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## Medicare Meltdown

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What's going to happen when the money runs out for Medicare? A recently released report by the program's trustees found that within seven years Medicare taxes will fall short of Medicare expenses by more than 45%. What's more, Medicare and Social Security combined are on track to eat up the entire federal budget.

While the bulk of Medicare dollars comes from payroll taxes and beneficiary premiums, a large and growing share of Medicare expenses is borne by general taxpayers. And although the same law that created the new Medicare drug benefit also requires the president to propose remedial legislation, Congress is not required to actually do anything.

The trustees' wake-up call comes none too soon. But what is needed are not minor adjustments. A major overhaul is in order.

The projected cash flow deficits in these two programs are staggering. For Social Security, the trustees estimate the 75-year burden on general revenues at \$6.7 trillion. For Medicare the comparable burden on general revenues is \$24.2 trillion, even after allowing the current transfers to grow with the economy. Thus the total burden these programs will impose on

federal finances over the next 75 years is \$31.9 trillion, more than six times the current outstanding federal debt. Looking beyond 75 years into the indefinite future, the combined long-run funding gap for Social Security and Medicare is \$74.8 trillion in today's dollars.

Members of Congress will not have to wait long to experience the practical effects of all of this. Until a few years ago, Social Security and Medicare were taking in more than they spent, on the whole. Thus they provided revenue for other federal programs. That situation is now reversed, and last year the combined deficits in the two programs claimed 5.3% of federal income tax revenues. In 15 years these two programs will require more than a fourth of income tax revenues: In other words, in just 15 years the federal government will have to stop spending one out of every four non-entitlement dollars in order to balance the budget and keep its promises to the elderly.

As more and more baby boomers reach retirement, the financial picture will deteriorate rapidly. By 2030, about the midpoint of the baby boomer retirement years, these two programs will require almost one out of

every two federal income tax dollars. By 2040, they will require nearly two out of every three federal income tax dollars. Eventually, the deficits in these two programs will absorb the entire federal budget.

Could we force the elderly to pay for future deficits with higher Medicare premiums? Monthly premiums in constant dollars would more than quadruple by 2020, and be almost 30 times their current level by 2080. At that point, the required monthly premiums would consume more than the entire Social Security benefit (from which they are automatically deducted) for average-wage earners.

Using taxation to fund the projected Medicare shortfalls is equally unpalatable. We would need a 10% increase in all nonpayroll taxes by 2020 and a 50% increase by 2080, the close of the trustees' 75-year projection period.

So what else can be done? In general, no reform should be taken very seriously unless it is specifically designed to slow the rate of growth of health-care spending. On the demand side, someone must choose between health care and other uses of money. That is, someone must decide that the next MRI scan or the next knee replacement, for

example, is not worth the cost. Such decisions could be made by seniors themselves, by the government (as it is in other countries), or by private insurers operating under government rationing rules. On the supply side, the way health care is produced must fundamentally be changed, replacing cost-increasing innovations with cost-reducing ones.

To examine consequences of beneficiaries making their own rationing decisions, my colleague Andrew Rettenmaier and I estimated the effects of creating reformed Medicare based on a \$5,000-deductible Health Savings Account (HSA), beginning with the baby boomer retirees. The size of the deductible and the HSA would grow through time (as health costs grow), and since deposits would be made with after-tax dollars, withdrawals for any purpose would be tax free. In this way, beneficiaries would be encouraged to make their own tradeoffs between health care and every other good or service. We estimate the effects would result in a reduction in Medicare's unfunded liability by between 25% and 40%.

We did not attempt to estimate the impact of this reform on the supply side of Medicare. However, there is ample evidence that when people spend their own money on health services, supply side responses are considerable. This implies that a properly designed HSA could help us get off of the current spending course in two ways. First, it could allow the elderly to reallocate health-care dollars to goods

and services they value more. Secondly, it could spur providers to deliver care more efficiently.

Even with these reforms, however, we must still address the problem of pay-as-you-go financing. Today every dollar in Medicare payroll taxes is immediately spent. Nothing is saved. Nothing is invested. The payroll taxes contributed by today's workers pay the medical benefits of today's retirees. However, when today's workers retire, their benefits will be paid only if the next generation of workers agrees to pay even higher taxes.

The alternative is to move to a funded system in which each generation saves and invests in order to pay for its own benefits. Yet to take advantage of this potential, we need to act quickly. We must introduce reforms that capture the earning potential of the baby-boom generation before they escape into retirement and leave the young with a burden that will be increasingly burdensome. Unless we increase our level of saving now, we will leave our children and grandchildren strapped with escalating tax rates.

If nothing is done, Social Security and Medicare deficits will engulf the entire federal budget. If our policy makers wait to address the growing deficits until they are out of control, the solutions will be drastic and painful. Let us hope that the current wake-up call is not ignored.

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