The Daily Dish

“Fixing” Medicare

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Eakinomics: “Fixing” Medicare

As noted in yesterday’s Eakinomics, I recently received the following (very reasonable) question: “For Social Security and Medicare, in order for there to be NO changes to current retiree and near-retiree benefits, what key variables must be adjusted for Millennials and GenXers in order to save the programs for those generations? Is it possible to create sustainable growth rates in benefits given life expectancies over the next 50 years?”

Tuesday’s Eakinomics took a rough stab at what was at stake in Social Security. Today’s topic is Medicare. The key difference between the two programs is that in Social Security there is a tight link between the source of financing (payroll taxes) and the payment of benefits. Medicare has evolved to have no such link.

Medicare consists of four separate sub-programs. The first (“Part A”) covers inpatient hospitalizations and resembles Social Security. It is financed by a payroll tax of 2.9 percent (3.8 percent on income and investment for high earners) – split equally between employers and employees – and accompanied by an accounting ledger “trust fund” that will be exhausted before 2030.

The second (“Part B”) and fourth (“Part D”) cover outpatient care and prescription drugs, respectively. One quarter of each program’s costs are paid for by beneficiaries’ premiums, while the remaining 75 percent comes from general government revenue. The third program is Medicare Advantage (MA or “Part C”), which offers a bundle with all of the services under a single private insurance policy. It, too, has a 25-75 split of beneficiary premiums and general revenue financing.

Clearly, Medicare does not pay for itself. Indeed, Medicare has a cumulative cash shortfall of $4.3 trillion and is alone responsible for one-third of the national debt outstanding. For that reason, it is difficult to define what “fixing” Medicare really means.

Conveniently, however, the cash-flow deficit in Medicare is currently in the vicinity of $350 billion, so one could imagine raising payroll taxes by $350 billion. That would “pay for” Medicare and focus the cost on workers, which is a way to hold relatively harmless the retirees and near-retirees. At present, the Medicare payroll tax raises about $250 billion a year; it would require another 4.3 percentage points to raise an additional $350 billion. Put differently, the standard Medicare payroll tax rate would have to more than double from 2.9 percent to 7.2 percent.

Unfortunately, there is no guarantee that this would work. Unlike Social Security, Medicare does not have a fixed formula that delivers a dollar value of benefits for each participant. Instead, Medicare reimburses for medical services; if the costs of those services rise faster than the payroll tax base – and they always have – then the tax increase will quickly be overrun by needs for more revenue.

My conclusion is that the notion of "holding harmless" current and near-retirees is untenable for Medicare. Medicare is simply an unrealistic over-promise and it is dangerous to pretend that promise can be met. The goal should be to make a new promise that meets the health needs of seniors and the budgetary realities of the nation.