American Academy of Actuaries
ISSUE BRIEF
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Key Points

Using assumptions based on benefits and revenues scheduled under current law, the 2010 trustees' report projects:

- The HI trust fund will be depleted in 2029, 12 years later than projected last year.
- Except for the years between 2014 and 2021, HI expenditures are expected to exceed HI revenues.
- The 75-year deficit is 0.66 percent of taxable payroll.

At the request of the trustees, the CMS Office of the Actuary provided an alternative scenario:

- The alternative scenario illustrates the potential understatement of current-law projections if currently-scheduled provider payment reductions are not realized.
- The HI trust fund would be depleted in 2028, at which point the 75-year deficit would be 1.91 percent of taxable payroll.

Medicare's Financial Condition: Beyond Actuarial Balance

Each year, the Boards of Trustees of the Federal Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) Trust Funds report to Congress on the Medicare program's financial condition. The Medicare program provides health coverage for the aged and for certain individuals with disabilities. The HI trust fund pays primarily for hospital services. The SMI trust fund includes accounts for the Part B program, which covers physician and outpatient hospital services, and the Part D program, which covers the prescription drug program.

The trustees' report is the primary source of information on the financial status of the Medicare program, and the American Academy of Actuaries proudly recognizes the contribution that members of the actuarial profession have made in preparing the report and educating the public about this important issue.

The projections of Medicare's financial status in the 2010 Medicare trustees' report have improved compared to the projections in the 2009 report. The HI trust fund will be depleted in 2029, 12 years later than was projected a year ago. This improvement is due to provisions in the newly enacted Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (referred to collectively as the "Affordable Care Act" or ACA), which will lower HI costs and increase tax revenues. Nevertheless, beginning in 2022, HI expenditures are expected to exceed HI revenues, and this deficit is expected to persist

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annually thereafter. In addition, Medicare expenditures will continue to consume an increasing share of federal outlays and the Gross Domestic Product (GDP), albeit at a slower rate due to the enactment of ACA.

According to statutory requirements, the trustees' projections of Medicare's financial outlook must be based on benefits and revenues scheduled under current law. The trustees acknowledge, however, that these estimates likely overstate the improvement in Medicare's financial condition. In the Statement of Actuarial Opinion that is required by law, Richard Foster, the chief actuary of the Centers for Medicare and Medicaid Services (CMS), specifically notes that actual Medicare expenses are very likely to exceed the current-law projections. He states that "the financial projections shown in [the] report for Medicare do not represent a reasonable expectation for actual program operations in either the short range… or the long range…" In particular, the trustees and the chief actuary point to scheduled reductions in provider payments that are unlikely to occur. The ACA requires downward adjustments in provider payment updates to reflect productivity improvements; these adjustments might not be sustainable in the long term. In addition, currently scheduled physician payment reductions in accordance with the sustainable growth rate (SGR) mechanism are deemed likely to be overridden by Congress.

At the request of the trustees, the CMS Office of the Actuary developed an alternative analysis that provides an illustration of the potential understatement of current-law Medicare cost projections if the productivity adjustments are phased out and the physician payment reductions are overridden. The other ACA-related cost savings projected in the trustees' report, such as the savings projected from reducing the Medicare Advantage payment benchmarks, are also included in the alternative scenario. Although the illustrative alternative projections are not intended to be interpreted as the official best estimates of future Medicare costs, they do, as noted in the alternative analysis, "help to quantify and underscore the likely understatement of the current-law projections shown in the 2010 trustees' report." This issue brief presents projections based on both the current law and the illustrative alternative projections.[1]

The trustees conclude that, "While the projections in this year's [trustees'] report show a substantial improvement over last year's, they continue to demonstrate the need for timely and effective action to address Medicare's remaining financial challenges—including the projected exhaustion of the HI trust fund, this fund's long-range financial imbalance, and the issue of rapid growth in Medicare expenditures. Furthermore, if the lower prices payable for health services under Medicare are overridden, the financial challenges in the long range would be much more severe."

[1]Both the 2010 Medicare Trustees Report and the CMS Office of the Actuary's illustrative alternative scenario analysis are available at: http://www.cms.gov/ReportsTrustFunds/.

This issue brief examines more closely the findings of the trustees' report with respect to program solvency and sustainability. The American Academy of Actuaries' Medicare Steering Committee concludes that even with the enactment of ACA, the Medicare program faces serious financing problems. As highlighted in the 2010 Medicare trustees' report and its accompanying illustrative alternative analysis:

- As a result of newly enacted health reform legislation, the HI trust fund is projected to be depleted in 2029, 12 years later than projected last year.
- Despite the projected improvement in the HI trust fund's financial condition, the fund continues to face a serious long-term funding challenge. Except for the years between 2014 and 2021, HI expenditures are expected to exceed HI revenues. When the trust fund is projected to be depleted in 2029, tax revenues would cover only 85 percent of program costs.
- The projected HI deficit over the next 75 years is 0.66 percent of taxable payroll, down from last year's estimate of 3.88 percent. Eliminating this deficit would require an immediate 23 percent increase in payroll taxes or an immediate 15 percent reduction in benefits—or some combination of the two. Delaying action would require more drastic tax increases or benefit reductions in the future.
- The illustrative alternative projections show improvements to the HI trust fund compared with last year's report, but to a lesser extent than current-law projections. Under the alternative scenario, the HI trust fund would be depleted in 2028, and the 75-year HI deficit would be 1.91 percent of taxable payroll.
- The SMI trust fund is expected to remain solvent only because its financing is reset each year to meet projected future costs. Projected increases in SMI expenditures will require significant increases over time in beneficiary premiums and general revenue contributions over time. Under current-law projections, SMI spending is expected to grow from 1.9 percent of GDP in 2010 to 4.2 percent of GDP in 2080. Under the illustrative alternative scenario, however, SMI spending is expected to reach 6.8 percent of GDP in 2080—even greater than the 6.2 percent projected in last year's trustees' report.
- Total Medicare expenditures also are projected to increase as a share of GDP, thereby threatening Medicare's long-term sustainability. Under current-law projections, total Medicare spending as a share of GDP is expected to grow from 3.6 percent in 2010 to 6.4 percent in 2080. This is a much slower growth rate than projected in last year's report, when spending was projected to reach 11.2 percent in 2080. Under the illustrative alternative scenario, however, total Medicare spending is projected to reach 10.7 percent of GDP in 2080.

Medicare's financial condition has improved since last year, at least in the short term, due to the Medicare-related provisions in the ACA. Nevertheless, serious long-term challenges remain and must be addressed—especially when more realistic assumptions regarding future Medicare spending are incorporated into the projections.

The Medicare Steering Committee recommends that policymakers implement further reforms to improve Medicare's financial outlook. The sooner such corrective measures are enacted, the more flexible the approach and the more gradual the implementation can be. Failure to act now may necessitate far more onerous actions later.

MEDICARE FINANCING PROBLEMS

The Medicare program has three fundamental long-range financing challenges:

1. Income to the HI trust fund is not adequate to fund the HI portion of Medicare benefits;

2. Increases in SMI costs increase pressure on beneficiary household budgets and the federal budget;

3. Increases in total Medicare spending threaten the program's sustainability.

Each of these problems is discussed in more detail below.

Medicare HI Trust Fund Income Falls Short of the Amount Needed to Fund HI Benefits

Like the Social Security program, Medicare uses trust funds to account for all income and expenditures; and the HI and SMI programs operate separate trust funds with different financing mechanisms. Taxes, premiums, and other income are credited to the trust funds, which are used to pay benefits and administrative costs. Any unused income is required by law to be invested in U.S. government securities for use in future years. The trust fund assets represent loans to the U.S. Treasury's general fund. The HI trust fund, which pays for hospital services, is funded primarily through earmarked payroll taxes.

The trustees' report's projections of Medicare's financial outlook must be based on current law. Under these current-law projections, the financial condition of the HI trust fund has improved markedly since last year's trustees' report, due primarily to the Medicare-related provisions in the Affordable Care Act. The projected trust fund exhaustion date is 12 years later than in last year's report, and the 75-year HI deficit declined from 3.88 percent of taxable payroll to 0.66 percent.

- HI expenditures currently exceed HI revenues. Over the next few years, the gap is projected to narrow and HI revenues eventually are expected to exceed expenditures. Beginning in 2022, however, HI expenditures again are expected to exceed revenues, including interest income, and this deficit is projected to persist annually thereafter. At that time, the HI trust fund assets will need to be redeemed. If at that time the federal government is experiencing unified budget deficits, funding the redemptions will require that additional money be borrowed from the public, thereby increasing the federal debt.
- The HI trust fund is projected to be depleted in 2029. At that time, tax revenues are projected to cover only 85 percent of program costs, with the share declining to 76 percent in 2045, but then increasing to 89 percent by 2084. There is no current provision for general fund transfers to cover HI expenditures in excess of payroll tax revenues.
- The projected HI deficit over the next 75 years is 0.66 percent of taxable payroll. Eliminating this deficit would require an immediate 23 percent increase in payroll taxes, or a 15 percent reduction in benefits—or some combination of the two. Delaying action would require more drastic changes in the future.

Current-law projections, however, likely overstate the improvements to the Medicare HI trust fund. In particular, the scheduled reductions in provider payment rate updates to reflect productivity adjustments may not be sustainable in the long-term. At the request of the trustees, the CMS Office of the Actuary provided an illustrative alternative analysis that phases out the productivity adjustments gradually over 15 years, beginning in 2020.

- The illustrative alternative scenario projections show improvements compared with last year's trustees' report, but to a lesser extent than under the current-law projections. Under the alternative scenario, the HI trust fund would be depleted in 2028, one year earlier than under current-law projections, and the projected deficit over the next 75 years would be 1.91 percent of taxable payroll, nearly three times than that under current-law projections. Eliminating this deficit would require an immediate 66 per-

MEDICARE PROVISIONS IN THE AFFORDABLE CARE ACT

The Affordable Care Act (ACA) includes many provisions designed to reduce Medicare costs, increase Medicare revenues, and develop new health care delivery systems and payment models that improve health care quality and cost efficiency. Major provisions include:

- **REDUCTIONS TO PROVIDER PAYMENT UPDATES.** The annual updates for fee-for-service provider payment rates will be adjusted downward to reflect productivity improvements.
- **BASING MEDICARE ADVANTAGE PLAN PAYMENTS ON FEE-FOR-SERVICE RATES.** Medicare Advantage plan payments will be reduced gradually relative to fee-for service costs.
- **HEALTH CARE PAYMENT AND DELIVERY SYSTEM IMPROVEMENTS.** Pilot programs, demonstration projects, and other reforms will be implemented to increase the focus on delivering high quality and cost-effective care. These include initiatives on bundled payments and accountable-care organizations.
- **INCREASES IN MEDICARE REVENUES.** Provisions to increase Medicare revenues include: increasing the HI payroll tax for earnings above an unindexed threshold, temporarily freezing the income thresholds for Part B income-related premiums, and increasing Part D premiums for higher-income beneficiaries.
- **CREATION OF THE INDEPENDENT PAYMENT ADVISORY BOARD (IPAB).** Beginning in 2014, the board will submit recommendations to make changes to provider payments if Medicare spending exceeds a target per capita growth rate. Unless legislative action overrides the recommendations, they will be implemented automatically.

The net improvement in Medicare's financial condition in this year's Medicare trustees' report compared to last year's report relies on these provisions being implemented and sustained over time. The largest component of the ACA's net Medicare savings results from the downward adjustments to provider payment updates to reflect productivity improvements. The trustees recognize, however, that these adjustments may be difficult to sustain in the long-term and Congress could face mounting political pressure to override them. As a result, the long-term net improvement in Medicare's financial condition could be overstated in the trustees' report projections. On the other hand, the trustees' report does not include any specific savings for the ACA initiatives related to the development and implementation of new models for delivering and paying for health care. These new models have the potential to reduce Medicare cost growth, perhaps significantly.

cent increase in payroll taxes, or a 33 percent reduction in benefits—or some combination of the two.

Increases in SMI Costs Increase Pressure on Beneficiary Household Budgets and the Federal Budget

The SMI trust fund includes accounts for the Part B program, which covers physician and outpatient hospital services, and the Part D program, which covers the prescription drug program. About one-quarter of SMI spending is financed through beneficiary premiums, with federal general tax revenues covering the remaining three-quarters.[2]

The SMI trust fund is expected to remain solvent because its financing is reset each year to meet projected future costs. As a result, increases in SMI costs will require increases in beneficiary premiums and general revenue contributions. Increases in general revenue contributions put pressure on the federal budget. Increases in premiums put pressure on beneficiaries, especially when considered in conjunction with increasing beneficiary cost-sharing expenses.

[2]Part B beneficiaries pay monthly premiums covering about 25 percent of program costs; general revenues cover the remaining 75 percent of costs. Part D premiums are set at about 25 percent of Part D costs. Because of low-income premium subsidies, however, beneficiary premiums will cover only approximately 11 percent of total Part D costs in 2011. State payments on behalf of certain beneficiaries will cover approximately 11 percent of costs and general revenues will cover the remaining 78 percent of costs.

The 2010 trustees' report projects that under current law, SMI costs will grow more slowly than was projected under prior estimates, thereby narrowing the gap between SMI growth and the growth in GDP. SMI expenditures are projected to grow from 1.9 percent of GDP in 2010 to 3.1 percent of GDP in 2030 and 4.2 percent of GDP in 2080. This compares favorably to faster growth rates in the 2009 trustees' report, in which SMI spending was projected to reach 3.7 percent of GDP in 2030 and 6.2 percent of GDP in 2080.

The reductions in SMI growth result primarily from reductions in Part B growth. These are due in turn to provisions in the ACA related to reductions in payment updates for most non-physician services and reductions in the payment benchmarks for Medicare Advantage plans. As in the 2009 trustees' report, the 2010 report also assumes that physician payments will be reduced in accordance with the sustainable growth rate (SGR) mechanism specified in current law.[3]

The current-law projections likely overstate the reductions in Part B spending. Given that SGR-related physician payment reductions have been overridden every year since 2003, the likelihood of future reductions taking effect in full is low. In addition, the scheduled reductions in non-physician provider payment rate updates to reflect productivity adjustments may not be sustainable in the long term. The CMS Office of the Actuary's illustrative alternative analysis sets physician payment updates according to the increase in the Medicare Economic Index, which averages approximately 2 percent per year, rather than assuming that the SGR-related reductions take effect. In addition, the alternative analysis assumes a phasing out the productivity adjustments gradually over 15 years, beginning in 2020. The Part D projections are relatively unchanged between the 2009 and 2010 trustees' reports and the alternative scenario projections make no changes to the current-law Part D projections.

Under the illustrative alternative scenario projections, SMI spending would increase to 3.9 percent of GDP in 2030 and 6.8 percent of GDP in 2080. Because the alternative projections effectively eliminate the SGR-related payment reductions that are assumed to take effect in the 2009 trustees' report projections, the alternative SMI spending projections exceed not only the projections in the 2010 trustees' report, but also those in the 2009 trustees' report.

Table 1: SMI Expenditures as a Percent of GDP

Calendar Year	2009 Report (prior law)	2010 Report (current law)	2010 Alternative Projection
2010	1.8	1.9	1.9
2020	2.5	2.3	2.7
2030	3.7	3.1	3.9
2040	4.4	3.5	4.7
2050	4.9	3.7	5.2
2060	5.4	3.9	5.8
2070	5.9	4.1	6.4
2080	6.2	4.2	6.8

Sources: 2009 Medicare Trustees Report, 2010 Medicare Trustees Report, CMS Office of the Actuary

Increases in Total Medicare Spending Threaten the Program's Sustainability

A broader issue related to Medicare's financial condition is whether the economy can sustain Medicare spending in the long run. To gauge the future sustainability of the Medicare program, we examine the share of GDP that will be consumed by Medicare. Because Medicare spending is expected to continue growing faster than GDP, greater shares of the economy will be devoted to Medicare over time, meaning smaller shares of the economy will be available for other priorities.

According to the current-law projections,

[3]The sustainable growth rate (SGR) system was enacted as part of the Balanced Budget Act of 1997 to limit the growth in spending for physician services. The system compares actual cumulative spending to a specified spending target. If actual spending exceeds the target, then physician payment updates are adjusted downward. A cumulative reduction of 30 percent is estimated over the next three years.

Medicare expenditures as a percentage of GDP will grow more slowly compared to last year's report. Total Medicare spending, projected in the 2009 trustees' report to triple from 3.5 percent of GDP in 2010 to 11.2 percent of GDP in 2080, is projected in the 2010 trustees' report to grow to only 6.4 percent of GDP in 2080. Under the CMS Office of the Actuary alternative scenario, however, total Medicare expenditures would increase to 10.7 percent of GDP in 2080. This would be only a moderate improvement from the 2009 trustees' report projections.

Table 2: Total Medicare Expenditures as a Percent of GDP

Calendar Year	2009 Report (prior law)	2010 Report (current law)	2010 Alternative Projection
2010	3.5	3.6	3.6
2020	4.5	3.9	4.3
2030	6.4	5.1	6.0
2040	8.0	5.8	7.3
2050	8.7	5.9	8.2
2060	9.6	6.1	9.0
2070	10.5	6.3	9.9
2080	11.2	6.4	10.7

Sources: 2009 Medicare Trustees Report, 2010 Medicare Trustees Report, CMS Office of the Actuary

DISCUSSION

The Affordable Care Act contains many provisions designed to reduce Medicare costs, increase Medicare revenues, and develop new health care delivery systems and payment models that improve health care quality and cost efficiency. The 2010 Medicare trustees' report confirms that the implementation of these provisions can improve Medicare's finances and can help restore the program's long-term solvency and sustainability.

Even with the successful implementation of ACA, however, long-term challenges remain. The HI trust fund is projected to be depleted in 2029, and Medicare spending will continue to grow faster than the economy—increasing the pressure on beneficiary household budgets and the federal budget and threatening the program's sustainability. Policymakers need to take further action to address these problems.

In addition, Medicare's financial challenges are likely to be much more severe than projected in the trustees' report. The report's Medicare spending projections are understated to the extent that the ACA's downward adjustments in provider payment updates to reflect productivity improvements are unsustainable in the long-term and currently scheduled reductions in physician payments are likely to be overridden by Congress as they have been many times previously. If Medicare projections are calculated using assumptions that productivity adjustments are phased out and physician payment reductions are overridden, improvements to Medicare's financial condition are shown to be more modest.

The American Academy of Actuaries' Medicare Steering Committee continues to raise deep concerns about Medicare's financing problems, even under the current-law projections, and recommends that policymakers implement changes to further improve Medicare's financial outlook. Policymakers should work to ensure that the ACA provisions are implemented successfully and that promising approaches and demonstration projects are adopted on a broad scale in a timely manner. Although much has been done to help improve Medicare's long-term solvency and sustainability, even more is needed. Further actions must be taken to address Medicare's financial challenges that would remain even under the more favorable current-law scenario.

We agree with the 2010 trustees who state in their report:

Consideration of such further reforms should occur in the near future. The sooner the solutions are enacted, the more flexible and gradual they can be. Moreover, the early introduction of reforms increases the time available for affected individuals and organizations—including health care providers, beneficiaries, and taxpayers—to adjust their expectations. We believe that prompt action is necessary to address these challenges.

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