REFORMING MEDICARE

Option: Generate New Revenue by Increasing the Payroll Tax Rate

The primary source of funding for Medicare hospital services (Part A) comes from the payroll tax. Workers and their employers each contribute 1.45 percent of earnings for a total contribution of 2.9 percent. Medicare also offers coverage for physician services (Part B) and prescription drugs (Part D), but these services are not funded by the payroll tax. It's estimated that beginning in 2024 Medicare will not have enough money to pay for all of the expected hospital expenses. Increasing the payroll tax rate by 0.5 percent to 3.9 percent (or to 1.95 percent each for workers and employers) would raise additional revenue for Medicare's inpatient hospital expenses. For an individual earning about $50,000 a year in wages, this increase would amount to an extra $250 in Medicare payroll taxes per year.

Argument for:

Henry J. Aaron, Ph.D.
The Brookings Institution

Argument against:

Stuart Butler, Ph.D.
The Heritage Foundation

Henry Aaron

Medicare Part A—covering hospital and skilled-nursing home stays—faces a modest projected long-term deficit: that is, the available funds will not pay for all services, but the gap is small. Based on current projections, a 1 percentage point increase in the payroll tax would more than completely close that deficit. In fact, it would provide a modest cushion should current projections prove to be unduly optimistic. Alternatively, this added revenue could be used to cover the cost of a new and important benefit—eliminating the current annual and lifetime maximums on Part A services. Such a payroll tax increase should be enacted promptly to take effect as soon as the economic recovery is well established and well advanced.

The news that Medicare Part A (also known as Hospital Insurance) faces so small a projected deficit may surprise many. The projected deficit was much larger before the recent health reform legislation was enacted. The public has not yet recognized how much that legislation did to improve the financial status of the Hospital Insurance program. Moreover, this improvement was achieved by scaling back future growth of payments to providers and without cutting benefits for Medicare beneficiaries in any way.

Hospital Insurance is financed through a special trust fund governed by strict rules, under which total benefit payments can never exceed total earmarked revenues. The revenues come principally from two sources. The largest is a payroll tax levied on all earnings. Most employed workers and their employers each pay 1.45 percent of workers’ earnings,
for a total of 2.9 percent. The other sources are a small portion of personal income tax collections and payments from states to cover the cost of drugs for beneficiaries who receive both Medicare and Medicaid (a separate program covering the poor).

The Hospital Insurance trust fund currently has a balance of about $200 billion, roughly what Hospital Insurance now spends each year. Because of the recession, revenues are down and do not cover all Hospital Insurance costs. As a result, the trust fund is shrinking. Looking ahead, the retirement of the Baby Boom Generation will keep spending above revenues. But the gap is small, and it is projected to get even smaller for two reasons.

First, the health reform legislation slowed the growth of future payments to hospitals and some other providers. Second, the health reform legislation increased the taxes earmarked for Hospital Insurance by raising payroll tax rates for high earners and imposing a new tax on investment income of high-income households. These increases and other smaller changes closed most, but not quite all, of the projected Hospital Insurance funding gap. Boosting payroll taxes by just ½ percentage point on workers and by the same amount on their employers—a total of 1 percentage point that would increase the total payroll tax from 2.9 percent to 3.9 percent—would take care of the rest of the problem, with a bit to spare.

There is no reason to perpetuate the myth that Medicare Hospital Insurance is in crisis. It isn’t. Vigorous enforcement of the recently enacted health reform legislation together with this modest tax increase will secure Hospital Insurance for current and future Medicare beneficiaries. The time to act is now.

Stuart Butler

Addressing Medicare’s long-term financial problems by raising payroll taxes on working Americans is not the answer. That will make the situation worse for the economy and for our children and grandchildren, and will erode the political will to undertake needed reforms.

Medicare is taking a bigger and bigger proportion of our national economy as the years go by. Right now over 3.6 percent of our entire economy is spent on Medicare. In just over 20 years that will rise to 5.6 percent, and by the time a college graduate today retires it will be over 6 percent. Moreover, Medicare will run huge deficits in the future, meaning large debt burdens for future generations.

So why not just raise the Medicare payroll taxes to try to keep up with the future rise in Medicare’s hospital spending? Several reasons.

First, raising the payroll tax means higher taxes for each dollar earned by working Americans. That would slow economic growth—further harming our ability to afford health care in the future.

Second, raising the payroll tax rate means the people who will pay most to reduce Medicare’s burden on our children and grandchildren would be our children, and especially our grandchildren. That’s because higher payroll taxes today imposes the biggest total burden on those who will have to work the longest before reaching
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retirement. Worse still, the payroll tax is imposed on every dollar earned, so even those workers not earning enough to pay income taxes would still be hit.

And third, raising taxes on someone in the future just takes the pressure off Congress to take sensible steps today so that we can ensure adequate and affordable health care now as well as in the future. Washington needs to make hard decisions about Medicare itself, which politicians want to avoid making—they’d rather pass a “small” tax increase on working-age Americans. But we need to make sure that programs like Medicare don’t take such a large share of the economy in the future that there is not enough for other critical goals like education, rebuilding our roads and bridges, and defending America. So we’ve got to get the future costs of Medicare down, not tax Americans more.

It’s true that tackling the rising costs of Medicare does mean addressing the cost growth of our whole health system. Part of Medicare’s cost problem is the whole health system’s cost problem. Whether you think the new health law is the right way to do that or another approach, we need to take action to get all health spending under control.

But it is also necessary to revisit the commitments we made in the Medicare program, and make decisions to encourage older people to seek better value for money and, where necessary, shoulder more of the cost of health care themselves. This will involve hard decisions. But we will never even start to make such hard decisions if we think we can just tax future generations.

Henry J. Aaron, Ph.D., is a Senior Fellow in Economic Studies and The Bruce and Virginia MacLaury Chair at The Brookings Institution.

Stuart Butler, Ph.D., is a Distinguished Fellow and Director of the Heritage Foundation’s Center for Policy Innovation.

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AARP Public Policy Institute,
601 E Street, NW, Washington, DC 20049
www.aarp.org/ppi
202-434-3890, ppi@aarp.org
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