

Federal Update 2004-9

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TO: NCTR Membership

FROM: Cindie Moore

RE: Bad News on Medicare's Finances; Social Security's Situation Less Grim

Medicare's finances have grown increasingly worse over the year, said the trustees of Social Security and Medicare on March 23. The hospital trust fund will run out of money seven years earlier than projected last year. Even more dramatic, *expenditures from the trust fund during 2004 will exceed income*. By contrast, the status of Social Security's trust fund remains problematic, but its shortfall did not change appreciably from last year.

The trustees issue an annual report that provides the current and projected condition over the next 75 years of the Medicare trust funds and a similar, but separate report for the Social Security trust funds. A synopsis of both, which also contains helpful background, is located at <http://www.ssa.gov/OACT/TRSUM/trsummary.html>. The links for each annual report appear at the end of this Update.

The trustees project that the growing annual cash deficits in both programs will lead to exhaustion of reserves. Medicare's hospital trust fund will be depleted in 2019 and Social Security's combined trust funds in 2042.

Cause of Medicare's Problems and Possible Solutions

Both Medicare and Social Security face the demographic challenge of the baby boomers who will generally begin to draw benefits in 2010. The shortfall in Medicare's hospital trust fund is already upon us because its funding mechanism, beginning this year, no longer will yield sufficient dollars to cover expenses. The tax to finance the Medicare hospital trust fund is 1.45% of a worker's pay. His/her employer pays an equal amount. The funding mechanism is frequently called a payroll tax. The hospital trust fund is often referred to as HI (for "hospital insurance"). The benefits available under HI are sometimes called Part A services and they include in-patient hospital stays.

Beginning in 2004, the HI trust fund will run a cash flow deficit. This means that Medicare is paying out more money to finance benefits from the hospital trust fund than it is receiving in payroll taxes. To cover the shortfall, Medicare will draw down on interest in the trust fund. In practical terms, when Medicare taps its trust fund income or interest, the federal Treasury makes a cash transfer to the program.

To make matters worse, the HI trust fund will be exhausted in 2019, seven years earlier than predicted last year. At that point, payroll tax income will be sufficient to pay only 81% of HI costs.

The trustees look at the Medicare and Social Security trust funds over a 75-year period. In this year's report, they find that the projected 75-year actuarial deficit for the HI trust fund is now 3.12% of taxable payroll, up significantly from 2.40% in last year's report.

The trustees cite three reasons for Medicare's increasingly critical financial outlook:

- 1) higher health care costs;
- 2) lower than expected payroll tax collections; and
- 3) pressure from portions of the new Medicare legislation (the Medicare Prescription Drug, Improvement, and Modernization Act, Public Law 108-173).

The new legislation adds to costs by increasing payments to rural hospitals and to private health plans under the Medicare Advantage program. (These portions are separate from the new prescription drug benefit effective 2006.)

The following chart illustrates the worsening financial situation of the HI trust fund.

HI Trust Fund

	2003 Trustees' Report	2004 Trustees' Report
Costs exceed income	2013	2004
Trust fund exhausted	2026	2019

The trustees propose two solutions to the HI trust fund's shortfall. First, the 2.9% payroll tax could be immediately increased to 6.02% or expenditures could be

immediately reduced by 48%. The trustees point out that more realistic solutions would involve gradual, rather than immediate, changes, but they would have to reach much more substantial levels to eliminate the deficit.

In a release from the Department of the Treasury, the Bush Administration proposes solutions that relate to the new Medicare legislation and rising health care costs in general. The Administration lists the following items in the Medicare legislation that will put the program on long-term sustainability:

- Prescription drug cards for 2004 and 2005
- \$600 per year for 2004 and 2005 for low income beneficiaries to help them buy prescription drugs
- Improved preventive care coverage
- Health Savings Accounts (HSAs) to help people pay for out-of-pocket medical expenses with tax-free dollars
- Increased competition and choice
- Reductions in fraud and abuse

In the general area of holding down health care costs, the Administration proposes:

- Medical liability reform
- Association Health Plans to help small businesses provide affordable health insurance coverage to their workers
- Expanded tax credits and deductions
- Reductions in medical errors

New Medicare Prescription Drug Benefit

How does the new prescription drug benefit relate to the financial shortfall of the Medicare HI trust fund? It doesn't. The benefit, known as Part D, will be funded out of the Medicare Supplementary Medical Insurance (SMI) trust fund when it begins in 2006. At present, the SMI trust fund contains the monies used to finance physician and other outpatient services, sometimes referred to as Part B services.

Part B and D services are not funded by a payroll tax as under the HI portion of Medicare. They are financed largely (approximately 75%) by payments from federal general fund revenue supplemented by monthly premiums that beneficiaries must pay.

The monthly premium for Part B is \$66.60 in 2004. The Part D premium will begin in 2006. The trustees project that the SMI trust fund is adequately funded into the indefinite future because current law automatically sets financing each year to meet the following year's expected costs. However, the automatic provisions will result in a rapidly growing amount of general revenue financing as well as substantial increases over time in beneficiary premium charges.

Cause of Social Security's Problems and Possible Solutions

Like Medicare, Social Security's future financial shortfall is grim because of the impending retirement of the baby boomers. The program will encounter the greatest stress between 2010 and 2030. After that point, Social Security's costs will still grow because of projected increasing life expectancy, but at a slower rate. This outlook contrasts sharply with that of Medicare. In the post-boomer years, Medicare's costs will continue to grow rapidly due to expected increases in the use and cost of health care.

Like the HI trust fund of Medicare, Social Security is financed by a tax on a percentage of a worker's wages. The rate is different, however. While the HI rate is 1.45% (employee and employer each pay the rate), the rate for Social Security is 6.2% (again, the employee and employer each pay the rate). The payroll tax funds the Old Age and Survivors Insurance trust fund (OASI) and the Disability Insurance trust fund (DI). Together, they are referred to as the OASDI trust funds.

As with Medicare, the trustees look at the Social Security trust funds over a 75-year period. They find that the projected 75-year actuarial deficit for the OASDI trust funds is now 1.89% of taxable payroll, down slightly from 1.92% in last year's report. These rates contrast with Medicare's: 3.12% this year and 2.40% for last year.

Beginning in 2018, payroll tax income will fall short of annual benefit payments. In 2042, when the trust funds are exhausted, payroll tax income will be sufficient to finance only 73% of annual benefit payments. These are the same dates as last year. Thus, while the OASDI trust fund's finances are insufficient for the future, they are still more stable than the Medicare HI trust fund.

OASDI Trust Fund

	2003 Trustees' Report	2004 Trustees' Report
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Costs exceed income	2018	2018
Trust fund exhausted	2042	2042

The trustees propose several solutions to the OASDI trust funds shortfall: an immediate increase in payroll taxes of 15% or an immediate reduction in benefits of 13%, or some combination of the two. If the changes were phased in, greater adjustments in scheduled benefits and payroll taxes would be required.

The Bush Administration, in the Treasury Department release, discussed above, rejects higher payroll taxes or lower benefits for those in or near retirement. It proposes the creation of private accounts that would allow younger workers to invest part of their payroll taxes in the market.

Links

Medicare trustees report <http://www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf>

Social Security trustees report <http://www.ssa.gov/OACT/TR/TR04/index.html>