Budget Basics: Medicare

Apr 30, 2019

Medicare is an essential health insurance program serving millions of Americans, and a major part of the federal budget. It was signed into law by President Lyndon B. Johnson in 1965 to provide health insurance to people age 65 and older. Since then, the program has been expanded to serve the blind and disabled.

The number of people enrolled in Medicare has tripled since 1970, climbing from 20 million in 1970 to 60 million in 2018, and it is projected to reach about 90 million in 30 years. A major driver of Medicare enrollment is the increase in the number of older Americans. There are currently 52 million people age 65 and older, and that number is projected to increase nearly 60 percent by 2048. In addition to that population, Medicare also covers certain younger people with disabilities or specific illnesses.

One of the biggest misconceptions about Medicare is that it is self-financed by current beneficiaries through premiums and by future beneficiaries through payroll taxes. In fact, payroll taxes and premiums together only cover about half of the program’s cost.

Key Facts

- Medicare is the second largest program in the federal budget. In 2018, it cost $582 billion — representing 14 percent of total federal spending.1
- Medicare has a large impact on the overall healthcare market: it finances about one-fifth of all health spending and about 40 percent of all home health spending.
- In 2018, Medicare provided benefits to 18 percent of the population.2
- Medicare spending is a major driver of long-term federal spending and is projected to nearly double from 2.9 percent of GDP in Fiscal Year (FY) 2018 to 5.9 percent in FY 2048 due to the retirement of the Baby Boom Generation and the rapid growth of per capita healthcare costs.

What are the components of Medicare?

Medicare is a federal program that provides health insurance to people who are age 65 and older, blind, or disabled. Medicare consists of four "parts":

- **Part A** pays for hospital care;
- **Part B** provides medical insurance for doctor’s fees and other medical services;
- **Part C** is Medicare Advantage, which allows beneficiaries to enroll in private health plans to receive Part A and Part B Medicare benefits;
- **Part D** covers prescription drugs.

Almost all seniors are automatically enrolled in Part A at no additional cost once they turn 65. Parts B, C, and D are voluntary and require enrollees to pay premiums to receive coverage.

Where does Medicare funding come from?

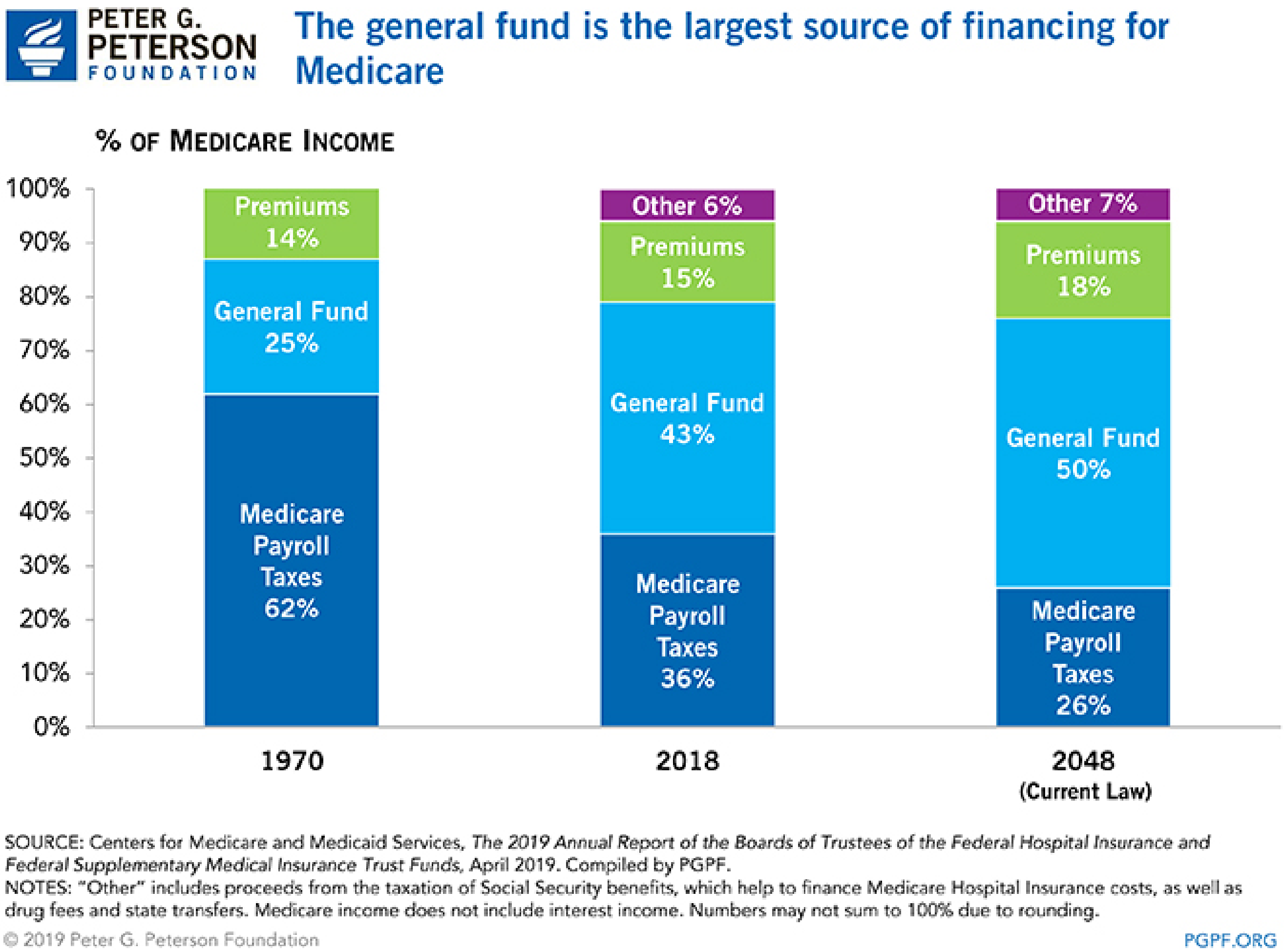
Medicare is financed by two trust funds: the Hospital Insurance (HI) trust fund and the Supplementary Medical Insurance (SMI) trust fund. The HI trust fund finances Medicare Part A and collects its income primarily through a payroll tax on U.S. workers and employers. The SMI trust fund, which supports both Part B and Part D, receives most of its income from the federal government's general fund because premiums only cover about one-quarter of this fund's costs. Part C, on the other hand, is paid for through both the HI and SMI trust funds and collects its income from a combination of the general fund, payroll taxes, premiums paid by beneficiaries, and out-of-pocket charges.

As a whole, only 56 percent of Medicare's costs were financed through payroll taxes, premiums, and other receipts in 2018. Payments from the federal government's general fund made up the difference.

The composition of Medicare financing has changed significantly over the past 40 years, with an evolving mix of premiums, payroll taxes, and general fund support. In 1970, payroll taxes financed 65 percent of Medicare spending. In 2018, however, payroll taxes covered only 36 percent of the program's costs. That decline occurred despite changes in the structure of the Medicare payroll tax, which increased revenues from that source. In 1986, for example, the payroll tax rate for Medicare increased the contribution rates for both employers and employees from 0.6 percent to 1.45 percent of wages.3 Later, in 1994, the cap on earnings, which limited the amount of income subject to the Medicare payroll tax, was eliminated (the cap on earnings for the payroll tax that funds Social Security, however, was not eliminated). Most recently, the Affordable Care Act increased payroll tax rates for high earners by an additional 0.9 percentage points beginning in 2013. Unfortunately, the sum of those changes will not be sufficient to offset future cost growth.

Premiums play only a modest role in funding the Medicare program. They financed 15 percent of Medicare's overall costs in 2018, about the same share as in 1970.

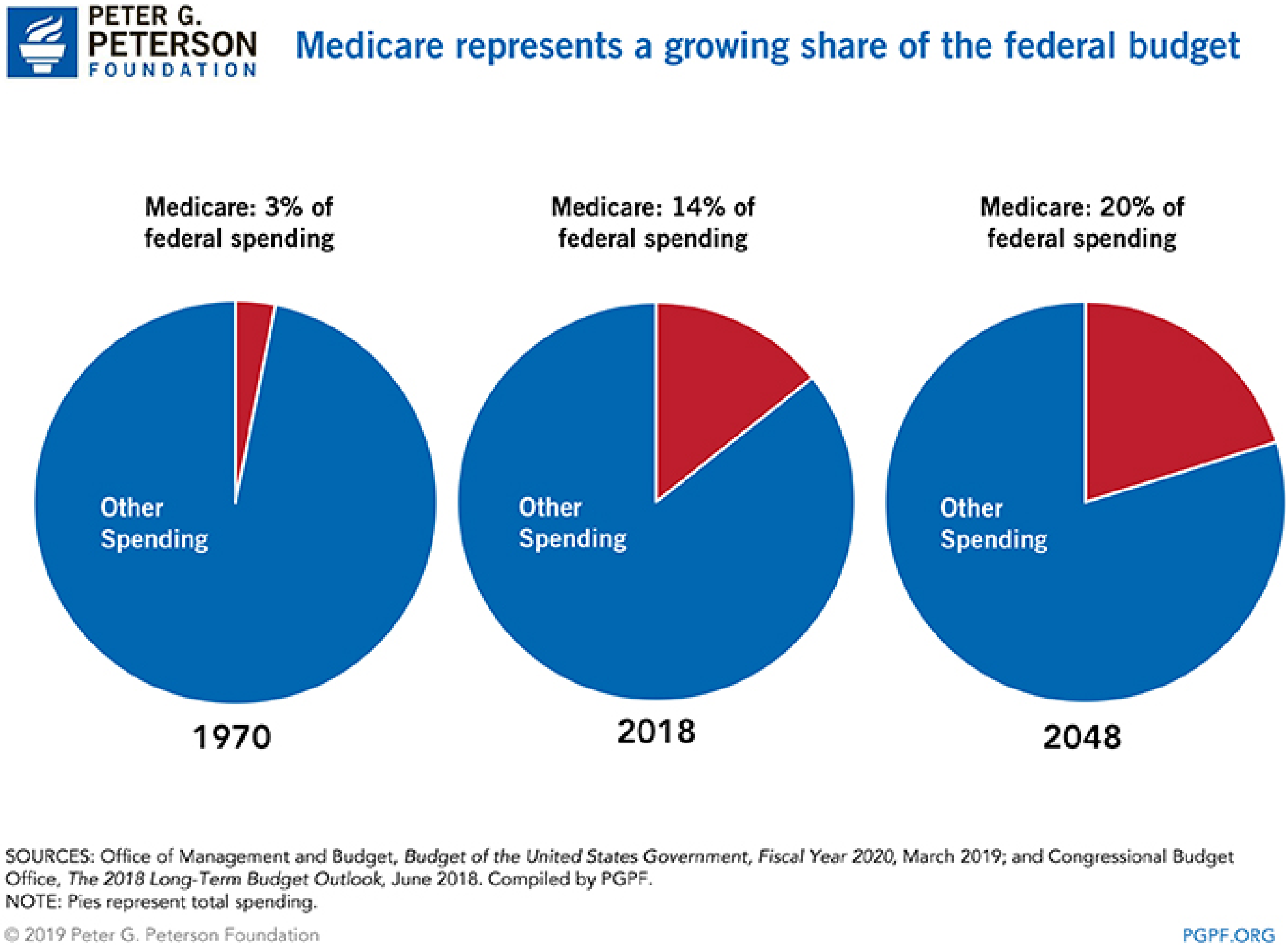
The federal government's general fund has been playing a larger role in Medicare financing. In 2018, 43 percent of Medicare's income came from the general fund, up from 25 percent in 1970. Looking forward, such revenues are projected to continue funding a major share of the Medicare program. By 2048, the Trustees project that general revenues will cover about half of the program's costs.



TWEET THIS

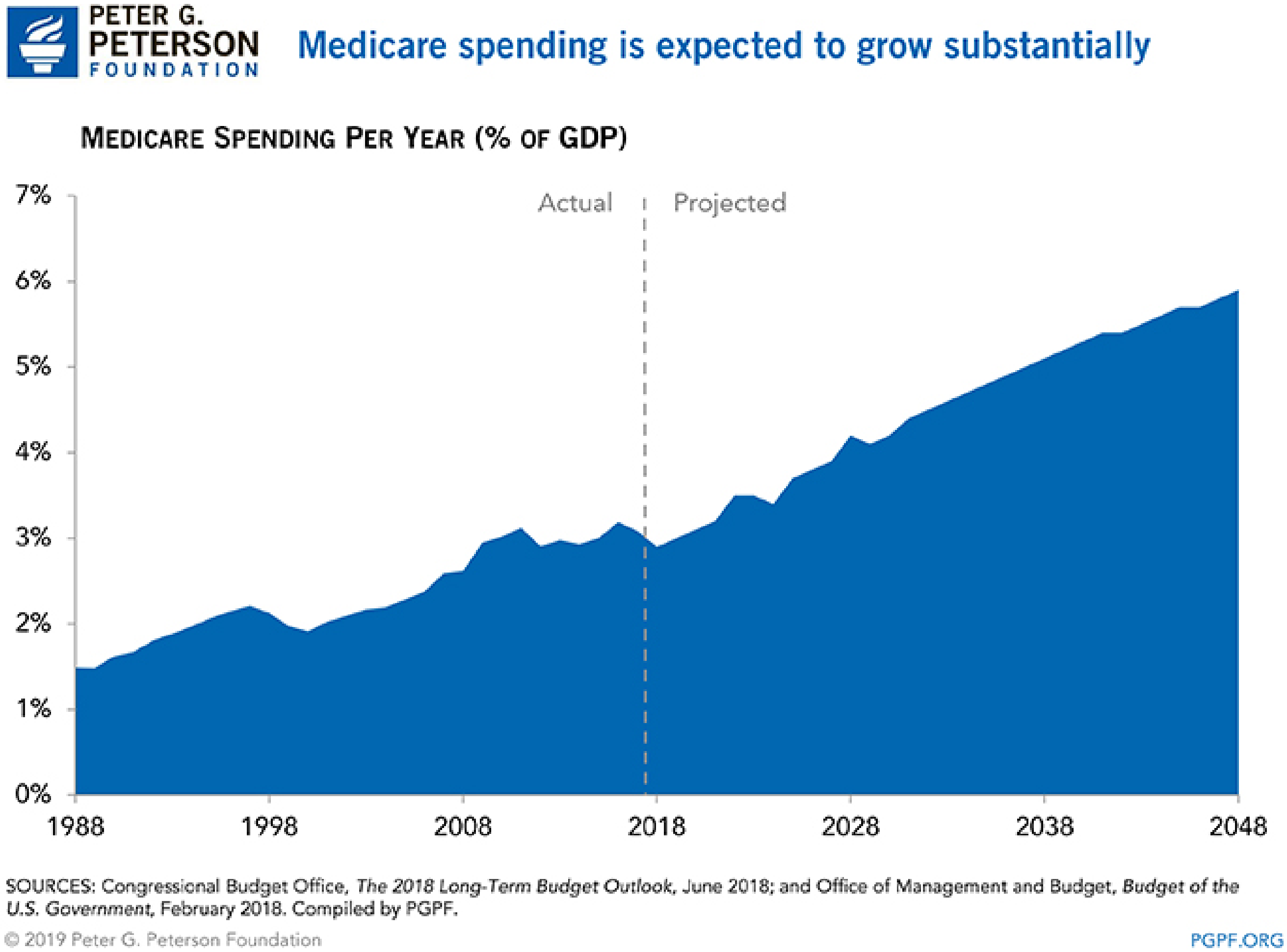
How much does Medicare cost and what does it cover?

Medicare accounts for a significant portion of federal spending. In FY 2018, the Medicare program cost $582 billion — about 14 percent of total federal government spending. After Social Security, Medicare was the second largest program in the federal budget last year.



TWEET THIS

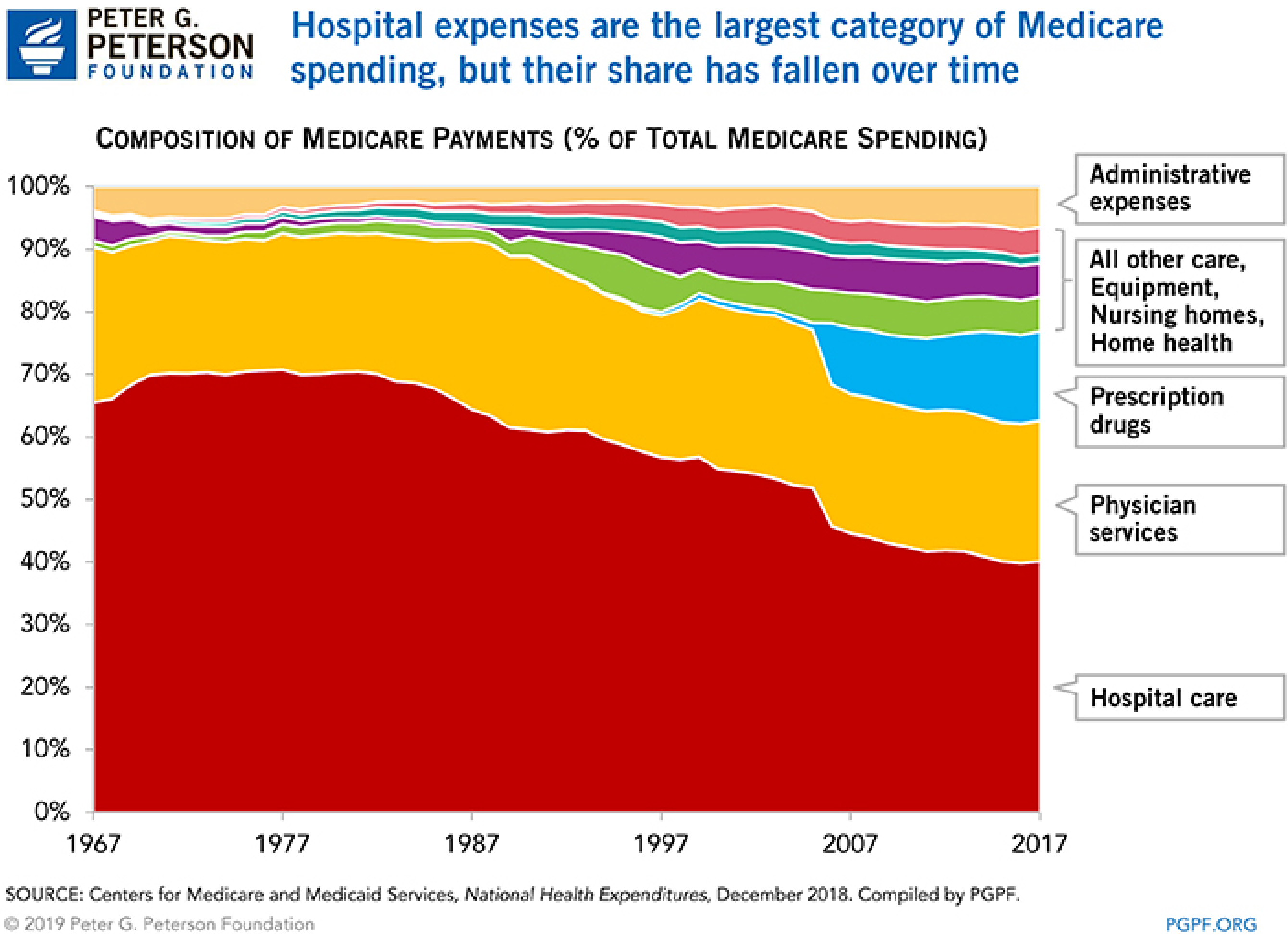
Medicare faces significant financial pressures as federal healthcare costs are expected to grow considerably as a share of the economy over the next few decades. In fact, Medicare spending is projected to rise from 2.9 percent of GDP in 2018 to 5.9 percent of GDP 30 years from now. This increase in spending is largely due to the retirement of the baby boomers, longer life expectancies, and healthcare costs that are growing faster than the economy.



TWEET THIS

Medicare finances an array of health services. Hospital expenses are the largest single component of Medicare's spending, accounting for about 40 percent of the program's spending. That is not surprising as hospitalizations are associated with high-cost health episodes.

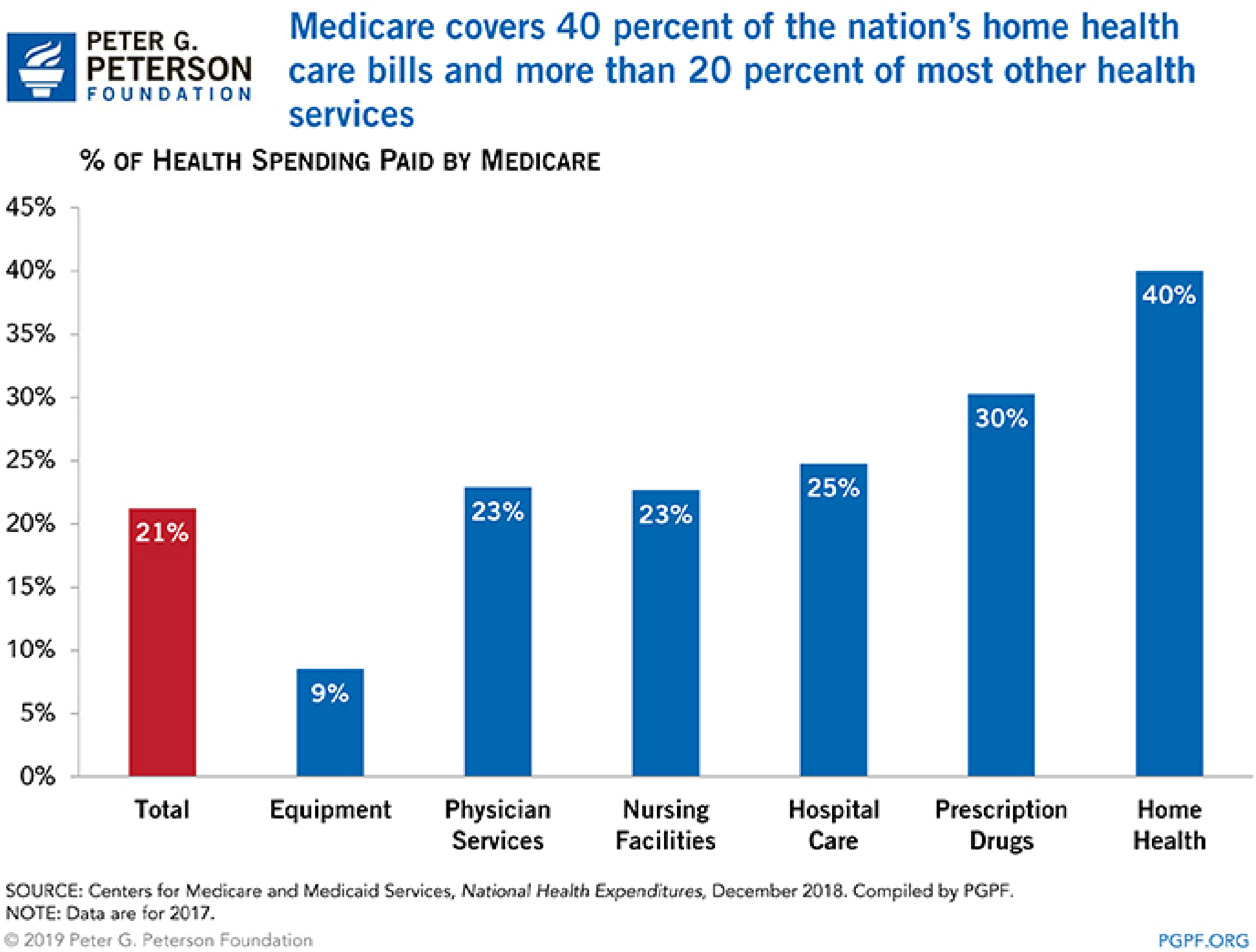
However, the share of spending devoted to hospital care has declined since the program's inception. While spending for physician services has hovered between 20 and 25 percent for most of the program's history, the share devoted to other benefits has grown. Most notably, the introduction of the prescription drug benefit in 2006 significantly shifted the composition of Medicare spending.



TWEET THIS

Medicare plays an important role in financing American healthcare

Medicare is a major player in our nation's health system and is the bedrock of care for millions of Americans. The program pays for about one-fifth of all healthcare spending in the United States, including 30 percent of all prescription drug costs and 40 percent of home health spending in the United States — which includes in-home care by skilled nurses to support recovery and self-sufficiency in the wake of illness or injury.



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The future of Medicare

To preserve Medicare and to put the nation on a sustainable fiscal path in the long term, more reforms are required and policymakers will need to address the program's growing costs — one of the primary drivers of our rising federal debt. Balancing cost concerns with considerations about the health and welfare of our nation's older citizens will be important for successful long-term solutions.

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1 Unless otherwise indicated, all numbers on Medicare spending in this paper are calculated net of premiums and payments from the states. Those receipts were $123 billion in 2018. (Back to citation)

2 Unless otherwise noted, all years indicate calendar year. (Back to citation)

3 The 2.9 percent payroll tax was split evenly between employers and employees (1.45 percent each). Self-employed people paid the entire 2.9 percent themselves. (Back to citation)

4 The numbers here reflect gross Medicare spending. (Back to citation)

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