HEALTH POLICY MEMO

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Medicare's Phony Problem: The 45 Percent Threshold

The 2007 Medicare Trustees' report projects that by the year 2013, more than 45 percent of Medicare's total funding will come from general revenues. Under the 2003 Medicare Modernization Act (MMA), this projection will trigger a series of specific steps to deal with the "problem." A closer look, however, shows that this 45 percent threshold has no real significance. Moreover, correcting this nonexistent problem could do serious harm to Medicare beneficiaries and distract policymakers from honest discussions about how best to strengthen Medicare.

Proponents of the 45 percent threshold claim that it is supposed to act as an "early warning system" to identify problems with Medicare's costs and affordability. But as a warning system, it is fundamentally flawed in at least three ways:

1. It fails to recognize that Medicare is covering more outpatient services, rather than hospital care.
2. It makes unnecessary and erroneous assumptions about the federal budget and our spending priorities.
3. It violates basic accounting principles by not allocating interest from the Medicare Part A Hospital Insurance Trust Fund to the Medicare program.

Such a meaningless measure should not be the catalyst for policy decisions, which could have a potentially devastating effect on the health care of millions of seniors and people with disabilities.

How We Got Here

■ What is the 45 percent threshold?

As part of the MMA, which created the Part D drug program, Congress included what it called a "cost containment" provision.[1] This provision states that the Medicare Trustees must include a finding in their annual report whenever they project that general revenues will make up more than 45 percent of total Medicare funding within seven years. If the Trustees make this determination for two consecutive years, it will trigger a "warning" about future Medicare funding, presumably because general revenues will constitute an "excessive" share of Medicare funding.

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After the warning is issued, the President is required to propose policies in the following year's budget that are designed to reduce general revenues as a share of Medicare costs. By law, both Houses of Congress must consider the President's proposals, though they do not have to approve them. This year will mark the second consecutive year that the Trustees have predicted that Medicare will exceed the 45 percent threshold within seven years (in 2013). This means that the President must propose changes to Medicare as part of next year's (fiscal year 2009) federal budget.

■ What does the 45 percent threshold actually measure?

The 45 percent threshold measures when general revenues will constitute 45 percent of total Medicare funding. Medicare is financed by three principal sources:

1. payroll taxes, which fund most of Part A (hospital insurance);
2. beneficiary premiums, which pay for about 25 percent of the cost of Part B (outpatient care) and Part D (prescription drug coverage); and
3. general revenues (for example, income taxes), which pay for the remaining 75 percent of Parts B and D.

Some additional funding also comes from interest on the Part A Trust Fund and other minor sources.

There are two primary reasons for the growth of general revenues as a share of Medicare funding. First, health care today is more often delivered through outpatient settings, and paid for by Part B, than was the case in the past. Second, the 2006 start of Part D, which is paid for mostly by general revenues, further accelerated the shift toward general revenue funding.

Flaws in the 45 Percent Threshold

Critics of Medicare cite the 45 percent threshold as an indicator of Medicare's future sustainability—essentially, whether the program will be affordable in the future. The threshold is also sometimes mentioned as an indicator of the program's solvency. In fact, *the threshold provides no insight into the program's sustainability, and it has nothing to do with solvency.*

1. The 45 percent threshold does not measure the sustainability of Medicare

"Medicare sustainability" refers to the ability of the federal government to meet its Medicare obligations over the long term. Assessing the sustainability of the program requires analyzing how much Medicare will cost compared to the overall federal budget and the overall economy. In 2006, the general revenues that fund Medicare represented about 12.3 percent of the nearly $1.4 trillion in income taxes collected. Based on projections by the Trustees and the Congressional Budget Office, in 2013, when Medicare is predicted to meet the 45 percent general revenue threshold, general revenues funding Medicare will constitute 13.0 percent of the more than $2 trillion in income taxes collected.[2] This slight increase in Medicare's share of general revenues from 2006 to 2013 reflects increases in health care costs and the number of Medicare beneficiaries. It will have an impact on the federal budget, but it is not an indicator of imminent calamity.

There are legitimate questions about what share of federal spending, and what share of the overall gross domestic product (GDP, the total market value of all goods and services produced within a country's borders in a year), should be dedicated to Medicare in the long run, especially as health care costs rise and the population ages. But addressing these questions requires looking at many factors, including projections for population demographics, economic growth, tax revenues, and health care costs, as well as examining moral questions about how the value of health care for seniors and people with disabilities fits within our national priorities. The 45 percent threshold does none of these things.

2. The threshold does not address concerns about Medicare solvency

"Medicare solvency" refers to how long the surpluses in the Part A Hospital Insurance Trust Fund will last. Medicare Part A is paid for by dedicated payroll taxes, not general revenues. These taxes are deposited in a Trust Fund to be used to pay for future Part A benefits.

There is currently a surplus in the Hospital Insurance Trust Fund. As baby boomers retire and health care costs increase, that surplus will decline and, under current projections, will reach zero by 2019. Projections of when the Trust Fund will be exhausted have varied dramatically over the past 15 years, from as early as 2001 (which obviously did not happen) to as far in the future as 2030. These projections are highly dependent on projections of economic growth, Medicare policies, and overall health care costs.

Of course, in the event that the Trust Fund were depleted, it would not mean that Medicare would cease to exist. Congress would instead have to make changes to the funding system to ensure that Medicare had adequate resources. Such changes might be difficult, but not impossible. After all, there are no Defense Department or Commerce Department trust funds, for example, but these agencies continue to exist.

The 45 percent threshold has nothing to do with solvency. It is unrelated to the size of the Trust Fund or the share of payroll taxes that fund it. General revenues, not payroll taxes, determine when the 45 percent trigger is set off. In fact, ironically, if Part A spending grew faster than anticipated, it would shrink the share of general revenues in Medicare financing. In that case, the 45 percent threshold might never be reached. Although this is not an advisable policy solution, it demonstrates the absurdity of the threshold as a measure of financial health.

3. Why general revenues make up an increasing share of Medicare funding

Medicare now draws more of its funding from general revenues (as opposed to payroll taxes and premiums) for two main reasons: 1) the introduction of the Part D drug program and 2) an overall shift in the way health care is delivered from inpatient hospitals to outpatient settings.

First, the start of the Part D drug program in 2006 significantly increased Medicare's use of general revenues. The basic financing of Part D is very similar to Part B: Medicare pays for roughly 75 percent of the program, and beneficiaries' premiums pay the rest. Simply adding a major new component to Medicare—one financed primarily by general revenues—increased the overall proportion of Medicare funding from general revenue. And in the future, as prescription drug costs increase, so will the need for general revenues to pay for Part D.

Second, medical practice has increasingly shifted away from inpatient hospital care covered by Part A (and financed by payroll taxes) and moved toward more outpatient care (doctors' visits, tests, prescription drugs, etc.), which is covered by Part B and Part D (financed by premiums and general revenues).

An increased reliance on general revenues is not necessarily a bad thing. In some ways, it makes the way Medicare is financed more fair: Income taxes are paid by all people, as well as corporations, on all income. More affluent people who get substantial income from investments, for example, pay taxes on that income as well. Income tax rates are also progressive, meaning that poorer people pay at a lower rate. Payroll taxes, on the other hand, tax only wages, and they tax all wages at the same rate. They therefore disproportionately burden lower-income workers, who have few sources of income besides their wages, and who must pay at the same percentage as higher-income earners. So, relying more on general revenue, which is derived from a progressive tax system, would more fairly distribute the burden of paying for the care of our nation's elderly and disabled population.

4. The threshold measurement is flawed

Even if the 45 percent threshold could provide some helpful information about Medicare's financial health, as currently written, it would not do so accurately. As defined by the MMA, the threshold uses an overly broad definition of "general revenues," which makes the share of general revenues appear larger than it is. The threshold measure explicitly counts interest earned on the Part A Trust Fund as general revenues, not "dedicated revenues." This accounting is not logical: Interest earned on the Trust Fund goes directly back to the Trust Fund to be used for future Medicare expenses. Prior to enactment of the MMA, Medicare Trustees had always considered such interest to be dedicated revenue.[3] Treating interest income as part of general revenues significantly accelerates the time at which the 45 percent trigger will be reached—by as much as eight years.[4]

The Dangers of the 45 Percent Threshold

If strictly applied, the 45 percent threshold would force Medicare to conform to an arbitrary measure of financial health that has no fiscal significance. Once the warning is triggered, Congress must consider proposals from the President to bring the share of Medicare spending derived from general revenue under 45 percent. Such proposals would include some combination of reductions in benefits under Part B and Part D, increases in Part B and D premiums, or, ultimately, a cap on the amount the government will pay per beneficiary, regardless of that person's health care needs. In his 2008 budget proposal, the President hinted at his plans: He proposed an across-the-board cut in Medicare to address a future 45 percent warning. If implemented, these policies would raise the costs and reduce the availability of health care for seniors and people with disabilities.

Moreover, discussions about the 45 percent threshold have already done the disservice of erroneously framing the debate about Medicare's fiscal status. The threshold focuses on what percentage of Medicare should come from general funding. Such a debate is distracting and unproductive at best, and harmful at worst. As explained above, this threshold has nothing to do with either the long-term sustainability or solvency of Medicare. The challenge facing Medicare is not the challenge of figuring out what share of general revenues actually funds the program. Rather, Medicare faces the challenge that our entire society faces: how to provide high-quality health care for an aging population in an era of rising health care costs. That challenge will likely take years to address, and it must be approached thoughtfully. The 45 percent threshold, and its attendant warnings and triggers, take us no closer to a solution.

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[1] Medicare Modernization Act of 2003 (Public Law No. 108-173), Section 801.

[2] Families USA calculations. Current and projected Medicare expenditures are from the 2007 Medicare Trustees' Report. Current and projected tax revenues are from the Congressional Budget Office Baseline Budget Projections.

[3] Marilyn Moon, *The Policy Implications of Medicare's New Measure of Financial Health* (Washington: Kaiser Family Foundation, October 2005).

[4] Robert Greenstein, Richard Kogan, Edwin Park, and James Horney, *Trustees' Report Focuses Attention on Misguided Medicare "45-Percent Trigger"* (Washington: Center on Budget and Policy Priorities, May 1, 2006).