



AN EXAMINATION OF MEDICARE'S CURRENT DESIGN AND AN ALTERNATIVE

Medicare's rapid growth in spending and its position as the dominant regulator of the nation's healthcare sector has made it the focal point of fiscal and health policy debates. Proposals to reform Medicare tend to maintain the basic structure of the program, ignoring flaws in that structure that have left the program with daunting unfunded liabilities.

In "[An Examination of Medicare's Current Design and an Alternative](#)," American Enterprise Institute Resident Fellow James C. Capretta reviews Medicare as it currently operates, including the financial challenges the program faces, and proposes a new architecture that will put the program on more solid financial footing. He concludes that Medicare should retain its insurance guarantee for retirees and disabled individuals while reserving large subsidies only for individuals who lack the means to pay for premiums themselves, instead of extending these subsidies to all individuals.

BACKGROUND

Medicare provides publicly operated and subsidized health insurance for individuals age 65 and older and for disabled individuals.

- *Financing.* Medicare enrollees pay premiums that are generally equivalent to about 25 percent of program costs, with the other 75 percent of costs being financed by Medicare taxes on current workers and support from the federal treasury.
- *Unfunded liability.* Medicare's unfunded liability—the amount by which program expenditures are expected to exceed resources, including Medicare payroll taxes—currently exceeds \$60 trillion, which will have to be paid by federal taxpayers unless costs are cut.

REFORM

Reforming Medicare should begin with disentangling the program's two main features.

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- *Guaranteed insurance.* Medicare provides guaranteed inclusion in a nationwide, community-rated risk pool to all Americans age 65 and older and eligible disabled individuals. The program charges everyone in the pool the same premium for coverage, regardless of health status. This is a valuable benefit regardless of any subsidies the program provides.
- *Tax-and-transfer program.* Medicare also acts as a transfer program: the benefits it provides are the same to all, but higher-income workers pay more in taxes to receive these benefits. Medicare outspends this tax income to provide additional benefits, which has led to a state of near-constant financial distress.

Effective reform of Medicare should maintain the guaranteed insurance aspect of the program while reducing the scope of the tax-and-transfer aspect, especially for those who could reasonably save enough while working to cover most of their own Medicare premiums.

- *Rationalized Medicare insurance product.* Instead of providing separate insurance products for hospitalization, outpatient services, and drugs, Medicare should provide a combined insurance product with a single premium and deductible.
- *Community-rated premiums.* Insurance premiums for enrolling in Medicare should not vary based on the age or health status of the enrollee, but they should vary based on enrollees' lifetime earnings and personal preferences for coverage type.
- *Smaller universal entitlement.* To ensure maximum enrollment, the program should continue to provide a small universal-entitlement benefit to all enrollees, perhaps covering 20 percent of the value of today's benefit. This entitlement could be funded with a payroll tax set at roughly 60 percent of today's rate, and it should be paid from a single Medicare trust fund with the goal of financing the program entirely from payroll taxes.
- *Additional support tied to lifetime earnings.* Medicare should provide additional support to those without the means to pay premiums on their own. This added benefit should be based on the lifetime earnings of the enrollee, a measurement that uses already existing payroll tax data, avoids intrusive means testing, and does not discourage personal savings during working years.
- *Defined contributions and beneficiary choice.* Beneficiaries should be presented with a number of competing options for their Medicare coverage, and then they should use the contribution defined above to reduce the cost of the plan they find most suitable. These options should include both the traditional Medicare program plan and private plans, which could offer varying levels of deductibles and cost-sharing.
- *Facilitating healthcare savings.* Adjustments in tax-preferred savings vehicles would help workers save for their own future healthcare expenses. The limits on contributions to Health Savings Accounts, as well as 401(k) and IRA accounts, should be increased to accommodate this need.
- *Gradual transition.* Transitioning to this system, which asks more of middle- and higher-income workers, would need to be gradual, perhaps over 30 years, with subsidies for

Medicare enrollees shifting slowly and predictably. This gradual transition would allow workers to save as necessary for the higher future premiums.