Medicare Financing

Introduction

Medicare's rapidly rising costs present a significant public policy problem. Without reforms to put it on a more sustainable trajectory, significant benefit cuts or tax increases may be necessary. There are many misconceptions about Medicare's finances. It is vital that policymakers understand the reality of Medicare's financing structure and fiscal challenges.

Background

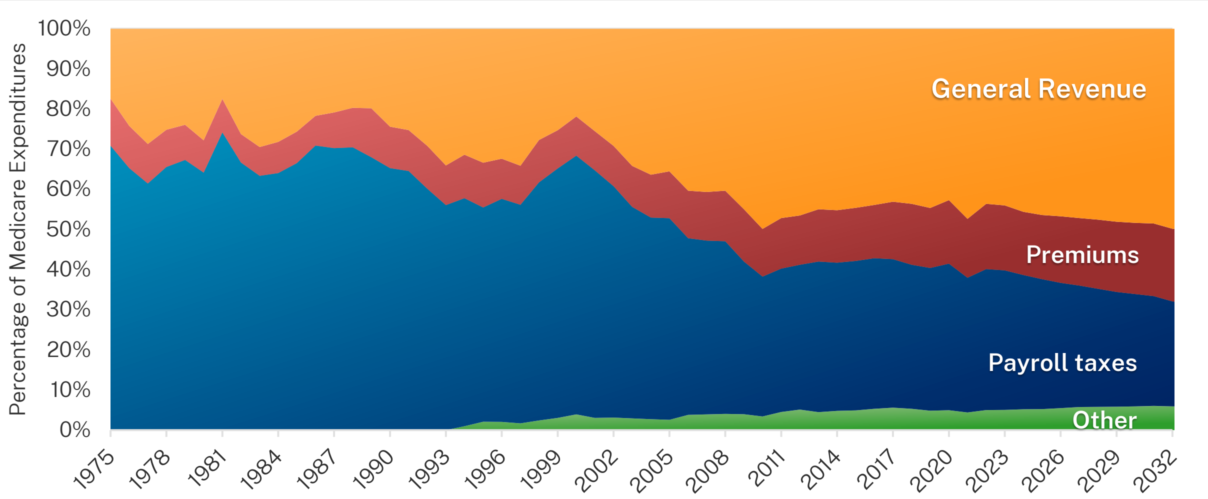
Medicare is a federal entitlement that pays for health care services for over 60 million elderly and disabled Americans. As a mandatory program, it does not require appropriations or authorization from Congress. Medicare is divided into four parts:

- Part A covers hospital, post-acute care benefits, and nursing home care;
- Part B covers other medical benefits like outpatient and physician care;
- Part C, or Medicare Advantage, administers Part A/B/D benefits via insurance plans; and
- Part D administers prescription drug benefits, also through insurance plans.

All Medicare benefits, including those covered in Part C, are paid out of two so-called trust funds (although these do not function like most trust funds, as described in the next section):

- The Hospital Insurance (HI) Trust Fund finances Part A benefits and is funded primarily by payroll taxes. This revenue has historically comprised 84 to 91 percent of the trust fund.[1] From 1970 to 2021, the share of total Medicare spending paid from the HI Trust Fund has fallen from 64 to 32 percent.
- The Supplemental Medical Insurance (SMI) Trust Fund finances Part B and Part D benefits. Rather than payroll taxes, its primary income sources are beneficiary premiums for these services and general tax revenue. Between 1970 and 2021, premiums have gone from 47 percent of the SMI Trust Fund to 22 percent. Meanwhile, general tax revenue has risen from 47 to 75 percent.

Figure 1. Sources of Medicare Expenditures (1975-2032)[2]



[1] Unless otherwise stated, all figures in this brief come from the 2022 Medicare Trustees Report. See: Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, "2022 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," June 2, 2022. https://www.cms.gov/files/document/2022-medicare-trustees-report.pdf

[2] HI Trust Fund deficits are included in General Revenue. These deficits occur when Part A expenses exceed current payroll tax revenues. The Treasury borrows prior year payroll tax surpluses for other federal spending, so this grouping reflects that, when there is a deficit, these existing HI Trust Fund balances are paid by general revenues until they are exhausted.

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Frequently Asked Questions

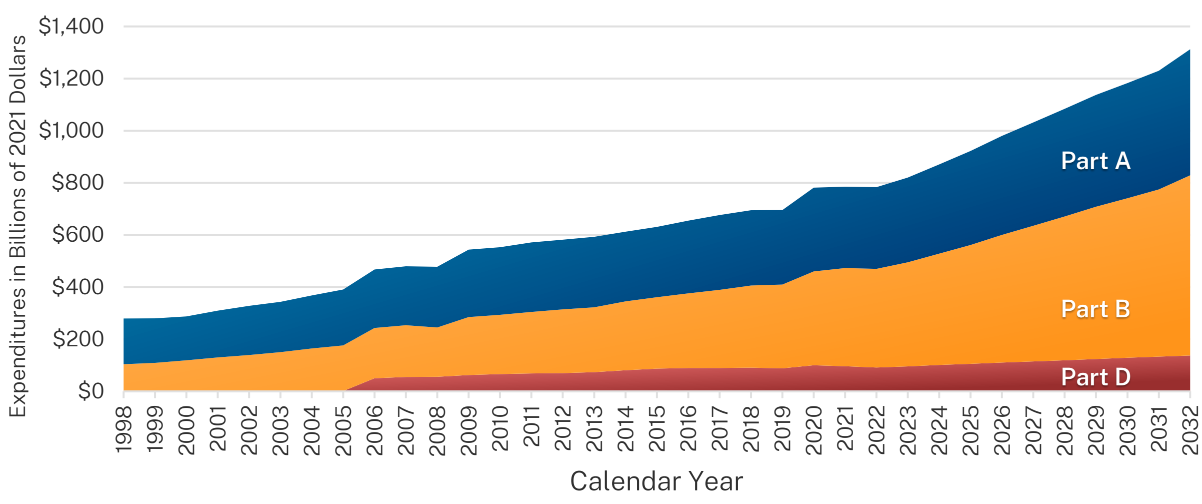
Why is Medicare cost growth a problem? — Medicare spending is growing as a share of the economy. From 1970 to 2021, it rose from 0.7 to 3.9 percent of GDP and is projected to reach 6.2 percent by 2046. Medicare spending increasingly goes towards Part B benefits, of which most funds come from general revenue transfers. Thus, it will directly divert tax dollars from other federal programs. By contributing to federal debt, it will also increase interest payments and eventually compromise the government's ability to borrow absent large benefit cuts or tax increases.[3]

Didn't seniors already pay into their benefits with their payroll taxes? — No. Medicare is funded in a pay-as-you-go manner, since its benefits are almost entirely funded by current tax and premium revenues. Indeed, beneficiaries generally receive more than what they pay in; a single, 65-year-old male with average income retiring in 2020 is expected to receive $238,000 in Medicare benefits (net of premiums) and have paid $86,000 in Medicare payroll taxes over the course of his lifetime.[4] Despite its name, the HI Trust Fund does not keep surplus revenues. The Treasury uses them for other expenses and makes Part A payments out of general revenues, crediting them to the trust fund.[5]

What happens when the HI Trust Fund runs out of money? — When Part A expenses exceed revenues, the HI Trust Fund's balances decrease. When it is depleted (referred to as "insolvency"), it will only be able to finance Part A benefits with current revenues. When this happens (projected around 2030), the HI Trust Fund will only be able to finance about 86 percent of Part A benefits. This issue is distinct from Medicare's broader fiscal challenges; solvency only refers to Part A, but the program as a whole has serious fiscal challenges.

How will Medicare's financing structure impact future beneficiaries? — Medicare's pay-as-you-go funding structure means it becomes less sustainable when a smaller pool of taxpayers is supporting it. From 1980 to 2008, each beneficiary was supported by about four workers; this fell to about 2.9 workers in 2021 and will fall to 2.5 workers by 2030. This will make it harder to contain program costs and avoid a fiscal crisis. Simply maintaining the solvency of the HI Trust Fund does not fix this problem.

Figure 2. Medicare Expenditures by Part (1998-2032)



[3] Paul Winfree, "The Contribution of Federal Health Programs to U.S. Fiscal Challenges and the Need for Reform," Paragon Health Institute, January 2023. https://paragoninstitute.org/the-contribution-of-federal-health-programs-to-us-fiscal-challenges-and-the-need-for-reform/
[4] Figures are calculated via expected present value in 2021 dollars.See: C. Eugene Steuerle and Karen E. Smith, "Social Security & Medicare Lifetime Benefits and Taxes: 2021," February 2022. https://www.urban.org/sites/default/files/2022-02/social-security-medicare-lifetime-benefits-and-taxes-2021.pdf
[5] Congressional Research Service, "Medicare Financial Status: In Brief," October 21, 2021. https://crsreports.congress.gov/product/pdf/R/R43122