Principle #3: Making Medicare and Medicaid Sustainable
July 1, 2009

In our previous two health care papers, we argued that health reform should focus on controlling the growth of health care costs to reduce long-term deficits, and include sufficient offsets so that it does not increase the short- or medium-term budget deficit.

In addition to these features, a comprehensive health care reform plan should focus on reducing spending on Medicare and Medicaid in order to make these two programs sustainable.

Unchecked, Medicare and Medicaid threaten to consume an ever-growing share of the budget. By 2025, the two programs are expected to reach around 7.3 percent of GDP, from less than 5 percent today. And by 2080, they are projected to consume as high a share of the economy as is raised by total taxes in a typical year.

Unfortunately, none of the options currently being considered as a part of health care reform are likely to be sufficient to fully fix these programs – and many of the most promising ways to save money are in line to be used to pay for the expansion of health care coverage. Thus, while more will have to be done in the future, efforts must be made now to aggressively bring down the costs of Medicare and Medicaid.

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About this Health Care Reform Series:

Given the precarious fiscal position of the country, it is critical that any efforts to reform the nation's health care system be fiscally responsible. Accordingly, the Committee for a Responsible Federal Budget has developed a list of principles for enacting reform:

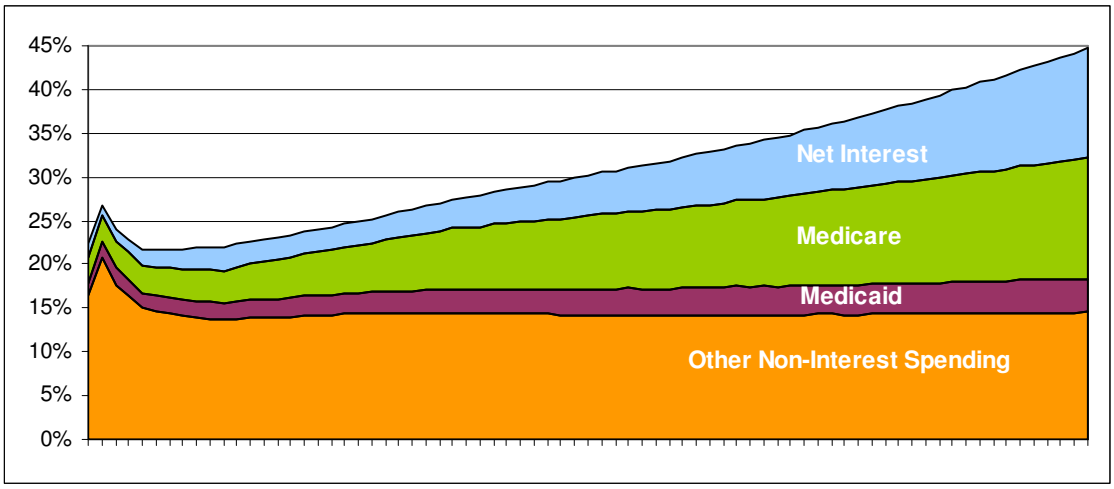
1) Health Care Reform Should Focus on Slowing Cost Growth
2) New Government Health Care Spending Should be Fully Offset
3) Government Health Care Programs Must be Made Sustainable
4) The Need to Reform Health Care Does Not Displace the Need to Reform Other Areas of the Budget
5) Health Care Reform is a Continuous Process and Will Require Continued Vigilance from Policymakers

Unsustainable Growth

Under the CBO baseline, government spending is project to grow from 20 percent of GDP in 2007 (and significantly more during the current economic crisis) to 23 percent in 2020, 32 percent in 2050, and 44 percent in 2080. This growth, which relies on fairly modest assumptions, is driven mainly by the increasing costs of Medicare and Medicaid.

CBO projects these two programs will grow from 5 percent of GDP today to almost 7.5 percent in 2025, 9.5 percent in 2035, and 17.5 percent by 2080. Importantly, these projections *already assume that significant cost control efforts from the private sector will slow the growth rate of non-federal health care spending* from 2.5 percent faster than GDP in the early years to just above GDP by 2080, with much of the savings spilling over to Medicare and Medicaid.

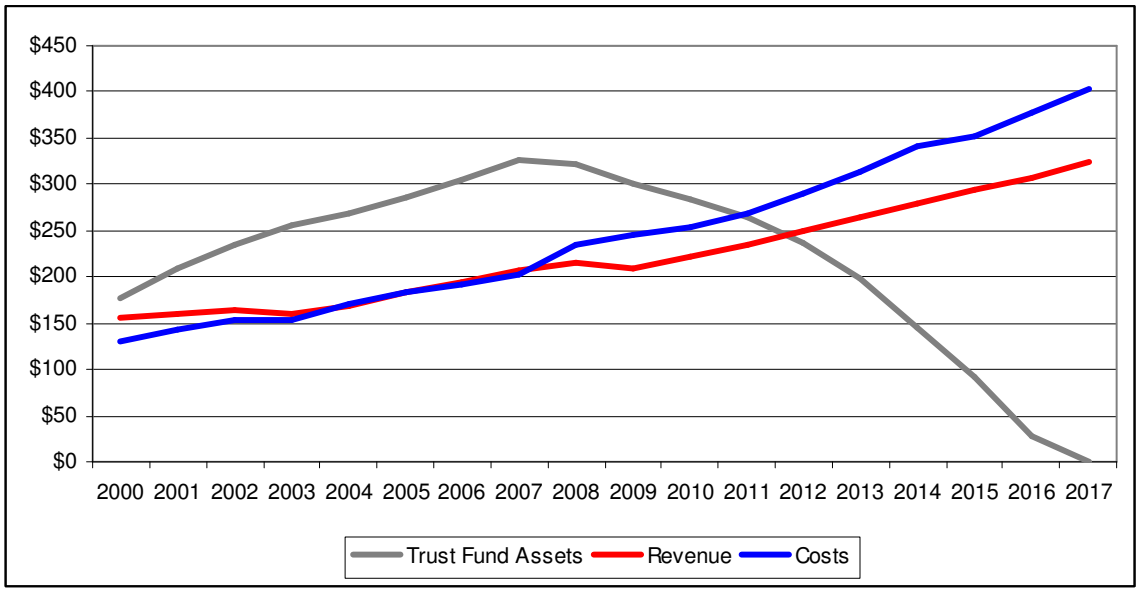
Fig. 1: Long-Term Non-Interest Spending Projections (percent of GDP)



Source: Congressional Budget Office

For Medicare Part A (Hospital Insurance), this growth represents a direct threat to the program, since it is financed from a trust fund with a dedicated revenue source (a 2.9 percent payroll tax split between employers and employees). Already the trust fund is running a deficit – around $35 billion in 2009. If the trust fund is allowed to become depleted, as it is projected to be by 2017, the program would have insufficient funds to fully pay providers, and beneficiary access to health care services would be rapidly curtailed. According to Medicare's Trustees, making Medicare Part A solvent over the next 75 years would require the equivalent of an immediate payroll tax increase of 4 percentage points – or a gradual increase of the combined payroll tax rate from 2.9 percent today to almost 12 percent by 2083. Restoring solvency through spending cuts would require expenditures to be only one third of their projected levels by the end of the 75-year period.

Fig. 2: Financial Status of Medicare Part A (billions)



Source: Medicare Trustees

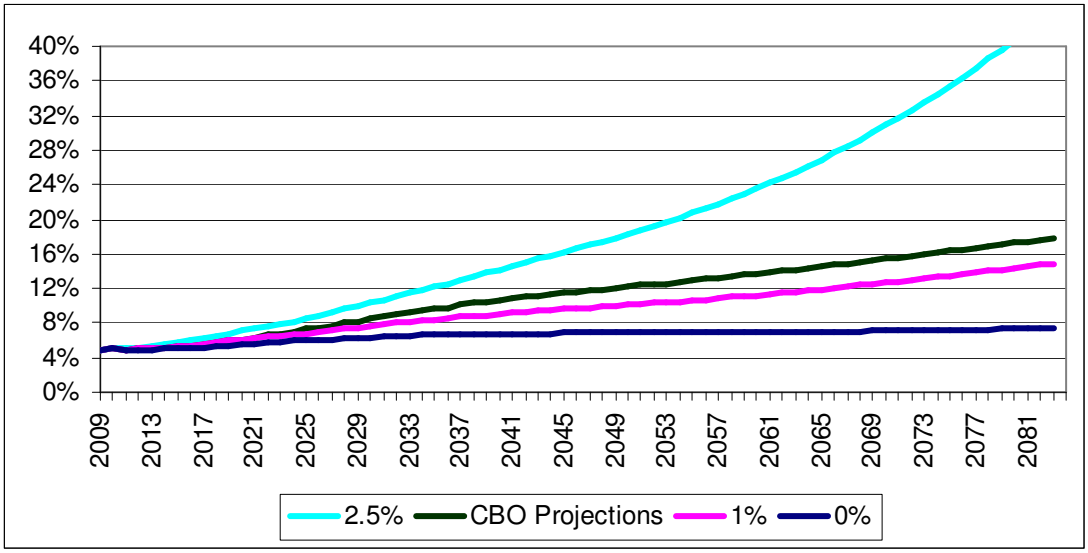
Medicare Part B (Medical Insurance) and Part D (Prescription Drug Coverage), typically referred to as the Supplemental Medical Insurance (SMI) programs, are growing at an even faster rate than Medicare Part A. But because they are funded by annually-adjusted premiums and general revenue transfers, they do not face serious threat of trust fund depletion. They do, however, promise to place increasing burdens on both participants and on general revenue, which covers roughly three quarters of their costs (though originally, they it was originally intended to cover only half). Combined with Part A, these programs threaten to grow from 3 percent of GDP today to 6 percent in 2030 and to 14 percent of GDP 75 years from now. And this assumes politicians allow steep cuts to physician payments, which they have been preventing every year since 2003.

It is also projected that Medicaid costs will grow faster than the economy, from 1.5 percent of GDP in 2008 to almost 4 percent by 2080. This growth not only threatens the federal budget, but jeopardizes state budgets, as they finance over 40 percent of Medicaid's costs.

Slowing Health Care Costs: Necessary but Not Sufficient

As we argued in a previous release (Principle #1: Slowing Health Care Cost Growth, http://crfb.org/documents/6-10-Principle1.pdf), slowing overall health care cost growth is essential to keeping Medicare and Medicaid affordable. The CEA and others have pointed out that controlling the growth of health care costs can have a tremendous effect on the long-term costs of the two programs (see http://www.whitehouse.gov/administration/eop/cea/TheEconomicCaseforHealthCareReform/), since there are considerable spillover effects from private sector spending into the Medicare and Medicaid systems.

Fig. 3: Medicare and Medicaid Costs with Different Excess Cost Growth Rates (percent of GDP)



Source: Congressional Budget Office

Even aggressive cost control measures, however, will not fully contain these programs' costs. If health care costs grew 1 percent faster than the economy each year, instead of their historical average of around 2.5 percent faster than the economy, these programs would still grow to 10 percent of GDP by 2050 (instead of 12 percent) and 15 percent by 2083 (instead of 18 percent). And even if costs were prevented from growing any faster than GDP – a tremendously unlikely scenario without a major technological or political shift – the programs would still grow from 5 percent of GDP today to 7.3 percent by 2083 as a result of population aging. Either of these scenarios would represent a dramatic improvement compared to the current baseline, but more would still need to be done to avoid a worsening fiscal situation.

Addressing Unsustainable Growth

Any measure that goes beyond simply slowing overall health care cost growth will have to make changes to the rules and structure of how the Medicare and Medicaid programs provide health care services. These changes could include modifying eligibility rules, reforming provider payments, increasing cost-sharing for individuals, requiring a greater role for the states, ceasing to cover certain services, or engaging in other types of soft or explicit rationing.

Many of these options are already being considered to finance an expansion of health care coverage. (See http://www.usbudgetwatch.org/files/crfb/HC_Options.pdf). It is important to note, though, that ***enacting cost-saving policies in Medicare and Medicaid to pay for coverage expansion will leave these policies unavailable to mediate the unsustainable fiscal situation.*** Policies that save money one place to spend it somewhere else may be worthwhile, but they do nothing to help the overall fiscal picture.

While the Administration claims, for example, that its proposed Medicare changes would extend the life of the Hospital Insurance trust fund for two years, this is true only in a bookkeeping sense. In reality, this money is being used to finance new government spending and is therefore being reallocated rather than saved. Claiming this money as Medicare savings amounts to double counting.

Therefore, to the extent Medicare and Medicaid savings are used to pay for new priorities, even more aggressive measures will be needed to put these programs, and the overall budget situation, on a sustainable path. If these measures are insufficient to bring costs under control, taxes will need to increase and/or non-health care spending will have to fall.

Ultimately, the Medicare and Medicaid programs face enormous growth that dwarfs every other component of the budget. Managing them will require both slowing overall health care cost growth *and* making large and specific programmatic changes. It may also require accepting that, as we demand increasingly more health care spending, other budgetary changes outside of health care will be necessary.

Given the sheer size of the problem, few experts believe we can solve everything in one fell swoop. But the fact that we do not yet know how to make Medicare and Medicaid fully sustainable only strengthens the case that we must act now, as part of comprehensive health care reform, to begin to bring these programs under control.

CRFB Health Care Reform Series

Five Principles for Responsible Health Care Reform
(***http://www.crfb.org/documents/5_Principles_for_Health_Reform.pdf***)
Principle #1: Slowing Health Care Cost Growth
(***http://www.crfb.org/documents/Health_Principle_1.pdf***)
Principle #2: Paying for Health Care Reform
(***http://www.crfb.org/documents/Health_Principle2_000.pdf***)
Principle #3: Making Medicare and Medicaid Sustainable
Principle #4: Addressing Other Areas of the Budget
Principle #5: Continued Vigilance in Health Care Reform