

### Key Points

Using assumptions based on benefits and revenues scheduled under current law, the 2012 trustees' report projects:

- The HI trust fund will be depleted in 2024, the same as projected last year.
- HI expenditures are expected to exceed HI revenues for every year in the projection period.
- The 75-year deficit is 1.35 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 slightly earlier in 2024, and the 75-year deficit would be 2.43 percent of taxable payroll.

### Additional Resources

An Actuarial Perspective on Proposals to Improve Medicare's Financial Condition: [http://www.actuary.org/pdf/Medicare\\_Financial\\_IB\\_Final\\_051211.pdf](http://www.actuary.org/pdf/Medicare_Financial_IB_Final_051211.pdf)

Revising Medicare's Fee-For-Service Benefit Structure: [http://www.actuary.org/pdf/health/Medicare\\_Fee\\_Struc\\_Issue\\_Brief\\_022712.pdf](http://www.actuary.org/pdf/health/Medicare_Fee_Struc_Issue_Brief_022712.pdf)

A Guide to Analyzing the Issues: What Voters Should Know About Medicare: <http://www.actuary.org/pdf/health/Campaign%202012%20Medicare%20FINAL%20042312.pdf>

## 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. Medicare plays a critically important role in ensuring access to health care among Americans age 65 and older and certain younger adults with permanent disabilities. The program is operated through two trust funds. The HI trust fund (Medicare Part A) pays primarily for hospital services. The SMI trust fund includes accounts for the Medicare Part B program, which covers physician and outpatient hospital services, and the Medicare 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 recognizes the important contribution that members of the actuarial profession have made in preparing the report and educating the public about the important issues surrounding the program's solvency and sustainability.

The projected financial condition of Medicare as identified in the 2012 Medicare trustees' report has deteriorated compared with the projections from the 2011 report. While the year in which the HI trust fund is projected to be depleted, 2024, has not changed since last year's report, the 75-year HI deficit increased from 0.79 percent of taxable payroll in last year's report to 1.35 percent of taxable payroll in the 2012 report. This deterioration is due to fast-

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er projected increases in HI expenditures for other than inpatient hospital services that are only partially offset by slower increases in expenditures for inpatient hospital services or by reduced expenditures expected under the Budget Control Act of 2011.<sup>1</sup> HI expenditures are projected to exceed HI revenues in every year of the 75-year projection period. Total Medicare expenditures will make up an increasing share of federal outlays and the gross domestic product (GDP).

As required by statute, 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 understate the seriousness of Medicare's financial condition. In the Statement of Actuarial Opinion that accompanies the trustees' report, Richard Foster, the chief actuary of the Centers for Medicare & Medicaid Services (CMS), specifically notes that actual Medicare expenses are likely to exceed the current-law projections. He states, "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. Current law requires downward adjustments in payment updates for most non-physician providers 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 considered likely to be overridden by Congress (i.e., the Medicare "doc fix").

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 down and the physician payment reductions are overridden. 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 2012 Trustees Report." This issue brief presents projections

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<sup>1</sup>The Budget Control Act of 2011 is expected to require a 2 percent reduction in payments to Medicare providers and Medicare private plans from February 2013 through January 2022.

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based on both current law and the illustrative alternative projections.<sup>2</sup>

**The trustees conclude: “The projections in this year’s [trustees’] report 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 could not be sustained, then these further policy reforms would have to address much larger financial challenges than implied by the current law projections.”**

This issue brief more closely examines the findings of the trustees’ report with respect to program solvency and sustainability. The American Academy of Actuaries’ Medicare Steering Committee concurs that the Medicare program faces serious financing problems. As highlighted in the 2012 Medicare trustees’ report and its accompanying illustrative alternative analysis:

- The HI trust fund is projected to be depleted in 2024, the same as projected in last year’s report.
- The HI trust fund faces serious long-term funding challenges. HI expenditures are expected to exceed HI revenues in all future years. In the year that the trust fund is projected to be depleted—2024—tax revenues would cover only 87 percent of program costs.
- The projected HI deficit over the next

75 years is 1.35 percent of taxable payroll.<sup>3</sup> Eliminating this deficit would require an immediate 47 percent increase in payroll taxes or an immediate 26 percent reduction in benefits—or some combination of the two. Delaying action would require more drastic tax increases or benefit reductions in the future.

- Under the illustrative alternative scenario, the HI trust fund would be depleted a few months earlier in 2024 and the 75-year HI deficit would be 2.43 percent of taxable payroll.
- The SMI trust fund is expected to remain solvent 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. Under current-law projections, SMI spending is expected to grow from 2.0 percent of GDP in 2011 to 4.0 percent of GDP in 2085. Under the illustrative alternative scenario, SMI spending is expected to reach 6.0 percent of GDP in 2085.
- 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 3.7 percent in 2011 to 6.7 percent in 2085. Under the illustrative alternative scenario, total Medicare spending is projected to reach 10.3 percent of GDP in 2085.

<sup>2</sup>Both the 2012 Medicare Trustees Report and the CMS Office of the Actuary’s illustrative alternative scenario analysis are available at: <http://www.cms.gov/ReportsTrustFunds/>.

<sup>3</sup>The current HI payroll tax rate is 1.45 percent of taxable earnings, payable by both employees and their employers for a total of 2.90 percent. Self-employed individuals pay both shares. Beginning in 2013, earnings exceeding \$200,000 for individuals and \$250,000 for married couples filing jointly are subject to an additional HI tax of 0.9 percent.

**Because Medicare plays a critically important role in ensuring that older and certain disabled Americans have access to health care, the American Academy of Actuaries' Medicare Steering Committee urges action to restore the long-term solvency and financial sustainability of the program. The sooner such corrective measures are enacted, the more flexible the approach and the more gradual the implementation can be. Failure to act now will necessitate far more drastic 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 Social Security, Medicare relies on trust funds to account for all income and expenditures. The HI and SMI programs operate separate trust funds with different financing mechanisms. General revenues, payroll 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. In effect, 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 projections of Medicare's financial outlook in the trustees' report must be based on current law. Under these current-law projections, the financial condition of the HI trust fund has deteriorated since the 2011 trustees' report. This deterioration results from faster projected increases in HI expenditures for other than inpatient hospital services and a higher rate of increase in expenditures in the long range. Although the projected trust fund exhaustion date is the same as in last year's report, the 75-year HI deficit increased from 0.79 percent of taxable payroll to 1.35 percent.

- HI expenditures currently exceed HI revenues. Although the gap is projected to narrow over the next few years, HI expenditures are expected to exceed revenues, including interest income, throughout the 75-year projection period. The HI trust fund assets, therefore, will need to be redeemed. If 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 deficit and debt.
- The HI trust fund is projected to be depleted in 2024. At that time, payroll tax revenues are projected to cover only 87 percent of program costs, with the share declining to 67 percent in 2050. In 2085, payroll tax revenues are projected to cover 69 percent of program costs. There is no current provision for general fund transfers to cover HI expenditures in excess of dedicated revenues.
- The projected HI deficit over the next 75 years is 1.35 percent of taxable payroll. Eliminating this deficit would require an immediate 47 percent increase in payroll taxes or a 26 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 understate the fiscal challenges 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 down the productivity adjustments gradually over 15 years, beginning in 2020, from about 1.1 percent to 0.4 percent.

Under the illustrative alternative scenario, the HI trust fund also would be depleted in 2024, but the projected deficit over the next 75 years would be 2.43 percent of taxable payroll—compared to 1.35 percent under current-law projections. Eliminating this deficit would require an immediate 84 percent increase in payroll taxes or a 39 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 Medicare Part B program, which covers physician and outpatient hospital services, and the Medicare Part D program, which covers the prescription drug program. Approximately one-quarter of SMI spending is financed through beneficiary premiums, with federal general tax revenues covering the remaining three-quarters.<sup>4</sup>

The SMI trust fund is expected to remain sol-

vent 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 will put more pressure on the federal budget.

Premium increases similarly will place pressure on beneficiaries, especially when considered in conjunction with increasing beneficiary cost-sharing expenses. The average beneficiary expenses (premiums and cost sharing) for Parts B and D combined currently are 24 percent of the average Social Security benefit. These expenses will increase to 43 percent of the average Social Security benefit by 2085. These expenses do not include cost sharing under Part A.

The 2012 trustees' report projects that under current law, SMI spending will continue to grow faster than GDP, increasing from 2.0 percent of GDP in 2011 to 3.1 percent of GDP in 2030, and to 4.0 percent of GDP in 2085.

As acknowledged by the Trustees, the current-law projections likely understate the increases in Part B spending. Given that SGR-related physician payment reductions have been overridden every year since 2003, it is considered unlikely that future scheduled reductions will take effect in full.<sup>5</sup> In addition, the scheduled reductions in non-physician provider payment rate updates to reflect productivity adjustments might not be sustainable in the long term. The CMS Office of the Actuary's illustrative alternative analysis sets physician payment updates to one percent per year throughout the short range projection period, thereafter phasing down to the growth in per capita national health expenditures. In

<sup>4</sup>Part B beneficiaries pay monthly premiums covering approximately 25 percent of program costs; general revenues cover the remaining 75 percent of costs. Part D premiums are set at approximately 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 2012. 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.

<sup>5</sup>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 31 percent is estimated for next year.

addition, the alternative analysis phases down the productivity adjustments gradually over 15 years, beginning in 2020, from about 1.1 percent to 0.4 percent. The alternative scenario projections assume no changes to the current-law Part D projections.

Under the illustrative alternative scenario projections, SMI spending would increase from 2.0 percent of GDP in 2011 to 3.6 percent of GDP in 2030, and to 6.0 percent of GDP in 2085.

**Table 1: SMI Expenditures as a Percent of GDP**

Calendar Year	2012 Report (current law)	2012 Alternative Projection
2011	2.0	2.0
2020	2.3	2.5
2030	3.1	3.6
2040	3.4	4.2
2050	3.5	4.5
2060	3.7	5.0
2070	3.8	5.4
2080	4.0	5.8
2085	4.0	6.0

Sources: 2012 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 help 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, Medicare expenditures as a percentage of GDP

will grow from 3.7 percent of GDP in 2011 to 6.7 percent of GDP in 2085. Under the CMS Office of the Actuary alternative scenario, however, total Medicare expenditures would increase to 10.3 percent of GDP in 2085.

**Table 2: Total Medicare Expenditures as a Percent of GDP**

Calendar Year	2012 Report (current law)	2012 Alternative Projection
2010	3.7	3.7
2020	4.0	4.2
2030	5.3	5.8
2040	6.0	7.0
2050	6.2	7.7
2060	6.3	8.4
2070	6.5	9.2
2080	6.7	10.0
2085	6.7	10.3

Sources: 2012 Medicare Trustees' Report, CMS Office of the Actuary

## **CONCLUSION**

The Affordable Care Act (ACA), enacted in 2010, contains numerous 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. Additional steps need to be taken, however, to solve the long-term financial challenges to Medicare.

The HI trust fund is projected to be depleted in 2024, 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.

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 considered understated to the extent that the ACA's provisions for downward adjustments in provider payment updates to reflect productivity improvements are unsustainable in the long term and currently scheduled reductions in physician payments are expected to be overridden by Congress—as they have been every year since 2003. If Medicare projections are calculated using assumptions that productivity adjustments are phased down and physician payment reductions are overridden, Medicare's financial condition is shown to be even worse than under current-law projections.

The American Academy of Actuaries' Medicare Steering Committee continues to have significant concerns about Medicare's financing problems, even under the current-law projections, and strongly recommends that policymakers implement changes to improve Medicare's financial outlook.

We concur with the 2012 trustees when they say:

*The Board of Trustees believes that solutions can and must be found to ensure the financial integrity of HI in the short and long term and to reduce the rate of growth in Medicare costs through viable means, building on the measures enacted as part of the Affordable Care Act. 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. Congress and the executive branch must work closely together with a sense of urgency to address these challenges.*

And we wish to underscore this call for action.

### Medicare Provisions in the Affordable Care Act

The Affordable Care Act (ACA), enacted into law in 2010, 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.



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