AMERICAN ACADEMY of ACTUARIES

ISSUE BRIEF

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Medicare's Financial Condition: Beyond Actuarial Balance

KEY POINTS

- The HI trust fund will be depleted in 2030.
- Total Medicare expenditures will make up an increasing share of federal outlays and the gross domestic product (GDP), threatening the program's long-term sustainability.
- Changes are needed to improve Medicare's longterm solvency and sustainability. The sooner such corrective measures are enacted, the more flexible the approach and the more gradual the implementation can be.

Additional Resources

Revising Medicare's Fee-For-Service Benefit Structure: http://www.actuary.org/pdf/health/Medicare_Fee_Struc_Issue_Brief_022712.pdf

A Guide to Analyzing Medicare Premium Support: http://www.actuary.org/files/Issue_Guide_Medicare_Premium_021113.pdf

An Actuarial Perspective on Proposals to Improve Medicare's Financial Condition: http://www.actuary.org/pdf/Medicare_Financial_IB_Final_051211.pdf

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 program is operated through two trust funds. The HI trust fund (Medicare Part A) pays primarily for inpatient 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 Medicare 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 important contribution that members of the actuarial profession have made in preparing the report. They play a vital role in providing information to the public about the important issues surrounding the program's solvency and sustainability.

The 2015 Medicare trustees' report finds that compared with the projections from the 2014 report, the projected financial condition of Medicare has improved in the short-range for HI but deteriorated somewhat in the short-range for SMI. In the long-range the condition has improved for all parts of Medicare due to lower long-range health care cost growth assumptions in this year's report. Nevertheless, the program faces three fundamental long-range financing challenges:

- Income to the HI trust fund is not adequate to fund the HI portion of Medicare benefits;
- Increases in SMI costs increase pressure on beneficiary household budgets and the federal budget;
- Increases in total Medicare spending threaten the program's sustainability.

The trustees conclude: "The projections in this year's report continue to demonstrate the need for timely and effective action to address Medicare's remaining financial challenges—including the projected depletion of the HI trust fund, this fund's long-range financial imbalance, and the rapid growth in Medicare expenditures."

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The American Academy of Actuaries' Medicare Subcommittee agrees with the trustees that the Medicare program continues to face serious financing problems. Because Medicare plays a critically important role in ensuring that Americans age 65 and older and certain younger adults with permanent disabilities have access to health care, the Medicare Subcommittee 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. This issue brief more closely examines the findings of the trustees' report with respect to program solvency and sustainability.

Repeal of the Sustainable Growth Rate Mechanism

The sustainable growth rate (SGR) system was enacted as part of the Balanced Budget Act of 1997 to limit the growth in Medicare spending for physician and other medical professional services. The system compared actual cumulative spending for physician services to a specified spending target. If actual spending exceeded the target, then payment updates were adjusted downward. Every year since 2003, however, the SGR-related physician payment reductions were overridden by stop-gap legislation (i.e., the Medicare "doc fix"). The payment reductions would have been substantial. For instance, the cut scheduled to go into effect in 2015 was 21 percent.

The Medicare trustees acknowledged that current law projections of Medicare spending were likely understated, as the SGR reductions would likely continue to be overridden in the future. Recent alternative projections included in the trustees' reports illustrated the degree of the potential understatement. And the 2014 trustees report took the further step of presenting estimates that assumed an override of the SGR as the primary projections.

In April of this year, the Medicare Access and CHIP Reauthorization Act of 2015 was signed into law. This act repealed the SGR and instead established a schedule of future fee updates; higher updates will be available for providers participating in alternative payment models (APMs). In addition, beginning in 2019, providers not participating in APMs will transition to a merit-based incentive payment system (MIPS) which will set each eligible physician's annual payment increases or decreases based on their performance.

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

Like Social Security, Medicare's trust funds 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 are based on current law. Under these projections, the financial condition of the HI trust fund has improved since the 2014 trustees' report. This improvement primarily reflects lower assumed growth in long-range health care costs. The projected trust fund exhaustion date is 2030 (the same as in last year's report), and the 75-year HI deficit decreased from 0.87 percent of taxable payroll to 0.68 percent.

- HI expenditures currently exceed HI revenues. The gap is projected to narrow, becoming a surplus for a few years before HI expenditures are expected to exceed revenues, including interest income, for the remainder of 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.

Members of the Medicare/Medicaid Reform Work Group include: Martin E. Staehlin, chairperson, MAAA, FSA, FCA; Audrey Halvorson, chairperson Health Care Cost Work Group, MAAA, FSA; Timothy F. Harris, MAAA, FSA; Malgorzata Jankowiak-Roslanowska, MAAA, ASA; Jinn-Feng Lin, MAAA, FSA, FCA; and Thomas F. Wildsmith, MAAA, FSA.

- The HI trust fund is projected to be depleted in 2030. At that time, tax revenues are projected to cover only 86 percent of program costs, with the share declining to 79 percent in 2039 and then increasing to 84 percent in 2089. 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 0.68 percent of taxable payroll. Eliminating this deficit would require an immediate 23 percent increase in standard payroll taxes or an immediate 15 percent reduction in expenditures—or some combination of the two. Delaying action would require more severe changes in the future.

In this year's report, the trustees' projections of Medicare's financial outlook are based on benefits and revenues scheduled under current law. The trustees acknowledge that these estimates could understate the seriousness of Medicare's financial condition, because actual Medicare expenses might exceed current law estimates. In particular, the trustees and the chief actuary point to scheduled reductions in provider payments that may not 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. Current law also requires updates for physician services which are not expected to keep up with physician costs. In the Statement of Actuarial Opinion that accompanies the trustees' report, Paul Spitalnic, the chief actuary of the Centers for Medicare & Medicaid Services (CMS), specifically states, "overriding the price updates specified in current law … would lead to substantially higher costs for Medicare in the long range than those projected in this report."

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 gradually beginning in 2020, physician updates are more consistent with cost growth, and there are no savings from the Independent Payment Advisory Board (IPAB).[1] 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 illustrate and quantify the potential magnitude of the cost understatement."

Under the alternative scenario, the HI trust fund would be depleted in 2029, and the projected deficit over the next 75 years would be 1.70 percent of taxable payroll—compared to 0.68 percent under current law. Eliminating this deficit would require an immediate 59 percent increase in standard payroll taxes or a 31 percent reduction in expenditures—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.[2]

1 The IPAB is required to submit proposals to slow Medicare spending growth the year following a determination that the projected Medicare per capita growth rate exceeds a target growth rate. The first year of such a determination is projected to be 2017. Members of the IPAB have yet to be appointed.

2 Premiums for Medicare Parts B and D are income-related. Standard premiums are set to cover approximately 25 percent of program costs. Higher-income beneficiaries pay higher premiums, ranging from 35 percent of program costs to 80 percent of program costs. According to the Kaiser Family Foundation, in 2015, 6 percent of beneficiaries will face the higher income-related premiums for Part B and 5 percent of beneficiaries will face the higher income-related premiums for Part D. These shares are expected to increase over time. See the Kaiser Family Foundation, "Medicare's Income-Related Premiums: A Data Note," June 2015. Available at: http://files.kff.org/attachment/data-note-medicares-income-related-premiums-a-data-note.

Many Part D beneficiaries will receive low-income premium subsidies, lowering their premiums below 25 percent of program costs. In the aggregate, beneficiary premiums will cover only about 14 percent of total Part D costs in 2015. State payments on behalf of certain beneficiaries will cover about 10 percent of costs and general revenues will cover the remaining 76 percent of costs.

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 will put more pressure on the federal budget. SMI general revenue funding is scheduled to increase from 1.4 percent of GDP in 2015 to 2.8 percent in 2089.

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 are currently 23 percent of the average Social Security benefit. These expenses will increase to 36 percent of the average Social Security benefit by 2089. These expenses do not include cost sharing under Part A.

The 2015 trustees' report projects that total SMI spending will continue to grow faster than GDP, increasing from 2.0 percent of GDP in 2014 to 3.1 percent of GDP in 2030, and to 3.8 percent of GDP in 2089.

Spending under the illustrative alternative analysis would be slightly higher, reflecting the phase down of productivity adjustments for non-physician provider payments, higher physician updates in the long-range, and assuming no savings from IPAB. SMI spending would increase from 2.0 percent of GDP in 2014 to 3.2 percent of GDP in 2030, and to 5.3 percent of GDP in 2089.

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 consider 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.

Table 1: Total Medicare Expenditures as a Percent of GDP

CALENDAR YEAR	2015 REPORT	2015 ALTERNATIVE PROJECTION
2014	3.5	3.5
2020	3.8	3.8
2030	5.0	5.2
2040	5.6	6.1
2050	5.6	6.6
2060	5.7	7.2
2070	5.9	7.9
2080	6.0	8.5
2085	6.0	8.8

Sources: 2015 Medicare Trustees' Report, CMS Office of the Actuary

Under current law, Medicare expenditures as a percentage of GDP will grow from 3.5 percent of GDP in 2014 to 6.0 percent of GDP in 2085. Under the CMS Office of the Actuary alternative scenario, however, total Medicare expenditures would increase to 8.8 percent of GDP in 2085.

CONCLUSION

The Affordable Care Act (ACA), enacted in 2010, contains 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.[3] Additional steps need to be taken, however, to address the long-term financial challenges to Medicare.

The HI trust fund is projected to be depleted in 2030, 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.

3 The CMS Office of the Actuary recently certified that an expansion of the Pioneer ACO model would reduce net Medicare spending. This certification allows for the model to be expanded to additional Medicare beneficiaries. https://www.cms.gov/Research-Statistics-Data-and-Systems/Research/ActuarialStudies/Downloads/Pioneer-Certification-2015-04-10.pdf

In addition, Medicare's financial challenges could be 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 non-physician provider payment updates to reflect productivity improvements. In addition, long-range physician payment updates being held below physician costs are unsustainable in the long term. If Medicare projections are calculated using assumptions that the productivity adjustments are phased down and physician updates are more in line with their costs, Medicare's financial condition is shown to be even worse than under the projected baseline.

The American Academy of Actuaries' Medicare Subcommittee has significant concerns about Medicare's financing problems, and strongly recommends that policymakers implement changes to improve Medicare's financial outlook.

We concur with the 2015 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. Consideration of such reforms should not be delayed. 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 and behavior. The Board recommends that Congress and the executive branch work closely together with a sense of urgency to address these challenges.*

We wish to underscore the need for this call for action.

Medicare Provisions in the Affordable Care Act

The Affordable Care Act (ACA), enacted into law in 2010, includes 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 are adjusted downward to reflect productivity improvements.
- **Basing Medicare Advantage plan payments on fee-for-service rates.** Medicare Advantage plan payments are being reduced gradually relative to fee-for service costs.
- **Health care payment and delivery system improvements.** Pilot programs, demonstration projects, and other reforms are being implemented to increase the focus on delivering high quality and cost-effective care. These include initiatives on bundled payments and accountable-care organizations (ACOs).
- **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).** 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.