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 long-term 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. 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 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 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 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 2014 Medicare trustees' report has improved compared with the projections from the 2013 report. The year in which the HI trust fund is projected to be depleted is now 2030, four years later than projected last year. The 75-year HI deficit decreased from 1.11 percent of taxable payroll in last year's report to 0.87 percent of taxable payroll in the 2014 report. This improvement primar-

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ily reflects lower projected inpatient hospital spending based on lower-than-expected spending for 2013, other recent data, and technical changes in projection methods. Nevertheless, HI expenditures are projected to exceed HI revenues in most years of the 75-year projection period. Total Medicare expenditures will make up an increasing share of federal outlays and the gross domestic product (GDP).

In this year's report, the trustees' projections of Medicare's financial outlook are based on benefits and revenues scheduled under current law except for an assumed override of scheduled reductions in physician fee schedule payments under the sustainable growth rate (SGR) mechanism.[1] The trustees acknowledge that these estimates may understate the seriousness of Medicare's financial condition, because actual Medicare expenses may exceed projected baseline 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. 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 productivity adjustments … 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 and there are no savings from the Independent Payment Advisory Board (IPAB). 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." This issue brief presents projections based on both

[1]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. Under current law, a cumulative reduction of almost 21 percent is scheduled for next year.

Members of the Medicare Steering Committee include: Thomas F. Wildsmith, MAAA, FSA, Chairperson; Dennis J. Hulet, MAAA, FSA, FCA, Vice Chairperson; Joe Bawazer, MAAA, ASA; Jill H. Brostowitz, MAAA, FSA; Michael V. Carstens, MAAA, FSA, ; April S. Choi, MAAA, FSA; Randall S. Edwards, MAAA, FSA; Troy M. Filipek, MAAA, FSA, FCA; Joel C. Kabala, MAAA, ASA; Margot D. Kaplan, MAAA, FCA, ASA; Mark E. Litow, MAAA, FSA; Steve Niu, MAAA, FSA, EA; Susan E. Pierce, MAAA, FSA; Robert J. Pipich, MAAA, FSA; Anna M. Rappaport, MAAA, FSA, EA; Jeremiah D. Reuter, MAAA, ASA; Gordon R. Trapnell, MAAA, FSA; Cori E. Uccello, MAAA, FSA, FCA, MPP; John A. Wandishin, MAAA, FSA; Carl Wright, MAAA, FSA.

projected baseline and the illustrative alternative projections.[2]

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. Furthermore, if the growth in Medicare costs is comparable to growth under the illustrative alternative projections, then these further policy reforms will have to address much larger financial challenges than those assumed under the projected baseline scenario."

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 2014 Medicare trustees' report and its accompanying illustrative alternative analysis:

- The HI trust fund is projected to be depleted in 2030.
- HI expenditures are expected to exceed HI revenues in most future years. In the year that the trust fund is projected to be depleted—2030—tax revenues would cover only 85 percent of program costs.
- The projected HI deficit over the next 75 years is 0.87 percent of taxable payroll.[3] Eliminating this deficit would require an immediate 30 percent increase in standard payroll taxes or an immediate 19 percent reduction in expenditures—or some combination of the two. Delaying action would require more drastic tax increases or expenditure reductions in the future.
- Under the illustrative alternative scenario, the HI trust fund would be depleted in 2029 and the 75-year HI deficit would be 1.92 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 the projected baseline estimates, SMI spending is expected to grow from 1.9 percent of GDP in 2013 to 4.5 percent of GDP in 2085. Under the illustrative alternative scenario, SMI spending is expected to reach 4.6 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 the projected baseline estimates, total Medicare spending as a share of GDP is expected to grow from 3.5 percent in 2013 to 6.8

[2]Both the 2014 Medicare Trustees Report and the CMS Office of the Actuary's illustrative alternative scenario analysis are available at: http://www.cms.gov/ReportsTrustFunds/.

[3]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.

percent in 2085. Under the illustrative alternative scenario, total Medicare spending is projected to reach 8.3 percent of GDP in 2085.

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 are based on the projected baseline. Under these projections, the financial condition of the HI trust fund has improved since the 2013 trustees' report. This improvement primarily reflects lower projected inpatient hospital spending based on lower-than-expected spending for 2013, other recent data, and technical changes in projection methods. The projected trust fund exhaustion date is four years later than in last year's report, and the 75-year HI deficit decreased from 1.11 percent of taxable payroll to 0.87 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.
- The HI trust fund is projected to be depleted in 2030. At that time, tax revenues are projected to cover only 85 percent of program costs, with the share declining to 75 percent in 2045. In 2085, payroll tax revenues are projected to cover 77 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 0.87 percent of taxable payroll. Eliminating this deficit would require an immediate 30 percent increase in standard payroll taxes or a 19 percent reduction in expenditures—or some combination of the two. Delaying action would require more drastic changes in the future.

Projected baseline estimates may understate the fiscal challenges to the Medicare HI trust fund. In particular, the scheduled reductions in non-physician 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 and assumes no savings from IPAB.

Under the illustrative alternative scenario, the HI trust fund would be depleted in 2029, and the projected deficit over the next 75 years would be 1.92 percent of taxable payroll—compared to 0.87 percent under the projected baseline. Eliminating this deficit would require an immediate 66 percent increase in standard payroll taxes or a 33 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.[4]

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.

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 23 percent of the average Social Security benefit. These expenses will increase to 44 percent of the average Social Security benefit by 2088. These expenses do not include cost sharing under Part A.

The 2014 trustees' report projects that SMI spending will continue to grow faster than GDP, increasing from 1.9 percent of GDP in 2013 to 3.0 percent of GDP in 2030,

[4]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 15 percent of total Part D costs in 2013. State payments on behalf of certain beneficiaries will cover approximately 10 percent of costs and general revenues will cover the remaining 75 percent of costs.

and to 4.5 percent of GDP in 2085.

Spending under the illustrative alternative analysis would be slightly higher, reflecting the phase down of productivity adjustments for non-physician provider payments and assuming no savings from IPAB. SMI spending would increase from 1.9 percent of GDP in 2013 to 3.1 percent of GDP in 2030, and to 4.6 percent of GDP in 2085.

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 projected baseline, Medicare expenditures as a percentage of GDP will grow from 3.5 percent of GDP in 2013 to 6.8 percent of GDP in 2085. Under the CMS Office of the Actuary alternative scenario, however, total Medicare expenditures would increase to 8.3 percent of GDP in 2085.

Table 1: Total Medicare Expenditures as a Percent of GDP

Calendar Year	2014 Report (projected baseline)	2014 Alternative Projection
2013	3.5	3.5
2020	3.7	3.7
2030	4.9	5.1
2040	5.6	6.0
2050	5.9	6.5
2060	6.2	7.0
2070	6.6	7.6
2080	6.8	8.1
2085	6.8	8.3

Sources: 2014 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 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.

In addition, Medicare's financial challenges may 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 are unsustainable in the long term. If Medicare projections are calculated using assumptions that the productivity adjustments are phased down, Medicare's financial condition is shown to be even worse than under the projected baseline.

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

We concur with the 2014 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 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 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.
- **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.