent of program spending. Six percent of beneficiaries incurred \$25,000 or more in costs and accounted for 55 percent of spending (Kaiser 2007).

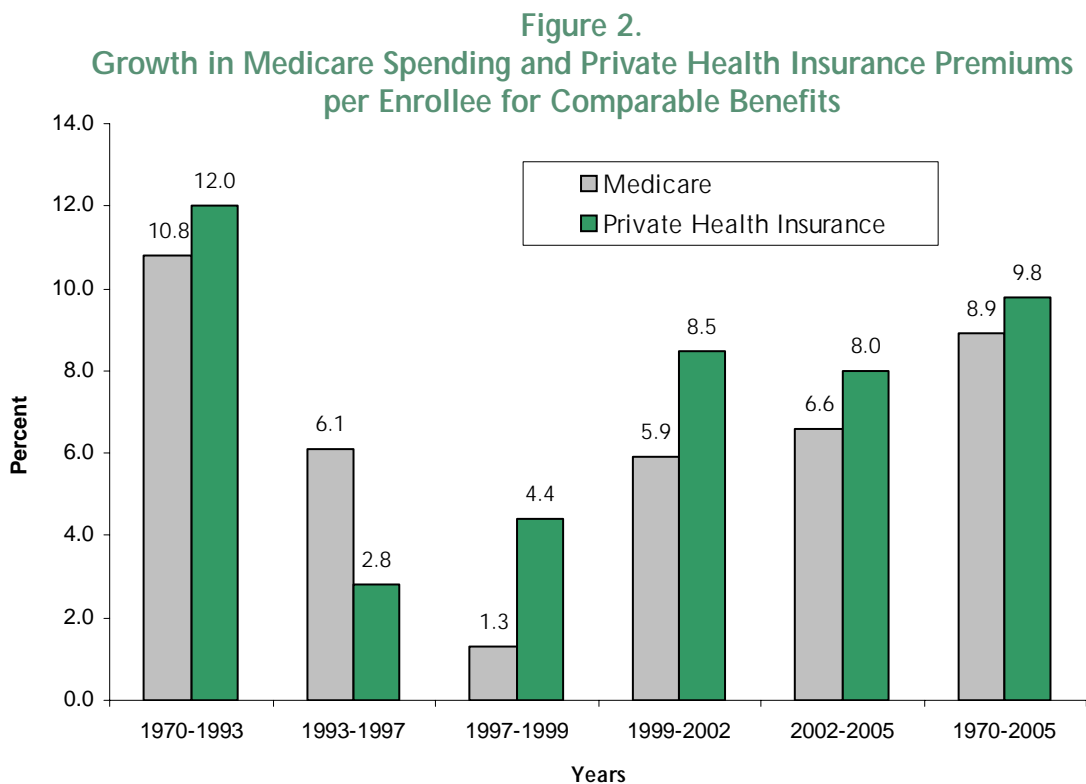
How do the 2007 projections compare to last year's?

There are no substantial changes in Medicare's financial outlook. The projected date of exhaustion of the Hospital Insurance Trust Fund has moved back one year (from 2018 to 2019). The 75-year HI deficit has increased slightly—from 3.51 percent to 3.55 percent of taxable payroll. Medicare spending is now projected to total 11.3 percent of GDP in 2080, compared to 11.0 percent of GDP in last year's report.

Why is Medicare spending growing so rapidly?

Medicare's spending is growing rapidly for the same reasons that private health spending is growing rapidly—increases in the cost and use of medical services. Much of these increases stem from advances in medical practice and technology that have enabled people to live longer and healthier lives. These technological advances have generally raised costs.

Over the years, spending for Medicare enrollees has grown at about the same rate as spending for people covered by private health insurance (see Figure 2). Medicare's costs have grown more slowly than those of the private sector in some periods, more rapidly in others, and this pattern is likely to continue. This similarity in growth rates is not surprising, because Medicare aims to provide its beneficiaries with access to the same health care services and providers as the rest of the population.



Source: Centers for Medicare & Medicaid Services 2007.

The aging of the population makes only a small contribution to the growth in Medicare's costs. Over the next 75 years, the number of enrollees is projected to grow by 1.3 percent a year, and expenditures per enrollee will grow by 5.2 percent a year, which will outstrip projected growth in GDP per person (4.0 percent a year).

What are the unfunded obligation and the infinite horizon?

A program's unfunded obligation is a way of summarizing its funding shortfall in a single dollar number. Technically speaking, it is the difference between the present value of the projected cost of a program over a specified time period and the present value of projected income (including the initial value of the trust fund). Put another way, the unfunded obligation is the amount of money that would have to be added to the trust fund today to make the program financially sound for the specified time period.

The 2007 trustees report estimates that the unfunded obligation of the Hospital Insurance Trust Fund for past, current, and future participants is \$11.6 trillion over the next 75 years, or the equivalent of 1.6 percent of GDP over that period. The Supplementary Medical Insurance Trust Fund has no unfunded obligation, because general revenues cover all spending that is not financed by other dedicated funding sources. However, the trustees report also provides an estimate of the present value of the required general revenue contributions to Parts B and D of Medicare, equal to \$22.3 trillion.

Some economists have argued that limiting the estimate of unfunded obligations to 75 years is inadequate because it includes the full amount of taxes paid by the next few generations of workers but not the full amount of their benefits. Therefore, since 2004, the trustees report has included a measure of unfunded obligations that extends indefinitely. Measured through this "infinite horizon," the unfunded obligation of the Hospital Insurance Trust Fund is \$29.5 trillion, or 2.6 percent of GDP. Other analysts contend that calculations over an infinite period are unreliable and of little value to policy makers (American Academy of Actuaries 2003).

What is the Medicare funding warning?

The Medicare Modernization Act of 2003 (Public Law 108-173) establishes a process for issuing a "Medicare funding warning" when the share of general revenue financing is projected to exceed a certain level. If the trustees project that general revenues will finance 45 percent or more of total Medicare spending in any of the next seven fiscal years, they must issue a determination of "excess general revenue Medicare funding." If the trustees make such a determination two years in a row, their action is treated as a Medicare funding warning. When the next budget is submitted to the Congress, the President must propose legislation to deal with the warning, and the Congress must consider the legislation on an expedited basis. However, the Congress may decide not to enact any legislation.

For purposes of the calculation, general revenue financing includes the general revenue contributions to Parts B and D and the interest on the assets of the trust funds. It excludes specified "dedicated financing sources," such as payroll taxes, premiums, income from the taxation of benefits, and payments from states for prescription drug benefits for Medicare/Medicaid dual eligibles.

The Medicare funding warning derives from a proposal made in 1999 by Senator John Breaux and Representative Bill Thomas, who described it as “programmatically solvency test” (Breaux and Thomas 1999). When the funding warning was added to the 2003 legislation, the intent was to generate proposals for reducing the amount of general revenues going to support the Medicare program.

Critics of the provision argue that the 45-percent level is not a measure of solvency but an arbitrary benchmark that is unrelated to the financial health of the program. Moreover, this measure is inconsistent with Medicare’s basic financing structure, because by design Medicare is financed in large part by general revenues. Restricting general revenues to 45 percent of Medicare spending would require raising dedicated taxes, such as the payroll tax, or cutting benefits even when the trust funds are in financial balance (Greenstein, Kogan, Park, and Horney 2006).

The 2007 trustees report is the second to include a determination of excess general revenue Medicare funding, which is projected to occur in 2013. As a result, the President is required to submit proposed legislation by February 2008.

References

- American Academy of Actuaries, Social Insurance Committee. 2003. Letter to the Board of Trustees of the Social Security System. December 19.
- Board of Trustees. 2007. *2007 Annual Report of the Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*. <http://www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2007.pdf>. Accessed April 23, 2007.
- Breaux, John, and Bill Thomas. 1999. *Building a Better Medicare for Today and Tomorrow*. Washington: National Bipartisan Commission on the Future of Medicare. <http://thomas.loc.gov/medicare/bbmtt31599.html>. Accessed April 13, 2007.
- Centers for Medicare & Medicaid Services. 2007. National Health Expenditure Web Tables. <http://www.cms.hhs.gov/NationalHealthExpendData/downloads/tables.pdf>. Accessed April 13, 2007.
- Greenstein, Robert, Richard Kogan, Edwin Park, and James Horney. 2006. *Trustees’ Report Focuses Attention on Misguided “45-Percent Trigger.”* Washington: Center on Budget and Policy Priorities.
- Kaiser Family Foundation. 2007. *Medicare: A Primer*. <http://www.kff.org/medicare/upload/7615.pdf>. Accessed April 16, 2007.
- MCBS Project. 2006. *Health & Health Care of the Medicare Population: Data from the 2003 Medicare Current Beneficiary Survey*. Rockville, MD: Westat.

**Also of interest from the National Academy of Social Insurance:
Available at www.nasi.org**

Social Security Finances: Findings of the 2007 Trustees Report
Social Security Brief No. 24 ~ April 2007

Strengthening Medicare's Role in Reducing Racial and Ethnic Health Disparities
Report of the Study Panel on Medicare and Disparities ~ October 2006 [full report]
Medicare Brief No. 16 ~ October 2006 [summary]

Improving Medicare's Data on Race and Ethnicity
Medicare Brief No. 15 ~ October 2006

Medicare, the National Quality Infrastructure, and Health Disparities
Medicare Brief No. 14 ~ October 2006

Survivor Benefits for Families of Deceased Servicemembers and Overseas Contract Workers
Social Security Brief No. 23 ~ October 2006

Improving the Medicare Savings Programs
Report of the Study Panel on Medicare/Medicaid Dual Eligibles ~ June 2006

Can We Afford Social Security When Baby Boomers Retire?
Social Security Brief No. 22 ~ May 2006

Developing a Better Long-Term Care Policy: A Vision and Strategy for America's Future
Report of the Long-Term Care Study Panel ~ November 2005

Long-Term Care Financing: Models from Abroad
Health and Income Security Brief No. 9 ~ November 2005

Long-Term Care: The Public's View
Health and Income Security Brief No.8 ~ November 2005

Options to Balance Social Security Funds Over the Next 75 Years
Social Security Brief No. 18 ~ February 2005

Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy
Study Panel Final Report ~ January 2005

NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

1776 Massachusetts Avenue, NW, Suite 615
Washington, DC 20036-1904
(202) 452-8097
(202) 452-8111 Fax
nasi@nasi.org
www.nasi.org