Center on Budget and Policy Priorities | POLICY FUTURES

December 14, 2020

Strengthening Medicare Financing

General Revenues Should Be Part of the Solution

By Paul N. Van de Water

Medicare's Hospital Insurance (HI) trust fund faces depletion in only about three years, according to the latest projections from the Congressional Budget Office (CBO). To improve program solvency and avoid cuts in benefits, action is needed before then. This short time horizon will force serious consideration of using general revenues, at least as a bridge while other policies can be phased in. But tax increases and spending reductions can also contribute to strengthening trust fund solvency over the longer run, while paying for needed improvements in Medicare benefits.

CBO projects that the HI trust fund will be depleted in fiscal year 2024. In 2025, income under current law will fall $78 billion, or 17 percent, short of annual expenditures. The shortfall will grow to 22 percent in 2044, according to Medicare's trustees, and then gradually shrink. Over the next decade, the trust fund's deficits will total about $750 billion, CBO projects.[1]

Phasing in spending cuts of that magnitude in such a few years would not be feasible — or desirable. With the nation still likely to be recovering from the pandemic and recession, raising payroll taxes in the near term would also be inappropriate. And allowing the trust fund to borrow would just dig the financing hole deeper. General revenues should therefore be part of the immediate solution for the trust fund depletion that's only a few years away, along with some of the other policies recommended below.

Dedicating the Medicare tax on unearned income to the HI trust fund. One logical form of general revenue financing would be to dedicate the proceeds of the net investment income tax (NIIT) to the HI trust fund. In the Health Care and Education Reconciliation Act of 2010, Congress enacted a 3.8 percent tax on the net investment income of high-income taxpayers. Because of procedural limitations on the congressional reconciliation process, however, NIIT proceeds could not be dedicated to the HI trust fund but instead go to the general fund. As a first step toward restoring solvency, policymakers should rectify this omission.

Under this proposal, future proceeds from the NIIT would be deposited in the HI trust fund, amounting to approximately $350 billion over the 2021-2030 period and closing nearly half of the ten-year shortfall. In addition, the general fund would transfer to the trust fund an amount equal to

[1] Congressional Budget Office, *The Outlook for Major Federal Trust Funds: 2020 to 2030*, September 2020, https://www.cbo.gov/system/files/2020-09/56523-Trust-Funds.pdf.

the present value of the past proceeds of the tax, or more than $200 billion. Since these actions would reallocate revenue from an existing tax but not raise new revenue, they would improve the status of the HI trust fund but not reduce the overall federal deficit.

Shifting spending out of the HI trust fund. An indirect approach to effectively finance more Medicare spending from general revenues would be to remove some category of spending from the HI trust fund and replace it with a new program financed by general revenues. The Trump Administration's 2021 budget proposed just such a shift for spending on graduate medical education, while reducing spending on medical education in making the shift.[2] The Obama Administration proposed smaller reductions in spending on medical education. The Trump Administration proposal would reduce Medicare spending by $168 billion over the 2021-2030 period, CBO estimates.[3]

Filling the gaps between the Medicare taxes on unearned income and earnings. In addition to the NIIT on unearned income, high-income taxpayers pay a 3.8 percent Medicare employment tax on earnings and self-employment income over $200,000 for single taxpayers and $250,000 for couples. (The 3.8 percent tax comprises the 2.9 percent payroll tax on all earnings plus an additional 0.9 percent for earnings above those dollar thresholds.) Some income from professional services — such as distributions received by active S corporation shareholders — is not subject to either tax, however. This creates significant opportunities for tax avoidance.

The Obama Administration's 2017 budget proposed eliminating these gaps.[4] This proposal would have raised $236 billion in new revenue over the 2017-2026 period, according to the Joint Committee on Taxation.[5] Over the next ten years it would raise even more. (This proposal could be modified to avoid raising taxes on people with incomes below $400,000, as the Biden presidential campaign promised, but at the expense of greater complexity and a loss in revenues.)

Reducing provider payments. Reducing excessive payments to health care providers, although insufficient by itself to avert trust fund depletion, can make an important contribution to improving solvency in the medium term. For example, the Medicare Payment Advisory Commission (MedPAC) and both the Obama and Trump Administrations have proposed scaling back payments to post-acute care providers — including skilled nursing facilities, inpatient rehabilitation facilities, and home health agencies — which are too high relative to the cost of care. The proposal in the 2021 budget would save Medicare $79 billion over ten years, according to CBO.

Some other proposals from MedPAC and the Trump Administration's fiscal year 2021 budget, such as site-neutral payments to equalize Medicare payments to different kinds of facilities, also

---

[2] Department of Health and Human Services, *2021 Budget in Brief*, February 2020, p. 74, https://www.hhs.gov/sites/default/files/fy-2021-budget-in-brief.pdf.

[3] Congressional Budget Office, *Proposals Affecting Medicare — CBO's Estimate of the President's Fiscal Year 2021 Budget*, March 25, 2020, https://www.cbo.gov/system/files/2020-03/56245-2020-03-medicare.pdf.

[4] Department of the Treasury, Office of Tax Analysis, *Gaps between the Net Investment Income Tax Base and the Employment Tax Base*, April 14, 2016, https://home.treasury.gov/system/files/131/NIIT-SECA-Coverage.pdf.

[5] Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Contained In The President's Fiscal Year 2017 Budget Proposal,* JCX-15-16, March 24, 2016, https://www.jct.gov/publications/2016/jcx-15-16/.

deserve serious consideration, although the budgetary savings, in that case, accrue not to HI but primarily to Medicare's Supplementary Medical Insurance trust fund.

Reducing overpayments to Medicare Advantage plans. Medicare beneficiaries may choose to receive their hospital and physician benefits either through traditional Medicare, which offers a wide range of providers, or through private Medicare Advantage (MA) plans, which offer some additional benefits but restrict the choice of providers and access to services. More than one-third of beneficiaries are enrolled in MA plans. Reducing overpayments to those plans can contribute to improving HI solvency.

Medicare Advantage plans have considerable latitude in designing their benefit packages and can use supplemental benefits, such as fitness benefits, to attract healthier or otherwise more profitable enrollees. Medicare's payment system attempts to correct for differences in the health status of plans' enrollees through risk adjustment, which compensates insurers with sicker-than-average enrollees. Nonetheless, MedPAC estimates that MA plans are overpaid by about 2 to 3 percent compared to traditional Medicare because of the way they code their enrollees' health conditions, generating about $6 billion a year in excess payments to MA plans.[6]

Some evidence indicates that the overpayments may be even greater. For example, the Kaiser Family Foundation found that people who switched from traditional Medicare to MA had $1,253 (or 13 percent) less Medicare spending, on average, in the year before switching than beneficiaries who remained in traditional Medicare, even after risk adjustment.[7] If Medicare Advantage tends to attract beneficiaries with lower spending, "basing payments to [MA] plans on the spending of those in traditional Medicare" — as under current law — "may systematically overestimate expected costs of Medicare Advantage enrollees," according to the Kaiser researchers. Richard Kronick of the University of California San Diego estimates that Medicare will overpay MA plans by about $200 billion over the next decade.[8]

Increasing the Medicare payroll tax rate. As noted, the HI program is financed primarily by a payroll tax contribution of 2.9 percent on all earnings (divided equally between employers and employees) and an additional tax of 0.9 percent on earnings above the NIIT thresholds. Although raising the payroll tax rate would not be timely while the economy is recovering from the recession, policymakers should consider phasing in an increase in the Medicare payroll tax as the economy approaches full employment. At the same time, they should keep in mind that Social Security also faces depletion of its trust fund in the next decade or so and may also need additional payroll tax financing.

---

[6] Medicare Payment Advisory Commission, *Medicare Payment Policy*, March 2020, pp. 392-4, http://medpac.gov/docs/default-source/reports/mar20_entirereport_sec.pdf.

[7] Gretchen Jacobson, Tricia Neuman, and Anthony Damico, *Do People Who Sign Up for Medicare Advantage Plans Have Lower Medicare Spending?,* Kaiser Family Foundation, May 7, 2019, https://www.kff.org/medicare/issue-brief/do-people-who-sign-up-for-medicare-advantage-plans-have-lower-medicare-spending/.

[8] Richard Kronick, "Why Medicare Advantage Plans Are Being Overpaid By $200 Billion And What To Do About It," *Health Affairs Blog*, January 29, 2020, https://www.healthaffairs.org/do/10.1377/hblog20200127.293799/full/.

The long-run HI shortfall amounts to 0.76 percent of taxable payroll, according to Medicare's trustees.[9] Thus, a payroll tax increase of 0.38 percent each on employers and employees would completely close the program's long-run deficit. A smaller increase could be combined with some of the other proposals suggested here to help close the imbalance or create room for benefit improvements.

Shifting some or all of the HI payroll tax to Social Security, as some have proposed, would be a step in the wrong direction. Although adding general revenues to HI is appropriate, eliminating or significantly reducing its payroll tax financing would threaten Medicare's character as an earned benefit.

Financing benefit improvements. The Medicare benefit package is not overly generous, and benefit reductions are unlikely to make a major contribution to improving HI solvency. To the contrary, several improvements in Medicare benefits merit consideration and would need to be paid for.

Placing a cap on total annual out-of-pocket spending by Medicare beneficiaries — a vital benefit that MA plans offer but traditional Medicare lacks — belongs high on the list. In addition, the Biden campaign proposed lowering Medicare's eligibility age to 60, while Rep. Frank Pallone, chair of the House Committee on Energy and Commerce, has released a draft proposal to create a new Medicare long-term care benefit.[10] And the House has passed legislation that would use prescription drug savings to pay for dental, hearing, and vision benefits and improved premium and cost-sharing assistance for low-income beneficiaries.[11,12] Benefit improvements like these would require new financing above and beyond what is needed to restore Medicare solvency.

---

[9] Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2020 Annual Report*, April 22, 2020, https://www.cms.gov/files/document/2020-medicare-trustees-report.pdf.

[10] House Committee on Energy and Commerce, *Pallone Unveils Proposal for Medicare Long-Term Care Benefit*, May 2, 2018, https://energycommerce.house.gov/newsroom/press-releases/pallone-unveils-proposal-for-medicare-long-term-care-benefit#:~:text=The%20comprehensive%20discussion%20draft%2C%20The,term%20care%20services%20and%20supports.

[11] H.R. 3, 116th Congress, *Elijah E. Cummings Lower Drug Costs Now Act*, https://www.congress.gov/bill/116th-congress/house-bill/3.

[12] See also Hannah Katch and Paul Van de Water, *Medicaid and Medicare Enrollees Need Dental, Vision, and Hearing Benefits*, Center on Budget and Policy Priorities, December 8, 2020, https://www.cbpp.org/research/health/medicaid-and-medicare-enrollees-need-dental-vision-and-hearing-benefits.