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Meeting Medicare's Spiraling Cost

Don't be fooled by overly optimistic projections. It's even worse than you think.

by AIER Research Staff

The 2012 annual report of Medicare trustees presents a gloomy picture for those counting on Medicare assistance. Unless something changes, the Medicare trust fund will be depleted in the next 12 years.

This means that a 65-year-old who enrolls in Medicare today will lose services when he or she turns 77—an age below the average U.S. life expectancy, and one at which medical needs are usually high.

Troubling as it may seem, this projection is actually the best case scenario. It is based on optimistic assumptions that are unlikely to hold true.

Chart 1 at right shows the annual report's official projection of total Medicare costs as a percent of GDP. It reveals a rapid increase in Medicare costs relative to GDP over the next 25 years as baby boomers become eligible and enroll.

Official estimates assume that current laws and institutional arrangements will prevail for the projection period. But reality is likely to unfold differently, making official projections—and the government and household decisions based upon them—highly inaccurate.

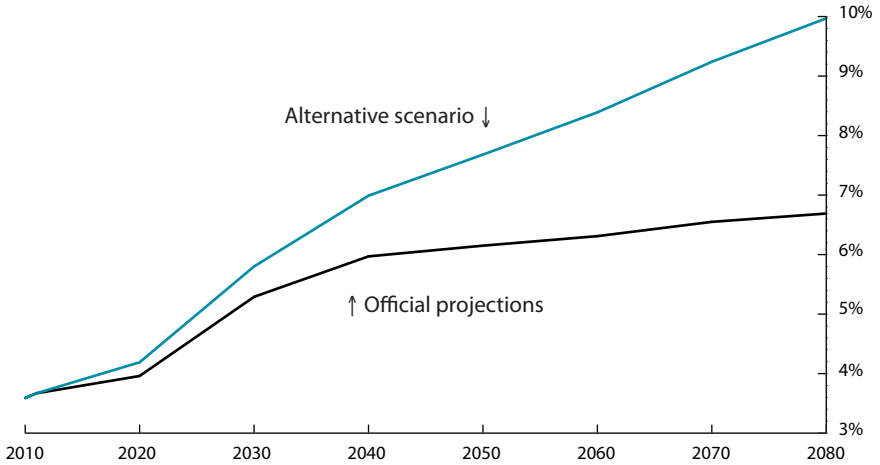
To address these inaccuracies, the Office of the Chief Actuary of Medicare created an alternative trajectory of Medicare costs based on more realistic assumptions (see Chart 1).

The alternative projections show that unless substantial changes are made, Medicare costs will be significantly above official projections. This substantial increase in costs will necessitate changes in both Medicare benefits and taxes—an eventuality for which everyone should prepare.

Past projections of Medicare costs have been far off the mark. When Medicare was first introduced in 1965, the House Ways and Means Committee estimated that inflation-adjusted Medicare would cost about $12 billion by 1990. In reality, it cost about $110 billion. By 2010, the cost rose to around $523 billion.

The sheer magnitude of the difference raises the question of whether projections have any real value. This has serious implications for U.S. public debt. Unreliable projections also mean that individuals may have a hard time predicting their tax liability and the availability of government-

Chart 1: **Projected Total Medicare Expenditures**
(official and alternative projections, percent of GDP)

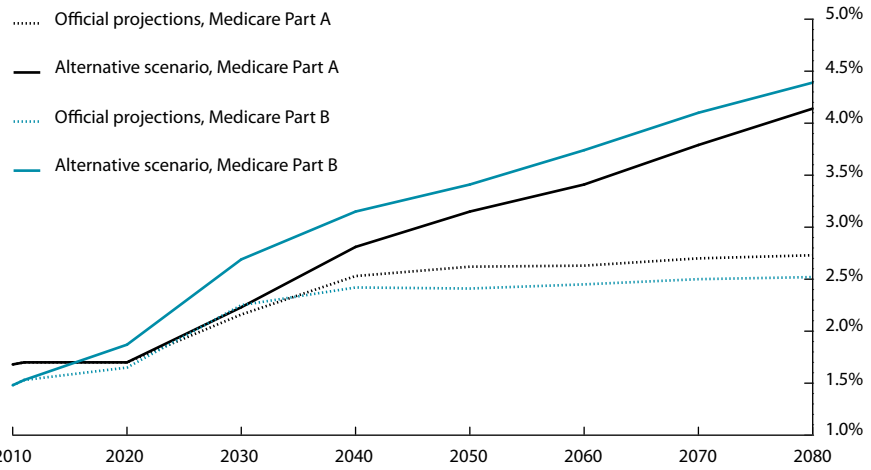


Source: *2012 Annual Report of the Trustees of Medicare Trust Funds.*

Inside this report Federal income taxes on Social Security benefits can take people by surprise. And the age at which an individual begins taking benefits can reduce or increase monthly payments. Research Fellow Walker Todd explains how to calculate the impact that federal tax liabilities and Social Security rules can have on retirement income. See back page.

Also People planning to make large gifts should take advantage of tax breaks before they expire. See Ask the Expert, page 3.

Chart 2: **Medicare Expenditures Projected to Rise Steeply**
(projected expenditures for Medicare part A and Part B, under two alternative scenarios, percent of GDP)



Source: Office of the Actuary of the Center for Medicare & Medicaid Services, *"Projected Medicare Expenditures under Illustrative Scenarios with Alternative Payment Updates to Medicare Providers,"* 2012.

sponsored health care assistance programs.

To understand the flawed assumptions in the official projections, it's important to know that Medicare has two components. Hospital Insurance (Medicare Part A) pays for hospital stays, skilled nursing facilities, and hospice care for the aged and disabled. Supplementary Medical Insurance (Medicare Parts B and D) pays for physicians' and other outpatient services and provides subsidized prescription drug insurance coverage.

Official projections assume that physicians' reimbursements under Medicare Part B will be reduced by 31 percent starting in 2013. This reduction is currently called for under the Medicare Sustainable Growth Rate (SGR) formula first introduced in 1997.

The projections also assume that payments for most non-physician Medicare providers will decrease because of growth in economy-wide productivity, according to the provision of the 2010 Patient Protection and Affordable Care Act. The annual report's estimates also depend on the proper functioning of the Independent Payment Advisory Board, also created by the Affordable Care Act, with a mandate to reduce the growth rate of Medicare costs.

It is unlikely that any of these assumptions will bear out in the future.

If health care costs grow at a faster rate than the economy does, the SGR formula is supposed to keep costs in check by cutting physicians' payments. In every year since 2001, the formula has called for physicians' reimbursement rates to be cut by 5 percent or more. But Congress has overridden this cut every year except 2002, fearing that doctors would stop accepting Medicare patients if their reimbursement rates decreased.

While Congress can reject recommended cuts, they do not go away. Instead, the law requires that postponed reductions be added to the reduction scheduled for the next year. Since reimbursement reductions have been delayed for a decade, the cumulative reduction scheduled for 2013 is very large—31 percent. It is unlikely that the Congress will allow Medicare payments to doctors to decrease by such a large amount. This makes projections that assume such a cut unrealistic.

The official projections also hinge on innovations in health care delivery systems that are highly uncertain. The Affordable Care Act requires that annual payments for most Medicare services be moderated by the rate of increase in economy-wide productivity.

In practice, the efficiency of the delivery of health care services has never increased as fast as overall productivity. The productivity adjustment required by law would reduce the effective payments doctors and hospitals receive for treating Medicare patients.

This, in turn, could compromise Medicare beneficiaries' access to medical care. For this reason, it is likely that the productivity adjustment will be legislatively amended or abandoned at some point. Actual Medicare costs will therefore be higher than the ones projected under the current law.

When Medicare spending per beneficiary exceeds specified thresholds, which is expected to happen often, the Advisory Board is charged with finding measures to reduce it. Since reductions in physicians' payments and productivity adjustments are not likely to be implemented, the Board will have to find some other way to bring costs substantially down. But it is unclear whether the Board will be able to effectively design proposals to do this.

The more realistic alternative scenario created by the Office of the Chief Actuary assumes that Medicare physicians' payments will grow at the rate of average U.S. health care spending. It assumes that Medicare providers might not keep their costs within the limits of reimbursement rates, leading Congress to increase rates. The alternative scenario additionally assumes that the Board will have limited ability to hold down Medicare cost growth rates.

Unsurprisingly, with these assumptions the future costs of

Medicare come in much higher than the official projections suggest. As Chart 2 on page 2 shows, under the alternative scenario costs for Medicare Part A will rise substantially above official projections beginning around 2027. Under official projections, Part A costs are expected to rise from 1.7 percent of GDP in 2011 to 2.7 percent of GDP in 2080. Under the alternative scenario, costs will rise to 4.1 percent of GDP in 2080.

No matter which projections we take, the trust fund for Medicare Part A will be exhausted in 2024. For Medicare to survive after that, costs will have to be covered by current tax revenue.

Under the official projections, we will need to collect an additional 1.4 percent of taxable payroll to keep Medicare Part A viable for the next 75 years. To cover the much higher costs projected under the alternative analysis, we will have to collect an additional 2.8 percent of taxable payroll in taxes.

In 2011, Medicare taxes amounted to 3.2 percent of taxable payroll. To cover future costs under the alternative scenario, taxes will have to be raised to 6.0 percent of taxable payroll—almost double their current level.

For Medicare Part B, the discrepancy between the official projections and more realistic alterative ones is even larger (see Chart 2). Under the current law, the cost of Medicare Part B is expected to rise from 1.5 percent of GDP in 2011 to 2.4 percent of GDP in 2040 and 2.5 percent in 2080. Under the more realistic scenario, costs of Medicare Part B will rise to 3.2 percent of GDP in 2040 and 4.4 percent in 2080.

Medicare Part B is covered by general tax revenue and by monthly premiums paid by enrollees. The premiums cover 25 percent of program costs. Taxpayers cover the remaining 75 percent.

If costs of Medicare Part B grow as the alternative scenario suggests, they will more than double relative to GDP by 2040. This means that the portion of general tax revenue devoted to funding Part B and the monthly premiums enrollees pay will have to double as well. This will be difficult to sustain without substantial changes in the tax structure.

In 2011, general tax revenue that went to fund Medicare Part B consumed 17 percent of all personal and corporate federal income taxes. If funding for Part B were to double (and if taxes remained relatively constant as percent of GDP), it would consume about 34 percent of all personal and corporate federal income taxes. It is doubtful that the government can devote such a large share of federal income taxes to just one program. Medicare will probably not remain in its current form much longer.

Some combination of increased taxes, increased Medicare premiums and co-payments for enrollees, and cuts in Medicare reimbursement rates (which may translate into effective reductions in benefits) will have to be implemented in the next several years. Everyone—those already enrolled in Medicare, those who plan to enroll in the next few years, and all taxpayers—should prepare for the coming changes.

Given that none of these actions are popular, politicians are likely to postpone them for as long as possible. But the ultimate deadline for making changes is the day the Medicare trust fund runs out. 2024 is only 12 years away.

To read more articles about Medicare and Social Security, go to www.aier.org.

ASK THE EXPERT
Timely Giving

If you're planning to make a large cash gift to children or grandchildren, now could be a good time to do it. At the end of 2012, the 2010 Tax Relief Act will expire. That act temporarily raised the ceiling on how much individuals can give without incurring gift and estate taxes.

Under the act, individuals can give away up to $5.12 million over their lifetimes without paying gift or estate taxes. In 2013, people will start paying taxes on gifts over $1 million.

Not only that, gift and estate tax rates will go up. Right now, the top tax rate for gifts over $5.12 million is 35 percent. But next year, the top tax rate will increase to 55 percent for gifts over $1 million. In addition, graduated rates for gifts over $10 million will be phased out: All contributions over that amount will be taxed at 55 percent.

The generation skipping tax, directed at gifts made to grandchildren and great-grandchildren, will be subject to the same changes in 2013.

One thing that won't change is the separate $13,000 annual gift tax exclusion per recipient. Annual gifts of $13,000 or below do not need to be reported to the IRS. Some people elect to give yearly contributions in this amount to children or grandchildren.

Before making a large gift, consider the potential consequences for beneficiaries' income taxes. As always, please consult with your tax advisor to decide what works best for your family.

—Kevin T. McGrath, CPA, is a tax partner with BST Advisors, LLC.

To submit questions for future columns, e-mail asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.

Taxing Social Security

Social Security benefits are not a free lunch—even after retirement.

by Walker F. Todd, PhD, JD, and Enrolled Agent, Research Fellow

When planning for retirement, most people expect their income to come from a variety of sources: pensions, 401(k) accounts, interest, dividends, and capital gains, as well as Social Security. But one of the calculations people fail to make is the impact of taxes on their Social Security benefits. In fact, the very existence of these taxes can come as a rude shock for some.

Social Security payments are usually exempt from state and local income taxes. Not so with federal taxes. Taxpayers receiving other income may be subject to taxes on at least a portion of their Social Security benefits. All income counts: wages, salaries, pensions, interest, dividends, capital gains, self-employment, or even tax-exempt sources such as municipal bond interest.

Fortunately, it's not that hard to understand how the Internal Revenue Service calculates taxable Social Security. Their formula is as follows.

Take one-half of annual Social Security payments.

Add *all* other income, including tax-exempt interest.

For single taxpayers and those claiming head of household status, the income threshold for taxation of Social Security is $25,000 for the sum of the two amounts, at which point 50 percent of benefits become taxable. For single taxpayers with incomes greater than $34,000, up to 85 percent of Social Security benefits can be taxable.

For married taxpayers filing jointly, 50 percent of benefits become taxable at a threshold income of $32,000 for the sum of the two amounts. Once income exceeds $44,000, 85 percent of Social Security benefits are taxable.

For married taxpayers filing separately who lived together at any time during the year, the income threshold is zero. Up to 85 percent of their Social Security benefits are taxable, even at very low levels of other income.

Another potential crimp on retirement income is the age at which a person starts to receive Social Security benefits. Individuals can start taking benefits at age 62, but what the Social Security Administration terms "full retirement age" comes some years later. For people born between 1943 and 1954, it is age 66. It rises gradually for people born later until it reaches age 67 for those born after 1959.

One of the calculations people fail to make is the impact of federal income taxes on their Social Security benefits.

People turning 62 during 2012 who choose to start receiving Social Security benefits will have payments reduced to 70 percent of the full benefit level. Benefits may be further limited if wage, salary, and self-employment income exceed a fairly low threshold, currently $14,640 per year.

The Social Security Administration withholds future payments at the rate of $1 for every $2 earned above that limit. Social Security usually withholds all payments until the penalty is recovered during the following calendar year. In practice, this means that if you file for benefits early but continue working, your payments may be severely reduced.

The earnings limitation is calculated monthly ($1,220). But it is relaxed somewhat for the calendar year in which an individual reaches full retirement age. During that year, a recipient may earn up to $38,880 without penalty, measured as of the birthday month. For the average taxpayer born during the first nine months of the year, this is not a binding constraint.

At full retirement age, income limits no longer apply when it comes to Social Security benefits. Benefits are paid in full.

For those who opt to postpone receiving benefits, there is a bonus. Monthly payments increase gradually until age 70. The year of a recipient's birthday and the number of months he or she delays taking benefits increase the payments.

The earlier a person starts receiving benefits, the lower the monthly payments, but he or she collects them longer. When people go on Social Security later, the payments are higher, but are paid out over fewer years.

AIER | gold corner

Price of gold, May 31, 2012, London PM fix.

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