Backgrounder

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Medicare Reform: Setting Attainable Goals for Sustainability

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Medicare's approaching financial distress is enormous and well publicized. The Medicare trustees calculate Medicare's total excess costs at $85.6 trillion.[1] This is the amount in present value by which Medicare's future spending exceeds its dedicated and internal revenues, such as payroll tax receipts and premium income. As this calculation illustrates, the Medicare program is unsustainable. Medicare's finances are not the only reason to reform the program, but they are a compelling one.

As with any difficult task, it is important to have a simple, bottom-line measure of success. Eliminating the program's excess costs is an obvious goal for Medicare reform. Medicare's projected total excess costs reflect the extent to which Medicare funds promised benefits by drawing on general revenues of the U.S. Treasury, that is, tax collections from all other sources. Eliminating Medicare's excess costs entirely would eliminate all general fund support. In 2007, that would have meant eliminating a $179 billion transfer from the general fund to Medicare.

While eliminating Medicare's total excess costs would be ideal, it is more than what is necessary to achieve sustainability. A lesser fiscal goal would be sufficient, and there are several from which to choose. As with all budget matters, the reduction to be achieved is a matter of setting priorities and weighing financing demands against other revenue and spending priorities.

While Medicare's drain on the economy and on the federal government's general revenues is signifi-

Talking Points

- Medicare is financially unsustainable. It faces excess costs of $85.6 trillion.
- Treasury's general fund subsidizes Medicare by an amount equal to about 1.3 percent of GDP, a large but manageable sum and an apparently sustainable level of support.
- Medicare reform needs a clear goal for sustainability. Eliminating all of Medicare's excess costs might be ideal, but that would be more than is necessary to achieve sustainability.
- Reform is more likely to succeed sooner if the goal is not excessively ambitious. A rule that Medicare not draw more than 1.3 percent of GDP from the general fund is consistent with sustainability and establishes a reasonable goal for reform. Applying this rule reduces the excess costs for elimination by about a quarter, to $63.4 trillion.
- Such a rule also helps to guide other needed Medicare reforms that might otherwise worsen Medicare's finances.

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cant, it has so far been manageable. This suggests that a rule to guide Medicare reform could be to hold constant Medicare's level of general revenue as a share of gross domestic product (GDP). In effect, such a rule would hold the budget pressures Medicare imposes at today's levels relative to the size of the economy.

In 2007, Medicare's claim on general revenues amounted to 1.3 percent of GDP. Establishing a rule that Medicare not claim more than this share of GDP reduces the dollar amount by which reforms must cut costs by more than 25 percent, leaving a more achievable $63.4 trillion in needed Medicare reform savings.[2]

The Necessity of Reform

As a basic element of the nation's social safety net, Medicare is a vital program for senior citizens. Yet the needs of seniors change over time, as do health care markets and the practice of medicine. Medicare needs to change accordingly, and many dimensions of the program should be reviewed as part of reform. Modernizing Medicare by adding a drug benefit, for instance, was sound, despite the serious flaws in design and implementation.

Reforms are needed for many reasons, but the compelling fact is that Medicare is unaffordable in its current form. Already expensive to seniors and burdensome to taxpayers, its costs will soon outstrip its own resources by a wide margin, putting enormous pressures on the federal budget and the economy. Left unchecked, Medicare's claim on national resources will rise from 2.7 percent of GDP in 2007 to 5.9 percent in 2030, and eventually to 15.6 percent in the following years.[3] Making Medicare fiscally sustainable challenges the nation's will and capacity to act.

One element driving Medicare spending is the imminent retirement of the baby boom generation, an enormous demographic bulge tracing back to the end of the World War II. Americans qualify for Medicare on their 65th birthday, and the first baby boomers turn 65 in 2011.

A second and more important driver of Medicare spending is health care inflation—which has exceeded inflation in the rest of the economy for many years and is expected to continue to do so. This relative excess in health care inflation has many causes, and is itself a main cause of the growing interest in reforming the broader health care markets. If health care markets are substantially reformed, and if the reforms reduce the rate of health care inflation, these reforms would significantly reduce the rate of growth in Medicare spending.[4]

However, health care reform will take time to devise, legislate, and implement, and its consequences will take time to materialize. In the meantime, the retirement of the baby boomers remains an abiding problem. Thus, even with highly successful reforms to the nation's health care markets, Medicare will still require major reforms to achieve long-run sustainability.

1. This is the total excess costs for Medicare Parts A, B, and D as described in Tables III.B.10, III.C.15, and III.C.23, respectively, of the 2008 Medicare trustees' report. The trustees also report a figure, $36 trillion, for the 75-year horizon.
2. These calculations derive from a model of projections of the Medicare program. The assumptions in the model regarding future outlays, general revenue contributions, discount rates, etc., are those presented by the Medicare trustees in their annual report. The trustees' estimate of excess costs understates the extent of Medicare's troubles due to a flawed assumption, which the trustees acknowledge and describe in their report and in a related memo released by the Office of the Actuary. Correcting this assumption raises Medicare's shortfall by an estimated $3.0 trillion to $5.9 trillion. See J. D. Foster, "Medicare's Financial Woes: Bigger than Official Estimates," Heritage Foundation *Backgrounder* No. 2174, September 2, 2008, at *http://www.heritage.org/Research/Budget/bg2174.cfm*.
3. Peter R. Orszag, Director of the Congressional Budget Office, letter to Representative Paul Ryan (R–WI), May 19, 2008, at *http://www.cbo.gov/ftpdocs/92xx/doc9216/05-19-LongtermBudget_Letter-to-Ryan.pdf* (March 12, 2009).
4. According to analysis by the Congressional Budget Office, over half the projected growth in Medicare spending is due to the growth in per capita health care costs exceeding growth in per capita GDP; about one-sixth is due to the retirement of the baby boom generation; and the balance is due to the interaction of those two factors. See Peter R. Orszag, Congressional Budget Office Director, "Growth in Health Care Costs," testimony before the Committee on the Budget, U.S House of Representatives, January 31, 2008, at *http://www.cbo.gov/ftpdocs/89xx/doc8948/01-31-HealthTestimony.pdf* (March 12, 2009).

A Suitable Budget Rule and an Attainable Goal

In every endeavor, especially a difficult one, it is important to set goals that reflect success and justify the effort, but also to set goals that are achievable and not unduly aggressive or unrealistic. Setting an appropriate goal for Medicare reform is all the more important because of the related and equally difficult tasks of reforming Social Security and Medicaid.

In 2007, Medicare tapped the general fund of the Treasury for $179 billion, or about 1.3 percent of GDP. To put this in perspective, this was equivalent to about half of all federal corporate income receipts. On the spending side, this was more than enough to cover the total outlays of the Departments of Homeland Security, Housing and Urban Development, Interior, Justice, Labor, and State. By any measure, $179 billion in general revenue support for Medicare represents a substantial use of resources.

Budgeting is an exercise in setting priorities. Medicare is already placing enormous demands on the federal budget, limiting the government's ability to dedicate resources to other purposes or to cut taxes. However, given the lack of outcry or comment to the contrary, Medicare's claim on general revenues equal to 1.3 percent of GDP was apparently manageable from both budgetary and economic perspectives, suggesting that this level of support is a reasonable and feasible limit for Medicare reform.

A second important aspect is that by limiting Medicare revenues to 1.3 percent of GDP, reforms can proceed without risk that these reforms would make Medicare's financial condition worse, and without entanglement in debates about Medicare's effects on competing budget priorities. Once Medicare's sustainability is assured, subsequent debates may address questions of competing budget priorities.

Holding Medicare's general fund support at 1.3 percent of GDP is a practical rule for Medicare reform consistent with long-term sustainability. Following the rule would reduce the amount of Medicare's excess costs that must be cut by about 25 percent to about $63.4 trillion. This is still an enormous sum, but a more attainable goal.

Can the Medicare Goal Approach Extend to Social Security and Medicaid?

Setting an appropriate goal for Medicare reform is especially important because the nation must also confront the similarly daunting and crucial tasks of reforming Social Security and Medicaid. Can the approach offered here for Medicare be applied to these two programs?

Social Security is supposed to be funded through payroll taxes and interest earned on amounts held in the Social Security trust fund. Yet according to the 2008 Social Security trustees' report, beginning in 2017 Social Security's outlays will exceed payroll tax receipts.[5] By 2041, the Social Security trust fund will be depleted and Social Security will be unable to pay promised benefits in full.

The Social Security trustees estimate the program's total excess promised benefits in present value terms to be $13.6 trillion.[6] This figure is comparable in nature to Medicare's $85.6 trillion excess costs. Social Security reform efforts typically assume the entire $13.6 trillion must be eliminated. But is there a more limited, sustainability-based goal for Social Security analogous to the one proposed for Medicare?

Unfortunately, no. Eliminating Social Security's excess costs requires a combination of reducing the growth of promised benefits and increasing the growth of dedicated tax receipts. Social Security reform that retains some level of excess costs implies using non-payroll tax revenues to cover these costs.[7] This would be inappropriate for at least two reasons:

1. Using tax revenue from sources other than payroll taxes to fund Social Security would be a

5. Social Security Administration, *The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, March 25, 2008, at *http://www.ssa.gov/OACT/TR/TR08/index.html* (March 12, 2009).
6. The comparable figure for Social Security over the 75-year horizon is $4.3 trillion.
7. The commonly cited third alternative for Social Security reform—deficit financing—is in fact only an intermediate step, as deficit financing of Social Security would simply mean much larger reductions in spending or increases in tax revenue in later years.

fundamental and unwarranted departure from the basic premise that Social Security is to be a self-contained pension program, not a welfare program.

2. Social Security today operates at a cash surplus. Allowing it to operate at a perpetual cash deficit financed by other tax revenues would necessarily and permanently deprive all other budget priorities of these resources. This would be inconsistent with the advantage of the proposed Medicare sustainability approach, which is the reform's neutrality with respect to other budget priorities.

The federal portion of Medicaid, on the other hand, was always intended to be funded predominantly with general revenues, so it is reasonable to establish a practical sustainability goal for Medicaid reform. In 2007, the federal government spent $191 billion on Medicaid,[8] equal to about 1.4 percent of GDP. Like for Medicare, Medicaid's costs are projected to outpace economic growth. According to the Medicare trustees, under current law the federal government's expenditures on Medicaid are projected to increase an average of 7.9 percent a year over the next 10 years, reaching $673.7 billion in 2017—roughly doubling as a percentage of GDP.[9]

While no long-run projection is yet available for Medicaid comparable to Medicare's $85.6 trillion in total excess costs, projected growth in Medicaid spending in just the next decade clearly indicates that Medicaid's present drain on the general fund is in the tens of trillions of dollars. Reforming Medicaid to bring its federal costs under control is as important as reforming Medicare and Social Security. As with Medicare, Medicaid reform should be guided by reasonable goals that restore the program to sustainability. And, similar to Medicare, a reasonable policy-neutral goal for Medicaid is to hold federal expenditures equivalent to the current level of 1.4 percent of GDP.

Conclusion

The Medicare program is in great need of modernization, but above all, it must be put on a sustainable financial footing. Medicare today is grossly unaffordable. To succeed, the debate on Medicare needs a clear, achievable measure of success for correcting Medicare's long-term finances. The Medicare trustees' estimate of Medicare's excess costs provides the basis for such a measure. This estimate shows the extent of general fund support necessary to pay projected Medicare claims.

Eliminating Medicare's future excess costs entirely, while ideal, is also a more difficult undertaking than necessary. Medicare receives a significant amount of general fund support, equal to 1.3 percent of GDP today. This diversion of resources constrains other budget options, such as tax relief and funding other spending priorities, yet this level of support for Medicare appears manageable. Therefore, a suitable rule for Medicare reform is to hold Medicare's level of general fund support at 1.3 percent of GDP. A second important advantage of this rule is that it allows Medicare reform to proceed without risk that other reforms would worsen Medicare's financial condition, and without the need to address Medicare's effects on other spending priorities. This rule implies a 25 percent reduction in costs that must be cut through Medicare reform, leaving a still-difficult task, but one that is sufficient to do the job and sustainable—and more likely to be achieved.

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8. U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Research, Office of the Actuary, *2008 Actuarial Report on the Financial Outlook for Medicaid*, October 17, 2008, at *http://www.cms.hhs.gov/ActuarialStudies/downloads/MedicaidReport2008.pdf* (March 12, 2009).

9. Author's calculation assuming nominal GDP growth slows from 4.9 percent in 2013 to 4.5 percent annual growth in 2018, reflecting the effects of the senior boom on labor force participation rates.