



## Office of the Actuary

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**DATE:** March 25, 2008

**FROM:** M. Kent Clemens

**SUBJECT:** Projected Medicare Part B Expenditures under Two Illustrative Scenarios with Alternative Physician Payment Updates

In the *2008 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, the Board warns that their projections of Medicare Part B expenditures under current law are “likely understated and should be interpreted cautiously.” The purpose of this memorandum is to help illustrate and quantify this potential understatement.

### *Overview*

Medicare payments for physicians’ services are based on a fee schedule, which reflects the relative level of time and effort required for each service and the relative complexity of each. These relative amounts per service are translated into dollars through a conversion factor, which is updated each calendar year based on the sustainable growth rate (SGR) mechanism specified in law. The SGR system compares the accumulated amount of actual physician-related spending to a specified target level. If actual cumulative spending exceeds the target cumulative spending level, then one or more future physician payment updates per service will be reduced so that future actual expenditures will be lower and ultimately reach the target amount allowed under the law. Similarly, if the actual spending is below the target level, then future physician updates will be increased. The update adjustments are subject to limits on both the increase and the decrease.<sup>1</sup> The intent of the SGR system is to limit growth in spending on physician services to a sustainable rate, roughly in line with the rate of overall economic growth.

Because actual physician-related spending has exceeded the target spending levels by progressively larger annual amounts since 2001, cumulative actual spending is greater than the cumulative target amount by about \$50 billion after 2007, and by a projected \$60 billion after 2008. As a result, under the current-law SGR system, the physician payment updates per service are projected to be negative for nearly every year from the second half of calendar year 2008 through 2016. A physician update of –4.8 percent was required and was allowed to take effect in 2002—the only historical year in which a negative physician update was implemented under the SGR. For each of the most recent 5 years (2003-2007), a scheduled

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<sup>1</sup> For more information on the sustainable growth rate system, see [http://www.cms.hhs.gov/SustainableGRatesConFact/01\\_Overview.asp](http://www.cms.hhs.gov/SustainableGRatesConFact/01_Overview.asp).

negative update of about –5 percent was overridden by new legislation, which provided updates ranging from 0 percent to 1.7 percent. For the first half of 2008, a scheduled negative update of –10.1 percent was avoided by legislation, which provided a 0.5 percent update. These legislative acts not only provided replacement updates for 2003 through 2006 and increased the actual physician spending, they also specified that the target level of spending would not be increased to match.<sup>2</sup> Thus, the cumulative difference between actual and target spending has increased significantly. The legislative change to the physician update for 2007 increased both actual and target spending, but required that the 2008 update be determined as if the 2007 update had not been changed.

Similarly, the recently passed Medicare, Medicaid, and SCHIP Extension Act (MMSEA) changed the physician update and increased both the actual and target spending, but only for the first half of 2008. Again, the legislation required that the update for the second half of 2008, and for 2009, be determined as if the update for the first half of 2008 had not been changed. In addition, MMSEA required that \$4,960 million from the Part B account of the SMI trust fund be used to increase the physician update in 2013. However, to implement this higher 2013 update, several difficulties will need to be overcome, including tracking the portion of each physician payment that is due to the higher update in 2013 in order to not exceed the cap of \$4,960 million, and excluding the additional payments from both actual and target spending under the SGR system so that no future updates are affected.

Based on this history and legislation affecting the SGR system, the current law physician updates are projected to be about –10 percent for the second half of 2008, about –10 percent for 2009, about –5 percent for each year 2010-2012, about 3 percent 2013, about –13 percent for 2014, about –5 percent for 2015, and about –4 percent 2016.<sup>3</sup>

Multiple consecutive years of large negative updates are extremely unlikely to occur. In fact, Congress has acted to override them in 5 1/2 of the past 6 1/2 years, and the scheduled –10-percent updates for the second half 2008 and for 2009 are double the size of nearly all of those previously avoided under the SGR. Despite their improbability, the negative physician updates are scheduled to occur under current law and are therefore included in the Part B estimates shown in the 2008 Medicare Trustees Report.<sup>4</sup>

It is important to note that the current-law estimates shown in the 2008 Medicare Trustees Report include only the direct impacts of the negative physician updates. Not included are possible secondary impacts, such as reduced beneficiary access to physician services, increased emergency room visits, increased mortality rates, increased enrollment in Medicare

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<sup>2</sup> For these legislative acts, increasing the actual physician spending, but not changing the target spending, resulted in a lower 10-year cost estimate than would have occurred if target spending had been adjusted to accommodate the higher costs resulting from the higher payment updates. Each such action, however, contributed to a significant increase in the difference between accumulated actual and target spending, requiring additional physician payment reductions in the future under the current-law SGR system.

<sup>3</sup> In each case, these percentages are calculated by comparing the average physician payment per service during the period indicated to the average physician payments per service over the same duration but 12 months earlier.

<sup>4</sup> The 2008 Medicare Trustees Report was released on March 25, 2008. It is available at [http://www.cms.hhs.gov/ReportsTrustFunds/01\\_Overview.asp](http://www.cms.hhs.gov/ReportsTrustFunds/01_Overview.asp)

managed care plans, and/or increased hospital utilization. In other words, the Part B cost estimates only include the reduction in the price paid per service, but not behavioral or healthcare system responses to these physician payment reductions.<sup>5</sup>

For example, the negative physician payment updates have the potential to result in physicians reducing the number of traditional fee-for-service (FFS) Medicare patients that they would see each day (reduced access). As MedPAC has noted, Medicare Advantage plans receive higher reimbursement per enrollee, on average, than paid in traditional FFS Medicare.<sup>6</sup> Therefore, these plans could pay physicians more than Medicare FFS pays, thereby permitting better access to physician services in Medicare Advantage plans. Medicare enrollees would then be more likely to choose to shift their enrollment from traditional FFS Medicare to Medicare Advantage in order to maintain access to physician care.

Regardless of which combination of these secondary impacts might be assumed to occur, including them in the current-law baseline would lead to an increasingly improbable result and only reduce the usefulness of the estimates across all other Medicare expenditure categories. However, by excluding the secondary impacts of the negative physician updates, the current-law baseline does not reflect the full scope of what would eventually result under the SGR system in the absence of legislative changes. In this respect, the projections do not represent the “best estimates” of Medicare expenditures; due to the speculative nature and extremely low likelihood of such an outcome, the “best estimate” would not be especially useful.

### *Comparison of Results*

The purpose of this document is to provide a comparison of the Part B projections under current law with those under two illustrative scenarios with alternative physician updates. The alternative physician update scenarios are for comparison purposes only and should not be interpreted or construed as advocating any particular legislative change. In particular, no endorsement of these alternatives by the Office of the Actuary, CMS, or the Medicare Board of Trustees should be inferred. This paper is an attempt to illustrate and loosely quantify the amount by which the Part B projections are understated, and to help inform discussions regarding potential legislation for resolving the current-law physician update situation. Again, this paper does not advocate any particular legislative change to current law.

The current-law Part B projections are compared with those that include physician updates, for 2009 through 2016, of (i) 0.0 percent, and (ii) the projected increase in the Medicare

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<sup>5</sup> A physician volume and intensity growth response to price changes is assumed through 2009. The physician response study can be found at [http://www.cms.hhs.gov/ActuarialStudies/02\\_PhysicianResponse.asp](http://www.cms.hhs.gov/ActuarialStudies/02_PhysicianResponse.asp).

<sup>6</sup> MedPAC’s March 2008 Report to Congress is available at [http://www.medpac.gov/documents/Mar08\\_EntireReport.pdf](http://www.medpac.gov/documents/Mar08_EntireReport.pdf)

economic index (MEI), which is estimated to be about 2 percent per year.<sup>7</sup> Under the two alternative scenarios, the physician update for 2008 is assumed to be 0.5 percent for the entire year. Table 1 shows the Part B calendar-year cash expenditures and growth rates under current law and the two alternative scenarios. Expenditures under the 0-percent update scenario are 4.2 percent higher than under current law in 2009 and grow to be 16.8 percent higher by 2017. The MEI update scenario is higher by 4.7 percent in 2009 and by 22.5 percent in 2017. The average annual expenditure growth rate for each scenario over the 10 years is 6.2 percent under current law, 7.8 percent for the 0-percent update scenario, and 8.3 percent for the MEI scenario.

Table 1. Estimated Part B Expenditures under Current Law and Two Alternative Physician Payment Update Scenarios (0 Percent and MEI), Calendar Years 2007-2017

Calendar year	Current law		0-percent physician payment updates			MEI physician payment updates		
	Expenditures (billions)	Growth rate	Expenditures (billions)	Growth rate	Percent of current law expenditures	Expenditures (billions)	Growth rate	Percent of current law expenditures
2007	\$178.9	5.9%	\$178.9	5.9%	100.0%	\$178.9	5.9%	100.0%
2008	187.0	4.5	189.0	5.6	101.1	189.0	5.6	101.1
2009	194.3	3.9	202.4	7.1	104.2	203.4	7.6	104.7
2010	204.6	5.3	217.8	7.6	106.4	219.9	8.1	107.5
2011	215.6	5.4	234.3	7.6	108.7	237.8	8.1	110.3
2012	229.1	6.3	253.7	8.3	110.7	259.0	8.9	113.1
2013	251.2	9.7	275.6	8.6	109.7	282.8	9.2	112.6
2014	261.3	4.0	298.8	8.4	114.4	308.2	9.0	118.0
2015	278.2	6.5	323.6	8.3	116.3	335.5	8.9	120.6
2016	297.7	7.0	350.3	8.3	117.7	365.2	8.8	122.7
2017	325.3	9.3	380.0	8.5	116.8	398.5	9.1	122.5

Like the Part B expenditures, the associated Part B premiums and general revenue income would also increase under the two scenarios, as shown in Table 2.<sup>8</sup> The financing for Part B automatically adjusts each year to match estimated costs and is thus projected to be adequate under current law and both alternative scenarios. It is important to note, however, that several of the past legislative overrides to the scheduled negative physician updates have occurred after the financing had been determined for the year. As a result, assets in the

<sup>7</sup> In practice, Congress could legislatively change Medicare elsewhere to help offset the cost of any legislated increase in physician updates. The two illustrative scenarios assume that only the physician updates are changed.

<sup>8</sup> The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) requires an examination of the difference between Medicare’s total outlays less its dedicated financing sources as a percent of the total outlays. In the 2008 Medicare Trustees Report, this ratio is estimated to reach 45 percent within the first 7 years of the projection and continue to be above 45 percent in all subsequent years. Consequently, the MMA requires the Board of Trustees to deliver a determination of “excess general revenue Medicare funding” this year, as they did in the last 2 year’s reports. Further, the MMA states that two consecutive “excess general revenue funding” determinations trigger a “Medicare funding warning,” which requires a response by the President and the Congress. This ratio (of total Medicare outlays less dedicated financing sources to total outlays) would be higher under either of the two alternative physician update scenarios and would not change the determination of “excess general revenue Medicare funding” or the “Medicare funding warning” in this year’s report.

Part B account were drawn down during the year to cover the higher physician payments, and future financing rates were increased to restore the assets in the following years. Unlike recent historical experience, the projections assume that the physician updates are known when the financing rates are set.

Table 2. Estimated Part B Account Income and Expenditures under Current Law and Two Alternative Physician Payment Update Scenarios (0 Percent and MEI), Calendar Years 2007-2017 (in billions)

Scenario	2007	2008	2009 <sup>1</sup>	2010 <sup>1</sup>	2011	2012	2013	2014	2015 <sup>1</sup>	2016 <sup>1</sup>	2017
<i>Current law</i>											
Income:											
Premiums	\$46.8	\$50.0	\$56.0	\$48.2	\$54.8	\$58.3	\$64.1	\$66.4	\$77.0	\$69.4	\$83.0
General revenue	139.6	146.4	160.2	139.0	158.7	168.9	185.7	192.5	223.9	201.7	241.1
Other	2.2	16.7	4.1	4.4	4.7	4.9	5.2	5.4	5.7	6.0	6.3
Total income	<u>188.7</u>	<u>213.2</u>	<u>220.4</u>	<u>191.6</u>	<u>218.2</u>	<u>232.1</u>	<u>255.0</u>	<u>264.3</u>	<u>306.6</u>	<u>277.1</u>	<u>330.4</u>
Expenditures	178.9	187.0	194.3	204.6	215.6	229.1	251.2	261.3	278.2	297.7	325.3
Part B account											
Balance (EOY)	42.1	68.2	94.3	81.3	83.9	87.0	90.8	93.8	122.2	101.7	106.8
<i>0-percent update scenario</i>											
Income:											
Premiums	46.8	50.0	56.3	51.1	60.0	65.1	70.7	76.7	90.5	82.5	97.6
General revenue	139.6	146.4	162.5	147.5	173.2	187.8	204.0	221.3	261.9	238.5	282.1
Other	2.2	16.7	3.9	4.0	4.2	4.5	4.8	5.1	5.4	5.8	6.3
Total income	<u>188.7</u>	<u>213.1</u>	<u>222.8</u>	<u>202.6</u>	<u>237.4</u>	<u>257.4</u>	<u>279.5</u>	<u>303.1</u>	<u>357.9</u>	<u>326.8</u>	<u>386.0</u>
Expenditures	178.9	189.0	202.4	217.8	234.3	253.7	275.6	298.8	323.6	350.3	380.0
Part B account											
Balance (EOY)	42.1	66.2	86.6	71.4	74.6	78.3	82.3	86.5	120.9	97.4	103.4
<i>MEI update scenario</i>											
Income:											
Premiums	46.8	50.0	56.7	51.6	61.0	66.5	72.7	79.2	94.1	86.1	102.6
General revenue	139.6	146.4	163.4	149.0	175.9	191.7	209.4	228.5	271.8	248.7	296.1
Other	2.2	16.7	3.9	4.0	4.3	4.5	4.8	5.2	5.5	5.9	6.4
Total income	<u>188.7</u>	<u>213.1</u>	<u>223.9</u>	<u>204.6</u>	<u>241.1</u>	<u>262.8</u>	<u>286.9</u>	<u>312.9</u>	<u>371.4</u>	<u>340.7</u>	<u>405.1</u>
Expenditures	178.9	189.0	203.4	219.9	237.8	259.0	282.8	308.2	335.5	365.2	398.5
Part B account											
Balance (EOY)	42.1	66.2	86.8	71.5	74.8	78.6	82.6	87.3	123.2	98.8	105.4

<sup>1</sup>January 3, 2010 falls on a Sunday; therefore, Part B premium income and associated general revenues will be received on December 31, 2009. Similarly, January 3, 2016 falls on a Sunday; therefore, Part B premium income and associated general revenues will be received on December 31, 2015.

The increased financing rates under the two alternative scenarios would affect beneficiary out-of-pocket spending for Part B, as well. As shown in Table 3, the Part B monthly premiums and annual deductibles paid by Part B enrollees would increase significantly. The projected monthly Part B premium for 2009 is \$96.40 under current law, but \$96.50 and \$97.00, respectively, under the 0-percent and MEI scenarios.<sup>9</sup> This initial difference would

<sup>9</sup> In 2005 through September 2007, Part B mistakenly paid for certain Part A hospice benefits. A correction of these errors is assumed to occur in June 2008, and would restore the Part B assets. This asset correction dampens the difference in the financing rates between current law and each of the two alternative scenarios in the near term projections.

increase over time in proportion to the higher per beneficiary expenditure levels resulting from the alternative physician payment updates. In 2017, the monthly Part B premium is projected to be 18 percent higher than the current-law projection under the 0-percent scenario and 24 percent higher under the MEI scenario.

Table 3. Estimated Part B Monthly Premium and Annual Deductible under Current Law and Two Alternative Physician Payment Update Scenarios (0 Percent and MEI), Calendar Years 2007-2017

Calendar year	Current law		0-percent update scenario		MEI update scenario	
	Monthly Part B premium <sup>1</sup>	Annual Part B deductible	Monthly Part B premium <sup>1</sup>	Annual Part B deductible	Monthly Part B premium <sup>1</sup>	Annual Part B deductible
2007 <sup>2</sup>	\$93.50	\$131.00	\$93.50	\$131.00	\$93.50	\$131.00
2008 <sup>2</sup>	96.40	135.00	96.40	135.00	96.40	135.00
2009	96.40	135.00	96.50	135.00	97.00	136.00
2010	96.40	135.00	102.30	143.00	103.30	145.00
2011	98.50	138.00	107.90	151.00	109.60	154.00
2012	102.00	143.00	113.90	159.00	116.40	163.00
2013	109.00	153.00	120.20	168.00	123.50	173.00
2014	109.70	154.00	126.90	177.00	131.00	184.00
2015	113.80	160.00	133.60	187.00	138.80	195.00
2016	118.60	167.00	140.90	197.00	147.10	207.00
2017	126.40	178.00	148.70	208.00	156.30	220.00

<sup>1</sup>The amount shown for each year is the standard monthly Part B premium paid by, or on behalf of, every Part B enrollee and does not include other Part B premium amounts such as the income-related Part B premium monthly adjustment amount, the late enrollment penalty, or the hold-harmless Part B premium reduction.

<sup>2</sup>Monthly Part B premium and annual deductible are actual values for this year.

To illustrate the impact of continuing rapid growth in Part B and total Medicare relative to the economy as a whole, it is customary to express Part B and Medicare expenditures over the 75-year projection period as a percentage of the gross domestic product (GDP). Through 2016, projected Part B expenditure growth is faster for both alternative scenarios than under the current-law projections.<sup>10</sup> As shown in Table 4, Part B spending is projected to increase from 1.31 percent of GDP in 2007 to 4.03 percent of GDP by 2080 under current law. For the alternative scenarios, Part B is expected to increase more rapidly—reaching, by 2080, 4.43 percent of GDP under the 0-percent update scenario and 4.85 percent of GDP under the MEI update scenario.

<sup>10</sup> For the Trustees Report projections, Medicare costs are estimated separately for each category of service for the first 10 years. For the 25<sup>th</sup> through the 75<sup>th</sup> years, Part A, Part B, and Part D costs are each estimated in aggregate based on a set of projected growth rates determined from an economic model. Between the 10<sup>th</sup> and 25<sup>th</sup> years of the projection, growth rates are interpolated. The alternative physician update scenarios directly affect projected growth rates for the first 10 years and indirectly for the next 15 years. The scenarios do not subsequently affect Part B expenditure growth rates, although the ongoing level of costs is higher through the remainder of the long-range projection period.

Table 4. Projected Part B and Total Medicare Expenditures as a Percentage of Gross Domestic Product (GDP) under Current Law and Two Alternative Physician Payment Update Scenarios (0 Percent and MEI), Selected Calendar Years 2007-2080

Calendar year	Part B expenditures as a percentage of GDP			Medicare expenditures as a percentage of GDP		
	Current law	0-percent update scenario	MEI update scenario	Current law	0-percent update scenario	MEI update scenario
2007	1.31%	1.31%	1.31%	3.18%	3.18%	3.18%
2008	1.29	1.31	1.31	3.24	3.25	3.25
2010	1.29	1.37	1.39	3.32	3.41	3.42
2020	1.68	1.92	2.04	4.44	4.68	4.81
2030	2.41	2.65	2.90	6.26	6.50	6.75
2040	2.89	3.18	3.48	7.58	7.87	8.17
2050	3.17	3.49	3.82	8.40	8.71	9.04
2060	3.49	3.84	4.20	9.21	9.56	9.92
2070	3.80	4.17	4.57	10.03	10.40	10.80
2080	4.03	4.43	4.85	10.69	11.09	11.51

### *Conclusion*

The sustainable growth rate (SGR) system is intended to restrain Medicare Part B physician spending growth by linking future physician payment updates to the difference between past physician-related spending and a target level of such spending. The SGR system, under current law, would result in many years of large negative physician payment updates—the first two of which, in the second half of 2008 and in 2009, would be about –10 percent. However, Congress has legislatively overridden a scheduled negative update in each of the past 5 1/2 years. The size of the current-law negative updates and the number of consecutive years of these payment reductions, together with the historical unwillingness of Congress to allow them, strongly suggest that the projected reductions are unlikely to occur in practice. Consequently, as the Medicare Trustees have warned, estimates of Part B expenditures under current law are very likely to understate actual future costs to a substantial degree.

An examination of two illustrative alternative physician payment update scenarios provides some insight into the magnitude of the likely understatement of Part B expenditures as projected under current law. The scenarios shown here should not be seen as recommended legislative replacements for the current SGR system. While it is reasonable to conclude that Congress will take action to address the physician payment reductions that would otherwise be required under current law, the nature of their efforts could differ substantially from the illustrative alternatives shown in this memorandum. Consequently, actual Part B expenditures, premiums, deductibles, and general revenue financing in the future will differ from the illustrations presented here, but are likely to be higher than estimated under current law.

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