



# ISSUE BRIEF

AMERICAN ACADEMY of ACTUARIES

## How Is Medicare Financed?

*Medicare provides substantial support to older and disabled Americans in meeting their health care needs, and it is a key component of the U.S. health care system. Almost 98 percent of the population age 65 years or older is covered by Medicare. No doubt in large part due to the significant number of Americans covered by the program, public policy-makers continue to debate how Medicare should be modified in response to the changing health care environment. A firm understanding of the way in which the current Medicare financing mechanisms operate is required to understand the likely impact of the different reform proposals, as well as the rationale behind them.*

- Medicare consists of two parts, each of which is financed separately: Hospital Insurance (HI, or Medicare Part A) and Supplementary Medical Insurance (SMI, or Medicare Part B). Almost everyone is automatically eligible for Part A of Medicare upon reaching age 65 or because they are disabled and have met certain requirements. Individuals may participate in the Part B program if they enroll and agree to pay premiums.
- The Hospital Insurance program is intended to be self-supporting (i.e., financed entirely through designated sources of income rather than relying on general tax revenues), much like Social Security, and it is funded primarily through earmarked payroll taxes.
- The Supplementary Medical Insurance program is not intended to be self-supporting. Beneficiaries pay a monthly premium, intended on average to cover roughly a fourth of the cost. Federal general tax revenue finance most of the remaining cost of the SMI program.

*Under current law, the financing methods used for Medicare Parts A and B are very different, reflecting the political compromises struck when Medicare was created. This issue brief provides a basic description of the financing mechanisms used for each program.<sup>1</sup>*

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### Medicare Trust Funds

Medicare is administered by the Centers for Medicare and Medicaid Services (CMS, previously known as the Health Care Financing Administration) through two trust funds — one for Hospital Insurance and one for Supplementary Medical Insurance. A board of trustees manages the two funds. That board has six members: the Secretaries of the Treasury, Labor, and Health and Human Services Departments; the Commissioner of Social Security; and two members of the public from different political parties (appointed by the president to four-year terms and subject to confirmation by the United States Senate). The Secretary of the Treasury is the managing trustee, and the administrator of CMS serves as secretary to the board.

### Financing Methods

#### **Hospital Insurance**

In much the same way as the Social Security system, the HI program is intended to be self-supporting. That is, the benefits provided by the program should be funded entirely or almost entirely from the following sources:

- Earmarked payroll taxes

- Interest income from assets accumulated in the HI trust fund
- Premiums paid by beneficiaries who voluntarily participate in the program (a very small group)
- A portion of the federal income taxes paid on Social Security benefits

In fiscal year 2000, approximately 94 percent of all revenue into the HI trust fund came from the first three sources, while most of the remaining six percent came from a portion of the revenue derived from the income taxation of Social Security benefits.<sup>2</sup> No fail-safe mechanism exists to ensure that the HI program has enough money to continue operating. The payroll-tax rate (which can be changed only by an act of Congress) has been adjusted periodically to maintain the financial adequacy of the program.

The current HI payroll tax rate is 1.45 percent of taxable earnings — this is paid by both employees and their employers. Self-employed individuals pay 2.9 percent of taxable earnings, representing both the employee and the employer share of the tax. Unlike the Social Security payroll tax, there is no annual limit on the earnings subject to the HI payroll tax. No changes are scheduled in current law for the HI tax rate.

Trust fund assets are invested in interest-bearing obligations of the U.S. Government.<sup>3</sup> Interest payments and redemptions come from current federal revenues or the issuance of additional federal debt.

***Supplementary Medical Insurance***

Unlike the HI program, the SMI program is not intended to be fully supported through designated sources of income. Instead, it relies heavily on general tax revenues. Beneficiaries are required to pay a monthly premium. Collectively, these premiums are intended to cover 25 percent of the projected cost of the program for beneficiaries age 65 and older. Currently, however, the monthly premium covers a slightly lower percentage of the cost due to the phased-in transfer of some home health care expenses from the hospital insurance fund to the supplementary medical insurance fund. Beneficiaries who enroll later than their first eligibility period and who were not covered by employer-provided health care plans as employees are required to pay higher monthly premiums (10 percent higher for each full year of delay) than do beneficiaries who enroll at the earliest opportunity. In fiscal year 2000, approximately 23 percent of the SMI trust fund’s revenue came from premiums paid by beneficiaries.<sup>4</sup>

1997 (actual) .....	\$43.80
1998.....	\$43.80
1999.....	\$45.50
2000.....	\$45.50
2001.....	\$50.00
2002 (projected) .....	\$58.50
2003.....	\$63.30
2004.....	\$68.00
2005.....	\$72.30
2006.....	\$76.30

Most of the cost of the SMI program is financed by the general tax revenues of the federal government. The government contribution is the difference between the projected total monthly cost rate of the program for the year (determined separately for beneficiaries age 65 and older and for disabled beneficiaries under age 65) and the basic monthly contribution paid by the beneficiaries. In fiscal year 2000, approximately 73 percent of the SMI trust fund’s revenue came from general tax revenues.<sup>6</sup>

The projected costs used to establish the government contribution are calculated on an incurred basis and make provisions for “incurred but not reported” claims — that is, claims in which the cost of medical care that beneficiaries will receive during the year will not be paid by or perhaps even submitted to Medicare until after the end of the year.

To the extent that projected contributions exceed the cash expenditures of the SMI program, funds may accumulate in the SMI trust fund. Most of these accumulated funds are used to provide a reserve for incurred but

unpaid claims, and the remainder are used as a contingency reserve. Amounts held by the trust fund generate interest income that covers part of the cost of the program. In 2000, approximately 3.5 percent of the SMI trust fund revenue was derived from interest income.<sup>7</sup>

Because the federal government bases both its contributions and the amount of premiums paid by beneficiaries on the projected cost of the program for each year, contributions into the SMI trust fund are automatically updated annually to ensure that the program has enough money to continue operating. As with HI payroll tax rates, the basic structure of this financing system can only be changed through an act of Congress.

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<sup>1</sup> This brief provides a broad overview of the financing mechanisms used. It does not discuss the broader impact of the cost of Medicare on the operations of the federal government or on the national economy as a whole, nor does it discuss the likely future cost of the program.

<sup>2</sup> The Board of Trustees, Federal Hospital Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, March 19, 2001, p. 37, Table II.C.1.

<sup>3</sup> The Board of Trustees, Federal Hospital Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, March 19, 2001, p. 35.

<sup>4</sup> The Board of Trustees, Federal Supplementary Medical Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund*, March 19, 2001, p. 35, Table II.C.1.

<sup>5</sup> The Board of Trustees, Federal Supplementary Medical Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund*, March 19, 2001, p. 77, Table III.C.1.

<sup>6</sup> The Board of Trustees, Federal Supplementary Medical Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund*, March 19, 2001, p. 35, Table II.C.1.

<sup>7</sup> The Board of Trustees, Federal Supplementary Medical Insurance Trust Fund, *2001 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund*, March 19, 2001, p. 35, Table II.C.1.



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