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Prefunding Medicare Without Individual Accounts

Prefunding can help to avoid a future payroll tax hike, but it needn’t rely on individual accounts as some have proposed.

by Laurence S. Seidman

PROLOGUE: Individual accounts to prefund retirement have been around since 1974. Their widespread acceptance among consumers has led some Medicare reform advocates to recommend a similar approach to prefund Medicare, given the demographic bulge and accompanying financial stress on the Medicare program as the baby-boom generation begins to retire. Prefunding entails inducing current workers to save now for their own medical care during retirement, instead of relying on the next generation to pay for it. One of the most prominent of such proposals has been put forward by Andrew Rettenmaier and Thomas Saving. In their scheme, workers would contribute a fixed percentage of their income into an individual account known as Personal Retirement Insurance for Medical Expenses (PRIME). When they retire, they could then use these funds to purchase health insurance in the private market.

Laurence Seidman agrees in principle that prefunding offers a viable solution to the problem of financing Medicare in the coming decades. However, his proposal does not hinge on individual accounts but instead advocates a collective approach through reform of the Medicare trust funds. His plan represents a way to preserve the collective nature of Medicare while helping to avert a larger tax increase or benefit reduction as the program reaches its projected trust fund exhaustion.

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ABSTRACT: It has recently been proposed that Medicare be prefunded through the creation of individual medical retirement accounts. There is a strong case for prefunding Medicare in anticipation of the retirement of the numerous baby boomers. But the creation of individual accounts would involve a new departure for Medicare with serious potential shortcomings. This paper shows how Medicare can be prefunded without the creation of individual accounts—through a Medicare trust fund reform.

As part of our nation’s ongoing attempt to address the shortcomings of the Medicare program, several recent papers have advocated “prefunding” Medicare. Prefunding means accumulating a fund that generates significant investment income to supplement payroll taxes as a source of financing future benefits. The aim of prefunding is to avert a large future payroll tax hike or benefit cut, which otherwise would occur when the numerous baby boomers retire. These advocates favor prefunding through the creation of individual medical retirement accounts. They propose that Americans accumulate their own individual Medicare fund, which they can use to purchase health insurance during retirement. Because they favor individual accounts, these advocates may leave the impression that prefunding Medicare requires individual accounts and individual purchase of health insurance.

The debate over prefunding Medicare echoes the debate over prefunding Social Security. Initially, most advocates of prefunding Social Security left the impression that individual accounts were required. Gradually, other analysts pointed out that Social Security could be prefunded collectively as well as individually. One purpose of this paper is to make the same clarification for the debate over prefunding Medicare.

The proposal advanced here to collectively prefund Medicare is all about financing. It is compatible with either preserving Medicare’s current benefit structure or shifting to a premium-support system. With collective prefunding implemented by a Medicare trust fund reform, a substantial fund would accumulate. But this leaves open whether the trust fund would pay providers directly, as under Medicare’s current structure, or instead pay a high percentage of the premium of the health plan selected by each retiree—that is, whether Medicare remains a defined-benefit entitlement to medical services or becomes an entitlement to premium reimbursement. Thus, the decision of whether to collectively prefund Medicare is separate from the decision of whether to convert Medicare to a premium-support system.

A baby boomer might reason: “I’m willing to join others today in paying a higher Medicare payroll tax to accumulate a collective fund that will be used to help finance Medicare benefits when we retire.
But before we pay the higher tax today, we want some assurance that our additional tax will in fact be reserved for our future Medicare benefits.” How can such assurance be provided?

**A Medicare Trust Fund Reform**

One way to provide assurance would be for Congress to pass a Medicare trust fund reform. Under the reform the Health Care Financing Administration (HCFA), which administers Medicare and is currently part of the Department of Health and Human Services (HHS), would be made an independent agency within the executive branch and be renamed the Medicare Administration, and its chief executive would be given the title Commissioner of Medicare. Thus, the Medicare Administration, like the Social Security Administration, would become an independent agency, and the Medicare commissioner, like the Social Security commissioner, would become a visible chief executive charged with a major social insurance program. Other programs administered by HCFA that are unrelated to Medicare would remain within HHS.

The two Medicare trust funds (the Hospital Insurance, or HI, trust fund for Part A and the Supplementary Medical Insurance, or SMI, trust fund for Part B) would be combined into a single Medicare trust fund. The annual contribution from general revenue to the Medicare trust fund would be designated by Congress as a specific “match” of premium revenue collected from beneficiaries. Recently, under Part B, general revenue has been about three times premium revenue. Thus, Congress might initially designate the “general revenue matching rate” to be 3.00: That is, every $1 of premium revenue would be automatically “matched” by $3 from the Treasury. The annual Medicare budget surplus would equal Medicare revenues (including this Treasury matching revenue and trust fund interest income) minus Medicare expenditures.

Under the reform the U.S. Treasury would be instructed to replace the special nonmarketable Treasury securities now credited to the two Medicare trust funds with an equal amount of regular marketable Treasury securities in the form of paper certificates, and to physically transfer these marketable paper securities to the Medicare Administration building to hold in a new Medicare trust fund vault. To inform the public, the secretary of the treasury and the Medicare commissioner would hold a joint press conference.

Every year the U.S. Treasury would be required to transfer to the Medicare Administration vault an amount of marketable Treasury securities equal to the Medicare budget surplus for the past fiscal year. In any year that Medicare runs a deficit, the Medicare Administration would be required to sell marketable securities in its vault
to obtain cash to finance the deficit. Congress would have the option of enacting an emergency loan or grant to the Medicare trust fund once the vault no longer contains any securities.

The U.S. Treasury actually collects the taxes and pays the benefits on behalf of Medicare, just as it does for most federal programs. Today, when the Medicare HI trust fund runs a surplus, the Treasury “credits” the trust fund with an equal amount of special nonmarketable U.S. Treasury securities. These securities are better than cash because they earn interest, and experts claim that they are really better than regular marketable securities are because the Treasury is required by law to promptly provide Medicare an equal amount of cash if it requests cash; hence, Medicare need not sell the securities in the open market to obtain cash.

The special nonmarketable securities, however, have a crucial shortcoming: They confuse much of the public. Suppose today’s workers want to collectively prefund Medicare. If they pay a higher Medicare payroll tax so that Medicare runs a larger surplus, what happens? The Treasury collects more in Medicare revenue than it pays out in Medicare benefits, electronically credits the Medicare trust fund with nonmarketable securities equal to the surplus, and then uses the excess cash it has collected to pay for other federal programs. Some politicians declare that the trust fund has been “raided”; others, that the government has “spent the Medicare surplus.” As a consequence, many workers are reluctant to support collective prefunding because they wonder whether these allegations are true.

Experts argue that the special securities are safe and reliable, regardless of what the government does with the excess cash it collects when Medicare runs a surplus. But political debate over the past decade shows that many politicians and much of the public remain confused about whether they can trust the Social Security and Medicare trust funds. As long as citizens retain this doubt, they will be reluctant to collectively prefund Medicare. To many experts, the solution is to continue to try to educate the public about the reliability of trust fund special securities. A better, more practical solution is to implement this Medicare trust fund reform.

Once the reform has been implemented, consider how easy it would be to reassure the public. Suppose someone asserts that the Treasury has been raiding the Medicare trust fund to pay for other federal programs. With the reform, the assertion is easy to investigate. Just check the Medicare trust fund vault in the Medicare Administration building. If the vault contains the proper amount of marketable paper securities, then the trust fund has not been raided. Suppose someone claims that the vault holds “mere IOUs” from the
rest of the government that may not be honored. With the reform, the claim is seen immediately to be incorrect. In its vault in its own building, the Medicare Administration is holding the same marketable Treasury securities that households and businesses hold.

There is always a chance that the Treasury will default on these securities. However, the Medicare trust fund would be in the same position as are all households and businesses holding the same securities. Everyone who holds Treasury securities has a stake in making sure that the amount of these securities does not become too great relative to the gross domestic product (GDP). Treasury securities held by the Federal Reserve are now counted as debt held by “the public.” With the reform, Treasury securities held by the Medicare trust fund also would be counted as debt held by “the public,” implying that the Treasury has the same commitment to honoring its debt to Medicare as to any member of the public.

The board of trustees of the Medicare trust fund would continue to present annual reports to Congress forecasting future revenues and expenditures for the next seventy-five years. With the reform, a new feature of the report would be a careful quantitative comparison of alternative prefunding plans. For example, Plan N might have no prefunding; Plan M, moderate prefunding; and Plan S, substantial prefunding. Each plan would require a different path for Medicare taxes and benefits over the next seventy-five years. Plan N might require no tax hike or benefit cut until the baby boomers retire, but then a sharp tax hike and/or benefit cut upon their retirement. By contrast, Plan S would entail a large immediate tax hike, but a much smaller tax hike than in Plan N when the baby boomers retire. Congress then would use these quantitative comparisons to choose the degree of collective prefunding for Medicare and the consequent path for taxes and benefits over the next seventy-five years.

With the reform, imagine the debate in Congress over alternative Plans N, M, and S. Advocates of Plan N would emphasize that it places only a small tax increase on today’s workers. But supporters of Plan S would cite the most recent annual report of the board of trustees of the Medicare trust fund, showing that under Plan N, either the next generation of workers will have to pay a much higher tax rate than this generation’s workers, or today’s workers will suffer severe benefit cuts. Advocates of intermediate Plan M then would argue that their approach is a compromise. With the reform, Congress would periodically debate the trade-offs between the generations.

It is possible to provide a rough estimate of the tax increase required for “substantial prefunding.” The most recent annual report of the Medicare trustees estimates that a 40 percent increase in
tax revenue would achieve actuarial balance in the HI trust fund over the next seventy-five years. A 40 percent increase would generate the accumulation of a large fund (and substantial interest income) over the next few decades, which would be drawn down in subsequent decades but would still equal one year’s benefits at the end of the seventy-five-year period. Hence, a 40 percent increase in the Medicare tax rate implies “substantial prefunding.” A 40 percent increase in the current HI payroll tax of 2.9 percent would require a tax rate of 4.1 percent for the next seventy-five years—an increase of 1.2 percent of payroll. By contrast, the annual report estimates that without prefunding, the required HI tax rate would have to rise from 2.9 percent to nearly 7 percent in 2075. “Moderate prefunding” would require a 20 percent increase in the Medicare tax rate—a constant rate of 3.5 percent for the next seventy-five years.

**Financing Collective Prefunding**

- **Medicare payroll tax.** Although general revenue can be used as a supplement, it seems appropriate to make the Medicare payroll tax the primary source of prefunding Medicare. The Medicare HI payroll tax rate is now 2.9 percent, split evenly between employers and employees. As noted above, substantial prefunding might require a 40 percent increase in tax revenue, requiring an increase in the HI tax rate to 4.1 percent.

  In sharp contrast to the Social Security payroll tax, the Medicare payroll tax applies to each employee’s entire wage earnings (whereas Social Security has a ceiling of $76,200 per employee in the year 2000). Most of the public understands that the payroll tax taken from their paycheck is earmarked for Social Security and Medicare. If today’s workers pay a higher Medicare payroll tax rate, they will be in a stronger position politically at retirement to press Congress to avoid benefit cuts, even if this means raising the Medicare payroll tax rate on the next generation of workers. Franklin Roosevelt’s famous quote concerning payroll taxes for Social Security is just as relevant for Medicare. When an adviser suggested that economics did not require using the payroll tax to finance Social Security, FDR responded:

  I guess you’re right on the economics, but those taxes were never a problem of economics. They are politics all the way through. We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions...With those taxes in there, no damn politician can ever scrap my Social Security program.7

  The clear earmarking of a tax levied on workers—the Medicare payroll tax—is even more important for collective prefunding by the baby-boom generation in anticipation of its own retirement. It is
politically important for the boomers, when they retire, to be able to accurately claim to Congress that their generation did bear the burden of prefunding Medicare. This is likely to be more effective if the Medicare payroll tax is the primary source of accumulating the Medicare trust fund.

Raising the payroll tax rate for Medicare is much more equitable than is raising the payroll tax rate for Social Security, because Medicare has no ceiling per employee, whereas Social Security does. An increase in the Social Security payroll tax rate raises the same amount of dollars from a worker earning $76,200 as from a worker earning ten times as much, $762,000; thus, payroll tax revenue can be raised equitably for Social Security primarily by raising the ceiling rather than the payroll tax rate. By contrast, an increase in the Medicare payroll tax rate raises ten times as many dollars from the worker earning ten times as much, even though Medicare will spend roughly the same amount of dollars on both workers when they retire. Thus, the combined effect of Medicare payroll taxes and benefits is highly progressive.

The earned income tax credit (EITC) could be used to offset the burden of an increase in the Medicare payroll tax rate on low-income workers—one of its original purposes when it was enacted in the mid 1970s. Unlike the income tax, which protects low-income workers through personal exemptions and a standard deduction, the payroll tax begins with the first dollar of earnings. Instead of complicating the administration of the payroll tax by trying to exempt low-income workers, Congress chose to let these workers obtain an approximate payroll tax refund by filing for an EITC on the personal income tax and, as a consequence, receiving a check annually from the government. With bipartisan support in Congress, the EITC has been expanded many times over the past two decades, most significantly in 1990 and 1993.

Here is how the EITC can protect low-income workers from an increase in the Medicare payroll tax rate: Today, a family with two or more children can obtain a credit equal to 40 percent of its earnings until they reach $10,000 and the credit reaches $4,000 (the numbers are approximate). For each $100 of income beyond $10,000, the credit is cut $20, so that a family receives no credit if its income exceeds $30,000. Suppose the Medicare payroll tax rate is raised 1.2 percent, to achieve substantial prefunding. Then, for a $10,000 worker, the worker and employer together would pay an additional $120 of payroll tax. This could be returned to the worker by raising the EITC rate from 40 percent to 41.2 percent, so that the $10,000 worker receives a credit of $4,120.

Thus, raising the Medicare payroll tax rate together with an EITC
offset is an equitable and appropriate means of collectively prefunding Medicare. In contrast to Social Security, the Medicare payroll tax has no ceiling per employee, so a worker with ten times the wage income pays ten times the tax. The EITC can easily protect low-income workers. By paying this clearly earmarked tax, workers will, as FDR said, have a “legal, moral, and political right” to their funds when they retire.

General revenues. Although the Medicare payroll tax should therefore be the primary instrument for prefunding Medicare, general revenues can be a useful secondary instrument. If Congress decides that today’s beneficiaries should bear some additional burden for today’s benefits, Congress can raise the Medicare premium on retirees (currently, the Part B premium) either across the board or according to retirees’ income. If Congress decides that the general public should bear some additional burden, it can raise the general revenue matching rate (above its current level of approximately three). But if today’s workers want a stronger political claim to benefits when they retire, they must be willing to pay a higher payroll tax today.

Collective Prefunding Versus Individual Accounts

The pros and cons of collective prefunding versus individual prefunding have been thoroughly debated concerning Social Security reform, and many of the same arguments apply to prefunding Medicare. Participants in the Medicare reform debate should be aware of these arguments.

Lack of political support. First, advocates of individual accounts claim that workers will not politically support a tax increase for a collective fund but will support a higher contribution for their own individual fund. Advocates of collective prefunding reply that on the contrary, workers are more likely to support a tax increase for a collective fund, because Medicare and Social Security have always been collective, not individual, programs. A payroll tax increase earmarked for the Medicare or Social Security trust fund has occurred many times. Perhaps the most dramatic example is the substantial payroll tax increase for Social Security, following the recommendation of the Bipartisan Greenspan Commission in 1983. By contrast, imposing a tax increase for newly created individual accounts would be a new departure, whose funding is likely to prove more difficult politically, because many questions would need to be answered about the rules and regulations governing such accounts.

Lack of congressional discipline. Second, advocates of individual accounts contend that Congress does not have the discipline to accumulate and preserve a large fund and will instead prema-
“By building a fund, each generation of workers would finance a share of its own retirement benefits.”

...turely raid any collective fund by raising benefits for today’s retirees at the expense of future retirees. But advocates of collective funding cite the substantial buildup of the Social Security trust fund since the mid-1980s as evidence that Congress in fact does have the discipline to accumulate a large fund for a clear purpose. Recall that in the early 1990s skeptics contended that Congress would never be able to balance the budget because of lack of discipline. But Congress has. Medicare and Social Security enjoy overwhelming public support, and much of the public has become aware of the baby-boom problem facing both programs. With a Medicare trust fund reform (and a comparable Social Security trust fund reform), the public is likely to support significant collective funding of both programs.

- **Need for individual planning.** Third, advocates of individual accounts believe that individuals should prepare for their own retirement. But advocates of collective funding point out that workers are already encouraged to supplement Social Security and Medicare with their own savings. No one lives a luxurious retirement on Social Security alone. Similarly, Medicare has never fully paid for all health care (including long-term care) that retirees might desire. The current system, then, already has two pillars: collectively financed Social Security and Medicare, and individual saving.

Advocates of collective prefunding raise other questions about individual accounts. What happens if someone makes poor investments? Would that person simply be out of luck come retirement, or would Medicare bail him or her out? If so, what criteria would Medicare use to decide who merits how much financial aid? Would people be permitted to tap into their Medicare individual accounts prior to retirement? Recently, Congress has permitted such withdrawals from individual retirement accounts (IRAs) for certain purposes. It seems likely that Congress would do the same for Medicare individual accounts—for example, to help pay for extraordinary medical bills not covered by private insurance. But then what happens if Medicare individual accounts are exhausted prior to retirement? However one weighs the pros and cons, it should be apparent that establishing individual accounts, for either Social Security or Medicare, would be a new and controversial departure.
The Permanent Funding Of Medicare

The most urgent reason for collectively prefunding Medicare is the looming retirement of the numerous baby boomers. But even in the long run, after the baby boomers are gone, it would be better to finance Medicare through a combination of fund investment income and payroll taxes, rather than through payroll taxes alone. To achieve this long-run goal, Congress would need to choose Plan S, where the tax increase is large enough to build a fund that can outlast the baby boomers. The sacrifice involved in building such a large permanent fund is obvious: the larger tax increase on today’s workers and consequent reduction in their current consumption. But the long-run gains for Medicare and the economy also are formidable. Medicare would achieve a diversified source of financing that is less vulnerable to demographic shifts. Under the current system of financing entirely by payroll taxes, each generation of retirees depends completely for its benefits on the tax revenue from the next generation of workers (and their employers). By contrast, by building a fund, each generation of workers would generate the investment income needed to finance an important share of its own retirement benefits. Medicare could operate permanently with a lower payroll tax rate because of the substantial investment income generated by a large permanent fund.

The economy would achieve a larger capital stock and hence a higher productivity and standard of living. Accumulating a government fund for Medicare constitutes an increase in national saving that finances more real investment in technology, plant, and equipment. When the U.S. Treasury collects a cash surplus on behalf of Medicare and transfers a corresponding amount of Treasury securities to the Medicare Administration, the Treasury can use the cash to redeem outstanding securities. The sellers of these Treasury securities can use their cash receipts either to purchase corporate stocks and bonds or to provide funds for the banking system to lend to business firms, thereby raising real investment.

If a large permanent Medicare fund is to be accumulated, it would be sensible to go beyond the above Medicare trust fund reform and create a Medicare Reserve Board (MRB) to supervise the trust fund’s management. The MRB might be structured in the manner of the Federal Reserve Board to insulate it from political pressure. Its members would be appointed with long, staggered terms. The MRB would contract with private investment firms to conservatively manage its portfolio. Rather than holding only Treasury securities, the MRB might instruct the private firms to invest a limited portion of the fund in a conservative diversified portfolio of corporate bonds.
and stocks. Similar proposals have been made for Social Security.\textsuperscript{11}

The MRB would not select individual stocks. In fact, even the private firms that manage the Medicare portfolio would be prohibited from selecting individual stocks. Instead, Congress would require the use of stock index funds, broadly diversified funds containing a mix of many stocks. Indexing is a passive investment approach that emphasizes broad diversification and low portfolio trading activity. It is especially appropriate for a public fund that needs to be insulated from political pressure. With index investing, the MRB would not vote the stock of particular companies. This is exactly the prohibition that Congress has imposed on the Federal Retirement Thrift Investment Board, which administers the Thrift Savings Plan for federal employees. Since the mid 1980s that board has selected a stock index (the Standard and Poor's 500), obtained competitive bids from large index fund managers, and established a highly efficient stock fund with minimal administrative expenses.\textsuperscript{12}

It would, of course, be possible to build a permanent fund for Medicare invested entirely in Treasury securities, with a prohibition against even stock index investing. But this would be a highly unusual way of managing a large permanent fund. There are numerous private, state, and local government pension funds, and more than one-third of the assets in these funds have been invested in the stock market; about half of the assets in private funds are corporate stocks. By investing in corporate stocks and bonds as well as Treasury securities, these pension funds are able to achieve a higher rate of return. It seems sensible to have Medicare and Social Security trust funds do the same.

\textbf{With this sensible investment policy} the vault in the Medicare Administration building would contain stock index certificates as well as Treasury securities and cash. The public could check the assets held by the Medicare trust fund at any time. To keep the public informed about the financial status of the fund, the commissioner of Medicare might find it useful to hold an annual trust fund press conference, complete with charts illustrating the size and composition of the Medicare trust fund portfolio.
NOTES

1. In “Prefunding Medicare,” American Economic Review (May 1999): 222–227, Martin Feldstein, professor of economics at Harvard and president of the National Bureau of Economic Research, writes: “The fact that most of the aged cannot finance their care through a current employment relationship or out of other retirement income does not imply that the government must finance that care through a pay-as-you-go tax-financed program that will become inordinately expensive and burdensome in the future. The natural life-cycle alternative is to have individuals accumulate funds during their working years with which to finance their health care in retirement. Now that the institutional structure for universal personal retirement accounts to supplement Social Security retirement pensions may become a reality, it is not difficult to imagine how a parallel structure would work to supplement or replace the pay-as-you-go financing of Medicare.”

   Similarly, economists Andrew Rettenmaier and Thomas Saving present the case for prefunding Medicare through individual accounts in “Converting Medicare to Prepaid Health Insurance,” in Medicare in the Twenty-first Century, ed. R. Helms (Washington: AEI Press, 1999), 41–66.


6. The 2000 annual report of the boards of trustees estimates the actuarial deficit of the HI trust fund to be 1.2 percent of payroll, which is about 40 percent of the current 2.9 percent HI payroll tax rate.


9. See L. Seidman, Funding Social Security.


11. Aaron and Reischauer, Countdown to Reform; and Seidman, Funding Social Security.