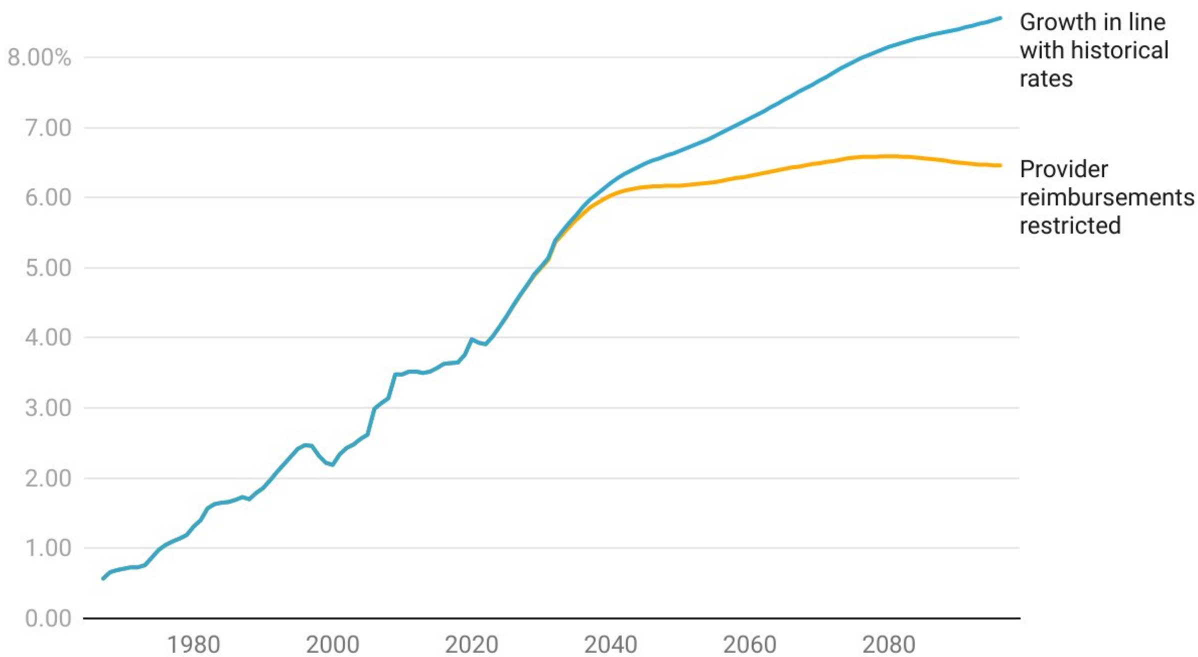
Why it's hard for the US to cut or even control Medicare spending

March 17 2023, by Dennis W. Jansen and Andrew Rettenmaier

Medicare spending as a share of US GDP

Medicare's trustees have projected that it is possible to stabilize Medicare spending, in terms of its share of the economy, as long as the government restricts its reimbursements to providers. They have also forecast what will happen if payments grow in line with historical rates.



The Medicare trustees are the secretaries of the Treasury, Labor and Health and Human Services departments, plus the Social Security commissioner. There can be up to two additional trustees, but those seats have long been vacant.

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President Joe Biden's 2024 proposed budget includes plans to shore up the finances of Medicare, the federal health insurance program that covers Americans who are 65 and up and some younger people with disabilities.

His administration aims to increase from 3.8% to 5% an existing Medicare tax that's collected on the labor and investment earnings of Americans who make more than US$400,000 annually. It also aims to reap some savings from having the government negotiate prices on more prescription drugs.

The White House projects that these changes would generate an additional $650 billion in revenue over a decade. Some independent experts concur.

As economists who have long researched the Medicare and Social Security programs, we believe the president's proposal is an important first step in opening the necessary debate on strengthening Medicare's finances.

Part A's precarious funding

Medicare consumes more than 15% of the federal budget. The program cost $975 billion in 2022, out of the government's $6.5 trillion in total federal spending.

As anyone who has enrolled in it can tell you, the program itself is rather complicated. It's divided into three parts, known as A, B and D, each of which relies on revenue from a different mix of sources.

Medicare Part A covers care delivered at hospitals and nursing homes, as well as home health care. Part B pays for doctor's visits and outpatient procedures, and Part D pays for prescription drugs. There's also Part C, a private insurance option, known as Medicare Advantage. However, its costs are included in the accounting for Parts A and B.

Part A is primarily funded by a 1.45% Medicare payroll tax on both employees and employers. When that tax and the program's other tax revenues don't raise enough money to cover Part A's costs, the program dips into the Medicare Hospital Insurance trust fund to make up the difference. The trust fund, amassed from past surplus payroll taxes, currently stands at around $143 billion.

Without spending cuts, funding increases or a combination of the two, the Medicare program's trustees have predicted in their annual report that the Medicare trust fund will be exhausted by 2028. The trustees are the secretaries of the Treasury, Labor and Health and Human Services departments, plus the Social Security commissioner. There can be up to two additional trustees, but those seats are vacant.

Medicare's expenses are rising rapidly with the retirement of baby boomers, the large generation of Americans born between 1946 and 1964, and rising health care costs.

Should the trust fund be emptied out, the trustees predict that hospital benefits would have to be cut by 10%. But those cuts are widely considered to be politically unacceptable, as illustrated by statements from Biden and his predecessor, former President Donald Trump.

In addition to proposing an increase in the tax levied on the investment earnings of high-income Americans, Biden also proposes that these revenues be fully dedicated to the trust fund. Currently the government treats that money as general revenue that can be used for any government program.

Two very different scenarios

Unlike Medicare Part A, Parts B and D are funded largely by general federal revenue and by premiums paid by retirees.

Because the government is allowed to use general revenue to pay for them, the funding of Parts B and D isn't jeopardized by the depletion of their trust fund—no matter how fast those costs rise.

Even without Biden's proposed changes, official Medicare spending projections rise rapidly through the mid-2030s and then plateau as a percentage of gross domestic product.

However, those projections are based on a presumption that payments to hospitals are constrained as specified in the Affordable Care Act and that other spending constraints on physician payments are realized.

Unfortunately, history provides little assurance that lawmakers will maintain all of these requirements to restrain future payments to health care providers.

We say this because of what happened after 1997, when Congress approved the sustainable growth rate system, which was intended to limit the annual increase in cost per Medicare beneficiary to the rate of economic growth. Starting in 2002, Congress passed legislation year after year to override it—and only stopped doing that once it did away with the system altogether in 2015.

Reflecting this uncertainty, the annual trustees report features an alternative projection that is arguably more credible and more scary. It indicates that Medicare costs will grow much faster than the economy starting in 2036.

Competing demands

The Social Security program, a national pension program that primarily supports older Americans, faces similar funding shortfalls.

Its trustees anticipate that the Social Security trust fund will be depleted by 2035 without changes in funding, promised benefits—or both. In that event, Social Security benefits may have to fall by about 20% from anticipated levels.

Medicare and Social Security are the nation's largest entitlement programs. Almost all Americans, if they live long enough, will eventually be eligible to obtain these benefits—regardless of their income or wealth.

While Americans do not yet agree on how to put these programs on a steadier fiscal footing, the math is clear.

Our elected representatives cannot avoid making hard decisions that involve increasing taxes, reducing benefits or both.

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