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Solutions to Social Security's and Medicare's Financial Problems

American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

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This paper was prepared by the Academy's Committee on Social Insurance, whose charge is provide and promote actuarial reviews and analyses of United States social insurance systems. The committee consists of actuaries knowledgeable about the details of various social insurance programs and the nuances of individual programs. The report presents potential solutions to the financing problems facing the Social Security and Medicare programs. The purpose of this report is to draw attention to those proposals with the greatest potential to solve the financing problems of the two programs. The intent is not to support a particular proposal, but to provide a clear, objective analysis of the options, intended to assist the public policy process.

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This monograph was produced through the American Academy of Actuaries, under the supervision of Assistant Director of Public Policy Christine M. Cassidy and Director of Public Policy Gary Hendricks.

Wilson W. Wyatt, Jr., Executive Director

Gary Hendricks, Director of Public Policy

Christine M. Cassidy, Assistant Director of Public Policy

Ken Krehbiel, Associate Director of Communications

American Academy of Actuaries

1100 Seventeenth Street NW 7th Floor

Washington DC 20036

Tel (202) 223-8196

Fax (202) 872-1948

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Overview and Recommendations

This paper presents and evaluates several potential solutions to the financing problems facing the Social Security and Medicare programs. Our purposes are (1) to draw attention to those proposals with the greatest potential for solving the financing problems and (2) to describe other proposals that have little potential to solve these problems but that may be widely debated. We believe that the debate should focus on proposals in the first group. This paper is intended as an objective analysis of potential solutions; it is not intended to favor any particular position.

The federal government operates a number of social insurance programs. The two largest such programs are Social Security and Medicare. Social Security consists of the Old-Age, Survivors, and Disability Insurance (OASDI) programs, which provide protection against the loss of earnings due to retirement, death, or disability. The Medicare program consists of the Hospital Insurance (HI) and the Supplementary Medical Insurance (SMI) programs, which, combined, provide a basic level of health insurance for the elderly and the disabled.

The Social Security program was designed with the following characteristics: (1) benefits are based on a balance between "individual equity" and "social adequacy," (2) financing from, or on behalf of, participants makes the program "self-supporting" and gives participants an "earned right" to benefits without a "means test," and (3) participation is mandatory. Most proposed changes would retain these characteristics. But some would not.

Nearly all Americans participate in the Social Security and Medicare programs and have a clear interest in their financial viability. Many are aware that financial problems are projected for each program. This paper summarizes the financial status of each program based on information provided in the 1995 Trustees Reports. These reports, which are published every year, describe the financial viability of the programs. The OASDI and HI programs are evaluated on the basis of 75-year projections, while the SMI program is evaluated on the basis of a determination of the adequacy of the current premium. To determine whether the OASDI or HI programs are expected to have income that is reasonably close to the expected cost over the next 75 years, tests of "long-range close actuarial balance" are applied.

The failure of any program to pass this test does not necessarily mean that insolvency is imminent. Rather, the test provides a warning to policy makers that changes are necessary to preserve the financing of the program in the long run.

The American Academy of Actuaries Committee on Social Insurance believes that the warning provided by these tests of long-range actuarial balance is strong enough that Congress should act now to bring these programs back into long-range balance. This would allow changes to be phased in and give workers sufficient time to adjust their personal savings habits such that they will be able to maintain a desired standard of living in retirement. A delay will limit the options for change and require that such changes be made with less notice, precipitating economic dislocations and resentment, and making the benefits less predictable.

Summary of the Financial Status of Social Security and Medicare

The OASDI programs are essentially financed on a pay-as-you-go basis; current taxes are used to provide current benefit payments. The retirement of the baby boom generation will greatly increase the growth of benefit payments, while simultaneously reducing the growth of payroll tax collections.

In 1995, the payroll tax rate for the OASDI program is 12.4 percent (6.2 percent paid by employers and 6.2 percent by employees). This tax rate is not scheduled to increase. In addition to the payroll tax, the OASDI program receives income from the taxation of Social Security benefits. This is currently equivalent to a payroll tax of 0.18 percent and is estimated to increase gradually to 0.93 percent by 2070. The program also receives interest income from Trust Fund assets. The cost of benefits and administrative expenses of the OASDI program in 1995 is estimated to be equivalent to 11.5 percent of payroll. Thus, at present the program's tax revenue exceeds its costs, and this is contributing to the current increases in the OASDI Trust Funds.

However, the benefit payments and administrative costs are projected to increase more rapidly than income, first exceeding tax income in 2013. This excess of expenditures over income will eventually deplete the Trust Funds, which are projected to be exhausted in 2030. At that point, full benefit payments could not be made on a timely basis. According to the 1995 Trustees Report (using "intermediate" economic assumptions), the OASDI program's income will be sufficient to pay only 86 percent of the program's costs over the next 75 years and only 73 percent of its costs over the last 25 years of that period. To illustrate the long-range imbalance, consider the year 2070; then expenditures are projected to be equivalent to about 19 percent of payroll, while the tax rate plus the income from taxation of benefits are projected to be about 13 percent.

The HI program (or Medicare Part A) is in the most urgent need of changes in order to preserve its financial viability. Already, in 1995, the cost of benefits and administrative expenses exceeds the income from payroll taxes and the taxation of benefits (3.3 percent versus 3.0 percent). The HI Trust Fund will soon start to diminish and is projected to be exhausted in 2002. According to the 1995 Trustees Report (intermediate assumptions), the HI program's income will be sufficient to pay only 47 percent of the program's cost over the next 75 years and only 35 percent of its costs over the last 25 years of that period. To illustrate the long-range imbalance, in 2070, expenditures are projected to be about 10 percent of payroll, while the tax rate plus the taxation of benefits are projected to be about 3 percent.

The SMI program (or Medicare Part B) does not have a separate payroll tax. Rather, it is financed through direct premiums from the program participants and contributions from general revenues. Because it is redetermined each year, the financing of this program is adequate, and a long-range test of financial adequacy does not apply. However, SMI expenditures are projected to triple during the next 10 years, from $60 billion in 1994 to $182 billion in 2004. These increases will have a dramatic impact on Federal budget outlays. Based on the President's 1996 Federal budget, SMI expenditures will rise from 4.3 percent of Federal outlays in FY 1995 to 6.0 percent in FY 2000. Immediate reforms are needed to control these rapidly increasing costs.

Those wishing to learn more about the financial condition of the Social Security and Medicare programs can obtain copies of the OASDI Trustees Report by calling 410-965-3015 and the HI and SMI Trustees Reports by calling 410-966-6386.

Solutions to Social Security's Financial Problems

Assuming that the existing structure of the OASDI program is maintained, there are only two basic options for restoring financial soundness: increase tax income, or reduce benefit outgo. Some combination of tax changes and benefit changes will likely be enacted, so the "pain" entailed in any reform is shared by workers and beneficiaries.

Tax Changes

1. **Increase the payroll tax.**

   Payroll tax rates (FICA and SECA) have been raised many times in the past. Currently, the tax rate for Social Security is 12.4 percent, split equally between employers and employees. **In theory, changes to the tax rate could solve as much of the long-range problem as policy makers choose.** Furthermore, the changes could be tailored to meet Social Security's cash-flow needs, thereby ameliorating the effects of building up and then drawing down, the trust funds. Also, the income rate at the end of the 75-year projection period could be very close to the cost rate then.

2. **Increase the limit on taxable earnings.**

   About 85-90 percent of earnings in covered employment are below the current limit on taxable earnings of $61,200. **Removing the limit for employees and employers could solve about half of the long-range financial problem**, even though the additional tax income would be partly offset by increased benefit costs if all covered earnings continued to be creditable for benefit-computation purposes. Removing the limit on just the employer tax, without increasing benefits, would offset about one-half of the long-range financial problem.

   However, the revenue that could be raised by such proposals would not track Social Security's needs very well, because income would increase immediately (when it is not needed), and the increased income in later years (when it is needed most) would be partially offset by higher benefits.

   Thus, these proposals would leave in place the current pattern of trust fund build-up and draw-down, although the year of fund exhaustion would occur much later. Finally, continuing to base benefits on all covered earnings raises questions as to the appropriate role of government in providing very high retirement benefits to workers with the highest incomes.

3. **Increase taxation of benefits.**

   Most of the benefits (up to 85 percent) will eventually be subject to income tax under current law. Most of the income raised through this benefit taxation is returned to the Social Security program, although a substantial portion is transferred to Medicare. The additional revenue that could be raised through additional benefit taxation is relatively modest, although, **together with a reallocation of Medicare's portion to Social Security, the total could meet nearly one-fourth of Social Security's long-range deficit** (while, however, making Medicare's worse). Taxation of benefits can be viewed as a benefit cut, rather than a tax. Also, it can be regarded as an alternative to a means test that preserves the "earned right" to benefits but treats them more like private pensions.

4. **Expand coverage.**

   This tried-and-true method of generating additional income has at this point, little potential for solving Social Security's projected long-range problem today. The remaining noncovered groups are small and very difficult to cover, for a variety of reasons, including constitutional concerns, because most noncovered employees work for religious organizations or state and local governments. **If all of the noncovered groups could be covered, the effect would be to eliminate about one-tenth of the long-range deficit.**

Benefit Changes

1. **Raise the retirement age.**

   The normal retirement age is already scheduled to increase gradually to age 67, starting after the turn of the century. The timing of these increases could be accelerated, and the ultimate age could be raised even higher.

   Such proposals track Social Security's financial needs quite well, because (1) they reduce benefit payments substantially and (2) the reductions in benefits occur just when they are needed. **Raising the normal retirement age gradually to age 70 for beneficiaries reaching that age in 2037 and later would solve about half of Social Security's long-range problem.**

   Such a proposal could save somewhat more if the early-retirement age (currently, age 62) were also raised. If the early-retirement age were not raised, the effects on benefit adequacy of greater actuarial-reduction factors becomes an important issue. Increasing the normal retirement age, while retaining the current earliest retirement age is tantamount to reducing benefits, because benefits would be available at the same ages after the change but at a reduced amount at each age.

2. **Reduce cost-of-living adjustments (COLAs).**

   The current annual cost-of-living increase–based on 100 percent of CPI—could be reduced or limited to some

portion of the total benefit (fully protecting low-income beneficiaries). This could save a considerable amount of money; the exact amount would depend on the details of the proposal. For example, **reducing each future COLA by 1 percentage point would eliminate about two-thirds of the long-range deficit.**

The timing of the savings would not track Social Security's needs well, however, because the savings would be a relatively constant percentage of benefits, while the need for such savings is greatest at the end of the long-range period. These proposals would also result in a "longevity penalty": benefits would be able to purchase less and less as beneficiaries age.

3. **Change the initial benefit formula.**

The percentages used in the formulas to compute initial benefit amounts could be reduced, either across-the-board or in some way that protects low-income beneficiaries. **This type of change can produce almost any desired amount of savings**, and, if the change were phased in, it could be timed to coincide with Social Security's needs. Adequacy issues should not be ignored, however; currently, the average Social Security benefit is only slightly higher than the poverty level for the aged. So reductions in the benefit formula can be too drastic, making monthly benefits inadequate for a substantial proportion of the beneficiary population.

4. **Switch to price-indexing of the initial benefit formula.**

The current wage-indexing could be replaced by price-indexing (based on the CPI). Looking back, it appears that over many periods of time, **price-indexing would have saved money**; but its effects are unpredictable. Over some periods, it would have cost money, and these tend to occur when the economy is struggling and Social Security's financing worsens.

OTHER ALTERNATIVES

Another alternative would not directly affect taxes or benefits, but would have a bearing on Social Security's financing problem:

1. **Change the investment procedures.**

Currently, the assets of the Social Security trust funds are invested in U.S. Government bonds, as required by law. Those bonds pay market rates of interest. But many analysts believe that greater returns could be achieved, on average, in the more volatile equity markets. Investment procedures could be changed to allow such investment, with appropriate safeguards against market manipulation through, for example, the use of indexed funds.

Still, the vast sums involved under the present-law tax rates could have unintended effects on the equity markets. Of course, **the potential additional income from changing the investment procedures would depend on the size of the fund.** If the program were returned to pay-as-you-go financing, the additional income would be trivial compared to the size of the long-range deficit.

A fourth group of proposals would involve changing some of Social Security's basic principles. These include:

1. **Partial or complete privatization.**

Chile privatized its social security system in 1981 (although certain government guarantees were left in place for low-income individuals and in the event of adverse experience with investments). The changes put into effect there are often cited as a model for changes that could be made in the United States. These changes could create a large unfunded liability that the federal government would still be responsible for. A less extreme variation on this idea is to divert the "extra" payroll taxes being collected today (above what is needed to meet current obligations) to IRA-type accounts. In a sense, this latter proposal is another way to modify the program's investment procedures, by placing a percentage of the accumulating assets in the private sector. Of course, **an important difference is that the private-sector accounts would be owned by the individuals contributing to them, and the funds would not be available to meet the needs of future beneficiaries who had not contributed**.

Thus, this change would shift the program's balance toward individual equity and away from social adequacy.

2. **General revenue financing.**

Many social insurance programs in other countries receive some financing from the general treasury, and that approach could be adapted to the United States Social Security program. General revenue financing would require significantly higher income tax collections. Alternatively, nonpayroll-based taxes, such as value-added taxes (VATs), can be earmarked for the program.

Although such proposals could solve Social Security's financing problems completely, they would compromise the basic principle of a "self-supporting" program that is financed by participants who "earn" their right to benefits.

3. **Means test.**

Rather than reducing benefits a little for most or all beneficiaries, comparable savings could be achieved by greatly reducing or even eliminating benefits to much smaller groups of otherwise eligible people who have income or assets above specified thresholds. **These proposals would also compromise the concept of an "earned right"** to benefits and shift the program's philosophical balance toward social adequacy, and away from individual equity.

With respect to proposals that would increase the program's income, the two with the greatest potential impact are (1) increasing the payroll-tax rate and (2) increasing the limit on taxable earnings. With respect to proposals that would

reduce the program's outgo, the three with the greatest potential effect are (1) raising the retirement age, (2) reducing the cost-of-living increases, and (3) changing the initial benefit formula.

In conclusion, Social Security's long-range deficit could be eliminated by the enactment of one or more of the proposals described above. Putting a solution into place now, rather than later, would restore the public's confidence in the program and provide time for individuals planning their retirement to accommodate the changes.

Solutions to Medicare's Financial Problems

The financing of the Supplementary Medical Insurance (SMI) program is considered adequate because the funding from premiums and general revenues is increased automatically each year to whatever level is necessary. General revenue contributions to the SMI program have increased by about 7 percent per year during the last five years and are projected to increase by about 15 percent per year during the next five years, under present law. These increases in general revenue contributions to the SMI program could be delayed by slowing the growth of benefit outlays (in a manner similar to the reductions specified below for the HI program) or by increasing the percentage of the program's cost covered by premiums from participants.

When the SMI program became effective in FY 1967, the premium paid by beneficiaries was set to cover 50 percent of the program's cost. During the 1970s, premium increases were limited by the percentage increases in Social Security benefits; as a result the premium gradually covered less and less of the program's cost. When the proportion reached 25 percent, the law was changed to keep it at 25 percent. During the last five years, the SMI premium was set by law (rather than by formula), and the proportion of the program's cost covered by the premium has increased (unexpectedly) to about 32 percent. Next year, the premium will once again be set by formula, so that it covers 25 percent of the program's cost.

Maintaining the 32-percent level, or gradually increasing the level back to the initial 50 percent, would significantly reduce the general revenue contributions to the SMI program. The only other way to increase income to the SMI program, from sources other than general revenue, is to impose new earmarked taxes.

The HI program requires immediate action to bring income and outlays into balance: increasing income, reducing benefit payments, or some combination of both.

Compared with Social Security, there are not as many options with HI for increasing tax income. Although the Social Security program can obtain significant additional income by raising the limit on taxable earnings, the limit has already been eliminated for HI. With the recent increase in the taxation of Social Security benefits, little additional money could be obtained from proposals to increase such taxation further.

However, the average value of Medicare benefits could, theoretically, be taxed like Social Security benefits. Elimination of the income thresholds below which benefits are not taxed would raise significant additional money in the short run. However, the long-range effect would be small if the thresholds remain frozen, thereby diminishing in real terms because of the effects of inflation. The money earmarked for the Social Security Trust Funds could be redirected to the HI Trust Fund, thus improving the financing of the HI program at the expense of the Social Security program.

Little additional money could be obtained from expanding coverage to new groups, because the number of individuals involved is small. In addition, the largest noncovered population consists of state and local employees hired before April 1986 and not already covered by Social Security, a group that is shrinking and will eventually disappear.

One option that would significantly boost the income to the HI Trust Fund is an increase in the tax rate. An immediate increase of 0.7 percentage points (from the current tax rate of 1.45 percent each for employers and employees to 2.15 percent) would fund the program for the next 25 years. However, the tax rate would have to climb to 4.5 percent each to be sufficient to fund the program during the last 25 years of the 75-year long-range projection period.

General revenue financing and means testing are two additional options for increasing HI program income. However, these would involve changing some of Medicare's basic principles, as described above for Social Security.

Options for Reducing Benefit Payments for HI and SMI

1. **Increase the age of eligibility.**

   The normal retirement age for Social Security is already scheduled to increase to 67, while Medicare's age of eligibility will remain at age 65. Medicare was designed to provide benefits after retirement, with individuals and their employers responsible for health care before retirement. Increasing the age of eligibility for Medicare to the normal retirement age for Social Security would be consistent with this original design, although a significant number of individuals who retire early might not be covered by any health insurance. If Medicare were to increase the age of eligibility to age 67, it would eliminate a small amount of the deficit. However, **if the normal retirement age for Social Security were to be increased to age 70, and Medicare's eligibility age increased as well, a significant portion of Medicare's long-range deficit would be eliminated.**

2. **Eliminate some covered services.**

   Medicare is limited to coverage of services necessary for treatment of a disease or injury; it does not cover prescription drugs or long-term care. However, there are some services now covered by Medicare that could be considered not medically necessary for the treatment of illness or injury. Medicare HI payments for nursing homes and home health care agencies, services often associated with long-term care, and SMI payments for durable medical equipment, have been growing rapidly. **Terminating coverage of these services would solve about two-fifths of HI's long-range deficit.**

3. **Increase the beneficiaries' share of the cost.**

The beneficiaries' share of the cost could be increased through increased deductibles and coinsurance. Theoretically, **the beneficiaries' share of the cost could be increased as much as necessary to eliminate the deficit.** If the increased cost-sharing were not covered by Medigap insurance, utilization could be expected to drop in response. But the savings from reduced utilization would be relatively small and would affect mostly SMI.

4. **Increase recoveries from other insurance (to reduce Medicare's share of the cost).**

Under current law, Medicare is frequently a secondary payer to other forms of health insurance such as employer-sponsored insurance, auto liability insurance, workers' compensation, and Veterans Administration benefits. For employer-sponsored insurance, Medicare is the primary payer for retirees (who are not covered as family members of active employees) and for active employees of small firms. **Stricter enforcement of present law, or expansion of the circumstances under which Medicare is considered the secondary payer, could reduce Medicare's cost.**

5. **Slow the growth of overall payments, or reduce payment rates to providers.**

The rates at which Medicare reimburses providers through DRGs and the RBRVS fee schedule could be reduced or the annual increases limited. Constraints in reimbursements have been implemented throughout the history of Medicare, the magnitude of reductions reflecting a balance between fiscal requirements of Medicare and impact on providers.

However, the constraints implemented to date have proved inadequate for restoring Medicare to solvency. Major reductions in growth would be needed, which could severely disrupt the providers. For example, **hospital reimbursement would be required to grow by only about 1 percent (less than the rate of inflation) for each of the next 25 years to maintain solvency over the 25-year time period.** Such changes should be consistent with overall health reimbursement policy and with the practices of other payers.

6. **Managed Care.**

Evidence indicates that well-designed managed care programs can reduce utilization by eliminating unnecessary care and by providing necessary care more efficiently. Whether managed care will in fact save money or not depends on the specifics of any proposal. In addition, managed care raises concerns about the quality of care and entails higher administrative expenses.

Nevertheless, several government programs use managed care to achieve savings relative to an unmanaged program, including some State Medicaid programs and CHAMPUS. Programs can be structured to provide beneficiaries with a wide range of choice as to how much managed care they are willing to live with.

Medicare has entered into risk-based contracts with HMOs and CMPs, in an attempt to use managed care to reduce costs. However, these contracts appear to result in greater costs to Medicare, not less. **These contracts could be restructured to save money by incorporating the following characteristics**, which also include some of the changes proposed above:

- Through a competitive bidding process, place an insurance organization(s) (that is concerned about cost) between Medicare and *all* the beneficiaries in an area.
- Lock in the choices of the beneficiaries (for a one-year period) and of the insurance organization (for a given-year period) to reduce adverse selection.
- Share the risk and the profit with the insurance organization.
- Revise Medicare's deductibles, coinsurance, and premium structure to increase the beneficiary's share of the cost on average while still providing incentives for beneficiaries to enroll in managed care programs.

Because these organizations will be at risk, they will be motivated to reduce utilization through managed-care techniques, and in addition will aggressively pursue provider discounts and third-party liabilities, thereby producing additional savings for Medicare. There may, however, be increases in administrative costs, because insurance organizations typically have higher administrative costs than the Medicare program, and because quality-of-care concerns will necessitate greater monitoring.

7. **Vouchers.**

In a voucher system, each beneficiary would receive a voucher to purchase private insurance coverage. The system could be designed so as to spend any targeted level of money, simply by specifying the face amount of the voucher.

Many issues would need to be considered, including the size of the voucher, relative ease of access to insurance, ability to purchase adequate insurance, reinsurance pools, health status, age, sex, geographic location, possibility of adverse selection decisions as to a voluntary or a mandatory system, and the ability of the elderly to make decisions about insurance. **The financial impact of a voucher system depends on its provisions.**

At one extreme, it could save money at the expense of the beneficiaries. At the other extreme, its design could increase Medicare expenditures. In either case, the cost of administration should not be overlooked. Insurance organizations have typically operated at considerably higher administrative costs than the Medicare program.

8. Medical Savings Accounts.

A novel approach to increase beneficiary cost-consciousness, and thereby decrease utilization, could result in significant savings to Medicare. The idea is to change the Medicare program so that it makes a fixed sum of money, e.g., $3,200, available to each beneficiary annually. This would be used to pay 80 percent of the beneficiary's first $4,000 of medical expenses. Then, Medicare would provide catastrophic coverage for any annual medical expenses above $4,000 in a given year. If a beneficiary did not incur $4,000 of medical expenses in a year, the balance in the account would roll over into an IRA. **For further discussion on this issue, refer to the Academy monographs on Medical Savings Accounts.**

In conclusion, Medicare's short-term and long-range financial viability could be restored by the enactment of some combination of the proposals described above. Any delay however, will only decrease the number of possible options and increase the abruptness of changes when they are introduced.

American Academy of Actuaries
1100 Seventeenth Street NW
7th Floor
Washington, DC 20036
202 223 8196
FAX 202 872 1948