AMERICAN ACADEMY *of* ACTUARIES

ISSUE BRIEF

MAY 2011

Key Points

Using assumptions based on benefits and revenues scheduled under current law, the 2011 trustees' report projects:

- The HI trust fund will be depleted in 2024, 5 years earlier than projected last year.
- HI expenditures are expected to exceed HI revenues for every year in the projection period.
- The 75-year deficit is 0.79 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 2.15 percent of taxable payroll.

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. The Medicare program provides health coverage for the aged and for certain individuals with disabilities. The HI trust fund (Part A) pays primarily for hospital services. The SMI trust fund includes accounts for the Part B program, which covers physician and outpatient hospital services, and the 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 contribution that members of the actuarial profession have made in preparing the report and educating the public about this important issue.

The projected financial condition of Medicare in the 2011 Medicare trustees' report has deteriorated compared with the projections in the 2010 report. According to this year's report, the HI trust fund will be depleted in 2024, five years earlier than was projected a year ago. This deterioration results from lower real (inflation-adjusted) payroll tax revenues due to a slower assumed economic recovery, and from higher real expenditures due to higher assumed near-term wage growth. HI expenditures are expected to exceed HI revenues for every year in the projection period. Medicare expen-

AMERICAN ACADEMY *of* ACTUARIES

1850 M Street NW, Suite 300, Washington, DC 20036
Tel 202 223 8196, Fax 202 872 1948
www.actuary.org

ditures will consume an increasing share of federal outlays and the gross domestic product (GDP).

According to statutory requirements, 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 is required by law, 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 provider payment updates 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 likely to be overridden by Congress.

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 out 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 2011 trustees' report." This issue brief presents projections based on both the current law and the illustrative alternative projections.[1]

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 im-

[1]Both the 2011 Medicare Trustees Report and the CMS Office of the Actuary's illustrative alternative scenario analysis are available at: http://www.cms.gov/ReportsTrustFunds/.

balance, and the issue of rapid growth in Medicare expenditures. Furthermore, if the lower prices payable for health services under Medicare are overridden, the financial challenges in the long range would be much more severe."

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 concludes that the Medicare program faces serious financing problems. As highlighted in the 2011 Medicare trustees' report and its accompanying illustrative alternative analysis:

- The HI trust fund is projected to be depleted in 2024, five years earlier than projected last year.
- The HI trust fund faces a serious long-term funding challenge. 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 90 percent of program costs.
- The projected HI deficit over the next 75 years is 0.79 percent of taxable payroll. Eliminating this deficit would require an immediate 24 percent increase in payroll taxes or an immediate 17 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 2.15 percent of taxable payroll.
- The SMI trust fund is expected to remain solvent only 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 1.9 percent of GDP in 2010 to 4.1 percent of GDP in 2085. Under the illustrative alternative scenario, however, SMI spending is expected to reach 6.6 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 current-law projections, total Medicare spending as a share of GDP is expected to grow from 3.6 percent in 2010 to 6.2 percent in 2085. Under the illustrative alternative scenario, however, total Medicare spending is projected to reach 10.7 percent of GDP in 2085.

Because Medicare plays a critically important role in ensuring that older and 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 the Social Security program, 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 trustees' report's projections of Medicare's financial outlook must be based on current law. Under these current-law projections, the financial condition of the HI trust fund has deteriorated since the 2010 trustees' report. This deterioration results from lower real (inflation-adjusted) payroll tax revenues due to a slower assumed economic recovery, and from higher real expenditures due to higher assumed near-term wage growth. The projected trust fund exhaustion date is five years earlier than in last year's report, and the 75-year HI deficit increased from 0.66 percent of taxable payroll to 0.79 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 debt.
- The HI trust fund is projected to be depleted in 2024. At that time, payroll tax revenues are projected to cover only 90 percent of program costs, with the share declining to 76 percent in 2050 but then increasing to 88 percent by 2085. 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 0.79 percent of taxable payroll. Eliminating this deficit would require an immediate 24 percent increase in payroll taxes or a 17 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 out the productivity adjustments gradually over 16 years, beginning in 2020.

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 2.15 percent of taxable payroll—nearly triple that under current-law projections. Eliminating this deficit would require an immediate 74 percent increase in payroll taxes or a 36 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 Part B program, which covers physician and outpatient hospital services, and the 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]

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.

Similarly, premium increases 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 27 percent of the average Social Security benefit. These expenses will increase to 46 percent of the average Social Security benefit by 2085. These expenses do not include cost sharing under Part A.

The 2011 trustees' report projects that under current law, SMI spending will continue to grow faster than GDP, increasing from 1.9 percent of GDP in 2010 to 3.1 percent of GDP in 2030, and to 4.1 percent of GDP in 2085.

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 unlikely that future scheduled reductions will take effect in full.[3] 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 according to the increase in the Medicare Economic Index, which averages approximately 2 percent per year—rather than assuming that the SGR-related reductions take effect. In addition, the alternative analysis as-

[2]Part B beneficiaries pay monthly premiums covering about 25 percent of program costs; general revenues cover the remaining 75 percent of costs. Part D premiums are set at about 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 2011. 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.

[3]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 30 percent is estimated over the next two years.

sumes a phasing out of the productivity adjustments gradually over 16 years, beginning in 2020. 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 1.9 percent of GDP in 2010 to 3.7 percent of GDP in 2030, and to 6.6 percent of GDP in 2085.

Table 1: SMI Expenditures as a Percent of GDP

Calendar Year	2011 Report (current law)	2011 Alternative Projection
2010	1.9	1.9
2020	2.3	2.6
2030	3.1	3.7
2040	3.5	4.5
2050	3.6	5.0
2060	3.8	5.5
2070	4.0	6.0
2080	4.1	6.4
2085	4.1	6.6

Sources: 2011 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 3.6 percent of GDP in 2010 to 6.2 percent of GDP in 2085. Under the CMS Office of the Actuary alternative scenario, however, total Medicare expenditures would nearly triple to 10.7 percent of GDP in 2080.

Table 2: Total Medicare Expenditures as a Percent of GDP

Calendar Year	2011 Report (current law)	2011 Alternative Projection
2010	3.6	3.6
2020	4.0	4.3
2030	5.2	5.9
2040	5.8	7.1
2050	5.9	8.0
2060	6.1	8.8
2070	6.2	9.6
2080	6.3	10.4
2085	6.2	10.7

Sources: 2011 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 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 many times previously. If Medicare projections are calculated using assumptions that productivity adjustments are phased out 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 agree with the 2011 trustees when they say:

We believe 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. We believe that prompt action is necessary to address these challenges.

And we wish to underscore this call for action.

American Academy *of* Actuaries

1850 M Street NW
Suite 300
Washington, DC 20036
Tel 202 223 8196
Fax 202 872 1948
www.actuary.org