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Medicare Premiums and Social Security's Cost-of-Living Adjustments

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Abstract

Medicare Part B and Part D premiums will soon increase for most beneficiaries, likely consuming much of the cost-of-living increase in their Social Security benefits. Part B premiums do not vary with affordability except for the relatively few single beneficiaries with annual incomes exceeding $85,000 and the relatively few married beneficiaries with incomes exceeding $170,000. Consequently, premium levels and increases are often burdensome at the lowest income levels. Rising health care costs leave the entire population with less to spend on nonhealth goods and services, and older adults are affected most because so much of their income goes to health care.

In most years, a significant portion of the cost-of-living increases received by most Social Security beneficiaries is devoted to paying for increases in Part B Medicare premiums for physician insurance and Part D premiums for the prescription drug program. That implies that the amount of the benefit that is left over is not keeping up with inflation, and for those retired a long time, the real value of the net benefit can erode significantly. Goda, Shoven, and Slavov (2011) show that the Part B premium went up approximately 1,600 percent between 1975 and 2011, while the cumulative cost-of-living adjustment (COLA) increase was just over 300 percent.[1]

Premium Design

Normally, premiums for Part B Medicare finance about 25 percent of the cost of the program for people 65 and over, while Part D premiums cover 25.5 percent of the cost of the standard prescription drug benefit package. The premium for Part B for about three-fourths of recipients is $96.40 per month in 2011. Others pay more by amounts that will be described later. The Part D premium is estimated to average $32.34.[2] Actual Part D premiums vary greatly depending on the private insurance plan chosen by the participant and whether the individual receives a low-income premium subsidy.

Higher-income people have paid more than the standard premium for Part B since 2007. Recent health reform legislation further raised costs for high-income recipients by relating Part D premiums to income for the first time in 2011. Something called Modified Adjusted Gross Income (MAGI) is used to determine premium levels. MAGI equals

[1] Munnell, Buessing, Soto, and Sass (2006) make a similar point.

[2] The actual average may turn out to be slightly less than the estimated average, because people can switch plans after premiums are announced.

adjusted gross income (AGI) as reported on tax returns plus tax-exempt municipal bond interest.[3] Because of lags in processing income tax data, the Social Security Administration looks back to 2009 tax returns in order to determine premium levels for 2011. That can cause an inequity for people whose income fell a great deal between 2009 and 2011, but it is possible to appeal if one's marital status changed or income fell greatly because of retirement. Reductions in income that occur for other reasons do not buy any relief.

For married couples filing jointly, the Part B and D premiums first go up $58.10 per month (or $697.20 per year) at a MAGI over $170,000. The complete schedule is shown in Table 1. The Part B income brackets have been indexed for inflation in the past, but the new health reform freezes both the Part B and Part D brackets through 2019.

Table 1: Annual Cost of Medicare Premiums, 2011

Annual Income, Married Couples	Part B Premium	Part D Premium	Part B and D Combined
Less than $170,000	$1,384.80	$388.08	$1,772.88
$170,000.01 - $214,000.00	$1,938.00	$532.08	$2,470.08
$214,000.01- $320,000.00	$2,768.40	$761.28	$3,529.68
$320,000.01 - $428,000.00	$3,598.80	$989.28	$4,588.08
More than $428,000.00	$4,429.20	$1,217.28	$5,646.48

Source: 2011 Medicare Trustees' Report

Note: The monthly Part B premium implied by the first line in the table is $115.40. That is higher than the $96.40 paid by most 2011 participants in Part B. The higher premium is paid by new enrollees and serves as a base for the schedule relating premiums to income.

There are different schedules for single people and married couples who file separately. For singles and married couples filing jointly, the premiums more than triple between the lowest and the highest income classes. Couples in the income class below $170,000.01 pay roughly 25 percent of the cost of their insurance. By the time income exceeds $428,000, premiums are covering 80 percent of the cost.

[3] MAGI is also used to determine the tax on Social Security benefits.

The schedule is peculiar in two respects. The premium goes up in large steps and each step covers a wide range of income. Because husband and wife each must pay the premiums shown in Table 1, they would pay a yearly Part B premium of $2,770 if their income is $170,000, but $3,876 (or $1,106 more) if their income is $170,000.01. Their Part D premium would go up $288. Clearly, it can be very expensive to earn that extra penny. But then their premiums remain the same until their MAGI exceeds $214,000. In economists' jargon, it can be said that their marginal tax rate is well over 100,000 percent as they cross from one income class to another, but zero within each range of the MAGI shown in Table 1.

If the increase in the premiums is measured between the middle of income classes starting above $170,000, it amounts to approximately 2.8 percent of the increase in income until you get to the top class. In a crude way, it approximates a proportional tax until you get above $428,000. Since the premium doesn't change no matter how much you exceed this threshold, it becomes equivalent to a lump sum tax, which is, of course, extremely regressive. It is not clear, however, that that is something to worry about when it only affects the lofty income range above $428,000.

Another peculiar feature of the premium is that it is based on MAGI. The personal income tax allows you to deduct exemptions from AGI and considers a variety of other deductions, exclusions, and credits before determining your tax liability. In contrast, a very broad measure of income is used to determine premiums. It is a tax reformer's dream come true. If the premium had been based on taxable income and had used a smoother schedule, it would be crudely similar to raising marginal tax rates by 2.8 percentage points for income classes between $170,000 and $428,000. But because a

different income concept is used, the relationship between premium increases and the ordinary income tax rate will vary from taxpayer to taxpayer.

Health reform adds yet another tax surcharge of 3.8 percent on investment income for couples above $250,000. When the surcharge and income-related premiums are added to the top income tax rate of 35 percent, the equivalent top rate for many affluent Medicare beneficiaries will exceed the 39.6 percent levied by the income tax before the Bush tax cuts.

The premium schedule may seem complicated as described so far, but it has become even more complex during the past few years. A "hold harmless" rule prevents Part B premium increases from reducing net Social Security benefits from year to year (the Social Security benefit minus the Part B premium) for those whose income is not high enough to pay more than the standard premium. (Part D premiums are not subject to a hold harmless rule.) That means that the increase in the Part B premium cannot exceed the COLA provided to beneficiaries. The size of the COLA for the next year is usually determined by the change in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) from the third quarter of one year to the third quarter of the next, but on rare occasions, when there has been a period of deflation, the COLA for the next year is based on the percentage increase between the third-quarter CPI-W and the last third-quarter CPI-W that triggered a positive COLA. Because the CPI-W was lower in the third quarters of 2009 and 2010 than it was in 2008, there were no COLA increases for 2010 and 2011. As a result, those whose premiums were not income related and who were on the rolls for both those two years continued to pay the 2009 Part B monthly premium of $96.40. Those with income-related premiums faced standard premiums of $110.50 in 2010 and $115.40 in 2011 plus additions related to income. New enrollees

also paid the higher premiums. In addition, people who are dually eligible for Medicare and Medicaid are charged the higher premiums, but their premiums are paid by Medicaid. Because Medicaid costs are shared between state and federal governments, money is thus diverted from state treasuries and federal general revenues into the Medicare program. In all, about one-quarter of Medicare beneficiaries faced premium increases in each of 2010 and 2011.

The small share of the Medicare population facing premium increases combined with a continuation of the rule that standard premiums must finance 25 percent of Part B costs for elderly beneficiaries resulted in standard premium increases for 2010 and 2011 that were considerably larger than if the hold harmless rule had not been in effect.[4] The end result of the hold harmless rule is that people whose premiums are below the level at which they are related to income can face monthly premiums in 2011 of $96.40 if they enrolled before 2010, $110.50 if they enrolled in 2010, or $115.40 if they enrolled in 2011.

The intermediate estimate of the Social Security trustees projects a COLA increase of 0.7 percent for 2012. That is a bit lower than the assumed inflation of 1.2 percent for 2011. The discrepancy arises because the CPI-W in the third quarter of 2010 fell short of that in the third quarter of 2008—the last CPI-W that triggered a COLA increase. Consequently, the COLA for 2012 will be based on the increase in the CPI-W between the third quarter of 2011 and the third quarter of 2008, and that percentage

[4] The Secretary of Health and Human Services has some discretion in setting premium levels and did modify the 2010 increase to some degree in order to ensure that trust fund reserves would be adequate in case estimated expenditure levels were exceeded.

increase is less than the expected inflation rate between 2010 and 2011. That happened because of a period of deflation between 2008 and 2010.

The positive COLA increase in 2012 implies that many who previously had their premium held constant at 2009 levels will now be able to devote their COLA to paying part or all of any premium increase. The fact that many more beneficiaries will finance a portion or all of any premium increase will lower the increase necessary to cover 25 percent of Part B costs in 2012. The trustees' official estimates imply a standard premium that is actually lower than in 2010 and 2011.

In the end, a very large number of beneficiaries enrolled before 2010 will experience no increase in nominal net benefits for the third year in a row.[5] Indeed, nominal monthly benefits, after deducting both Part B and D premiums, will fall very slightly because of an increase in the monthly Part D premium of $3.13 between 2009 and 2012.

If the officially estimated standard Part B premium increase of $10.20 occurs and the COLA increase actually turns out to be 0.7 percent, those with a gross monthly benefit less than $1,457 in 2009 will devote their entire COLA to paying the increase in the premium. About 75 percent of 2009 retired workers fall into this group. Their net benefit will actually decline slightly because of increases in the Part D premium. Those in this group whose premiums are income related in 2012 will suffer a larger net decrease in their nominal benefit.

Those at significantly higher benefit levels will receive a nominal increase in net benefits, but will see a significant share of their COLA increase disappear because their

[5] It should be noted that a special bonus of $250 provided in 2009 was not repeated, and this caused a fall in nominal benefits.

premiums will increase. For example, a beneficiary entitled to a gross benefit of $2,000 per month in 2009 will see a COLA increase in 2012 of $14, of which $13.33 will be needed to pay the part B and Part D premium increases since 2009. That implies a real cut in the net benefit of 0.7 percent. That may seem like a very small cut over three years, but similar cuts are likely to occur in the future and can accumulate to significant amounts over a retiree's lifetime.

The forecast that the CPI-W will rise 1.2 percent in 2011 seems somewhat low given that the year-over-year increase in the CPI-W was 3.6 percent as of April, 2011. If the same rate of year-over-year increase applies for the rest of 2011, the COLA for 2012 will be 3.1 percent—slightly lower than the inflation rate for reasons described above. Only those with a benefit less than $329 would find their net benefit frozen after deducting only the Part B premium. Fewer than 5 percent of retired workers who are 65 or over receive monthly Social Security benefits that are that low. However, if the COLA is higher than the 0.7 percent assumed by the trustees, the required premium increase may not be as high as the $10.20 assumed previously simply because a higher proportion of the beneficiaries will be paying all or some part of the increase. This effect may be offset to some degree because higher inflation raises Part B costs.

Future Premiums

Medicare trustees project Part B and D premiums into the future, but the projections for Part B assume current law, and current law will undoubtedly be changed. Current law assumes that physician and hospital reimbursements will be cut, the first dramatically and the second more gradually by an amount that depends in part on the

growth of total factor productivity[6] in the economy. If reimbursements were actually cut as harshly as by the amounts required by current law, the number of health care providers participating in Medicare would fall dramatically and program participants would find it difficult to obtain health care. Consequently, Congress regularly changes the law so that large reimbursement cuts are avoided. The end result is that the official cost and premium projections of the Medicare trustees are almost certain to be too optimistic.

Medicare's actuaries publish an alternative projection that makes more realistic assumptions regarding reimbursements.[7] They do not explicitly provide an alternative projection of Part B premiums, but they do indicate how much total Part B expenditures are increased by the alternative assumptions. If it is assumed that Part B participation is not affected by the size of the premium, Part B premiums would be increased by the same proportion as total expenditures.

Table 2 compares the official projection of Part B premiums with those implied by the alternative assumptions. Part D premiums are also shown. They are not affected by reimbursement assumptions.

Table 2: Official and Adjusted Part B & D Premiums

Year	Part B Premiums Official Estimates	Part B Premiums Adjusted*	Part D Premiums	Adjusted Part B & D Premiums
2012	$106.60	$120.03	$33.49	$153.52
2013	$110.50	$125.09	$35.75	$160.84
2014	$115.80	$131.32	$37.51	$168.83
2015	$120.80	$137.71	$40.11	$177.82

Source: 2011 Medicare Trustees' Report

*Adjusted by author for actuary's estimate of more realistic reimbursement rates.

Table 3 shows the COLA-adjusted benefits for someone receiving $1,200 per

[6] Total factor productivity refers to the increase in the gross domestic product that cannot be accounted for by increases in the number of hours worked or increases in the physical capital stock.

[7] See http://www.cms.gov/ActuarialStudies/Downloads/2011TRAlternativeScenario.pdf

month in 2012—not far from the average benefit for a retired worker 65 years old or over. The COLA estimates reflect the intermediate estimates of the Social Security trustees. Table 3 also shows the nominal and inflation-adjusted net benefit after deducting the Part B and D premiums for those who enrolled after 2010 and dual eligibles. Those whose premiums are income related obviously pay higher premiums. Those with a gross benefit of $1,200 who enrolled before 2011 would be protected in 2012 by the hold harmless provision. After 2012 their COLA adjustment is higher than their Part B premium increase and therefore the hold harmless provision does not apply.

Table 3: Nominal and Inflation-Adjusted Benefits*

Year	Gross Benefit	Adjusted Premium	Nominal Net Benefit	Net Benefit in 2012($)
2012	$1,200.00	$153.52	$1,046.48	$1,046.48
2013	$1,222.80	$160.84	$1,061.96	$1,042.16
2014	$1,247.26	$168.83	$1,078.43	$1,037.57
2015	$1,272.20	$177.82	$1,094.38	$1,032.27

Source: 2011 Medicare Trustees' Report
* For beneficiaries receiving $1,200.00 in 2012

Between 2012 and 2015, the inflation-adjusted net benefit is expected to decline by 1.4 percent for a person receiving $1,200 in 2012, assuming that the person is not affected by the income-related portion of the premium schedule. Someone receiving a lower benefit would lose more in purchasing power, while someone receiving more would have a lower percentage decline in the real value of the net benefit. In that sense, the combined effect of the premium increases and the COLA is regressive, but the level of Social Security benefits is not a perfect indicator of a recipient's total family income. In addition to premiums, Part B participants face a deductible and coinsurance, usually

equal to 20 percent of costs above the deductible. Official estimates have the deductible rising from $150 in 2012 to $170 in 2015, but the actual increase is likely to be significantly higher because of higher reimbursement rates. The Part D deductible is expected to rise from $320 to $365 over the same period. Although out-of-pocket costs facing Medicare beneficiaries are now rising rapidly, they did receive a significant new benefit that led to lower out-of-pocket costs when the prescription drug program started operating in 2006.

Table 4 shows the results for someone starting with a benefit of $1,600 in 2012. In that case the real value of the net benefit falls only by 1.0 percent by 2015.

Table 4: Nominal and Inflation-Adjusted Benefits**

Year	Gross Benefit	Adjusted Premium	Nominal Net Benefit	Net Benefit in 2012
2012	$1,600.00	$153.52	$1,446.48	$1,446.48
2013	$1,630.40	$160.84	$1,469.56	$1,442.16
2014	$1,663.01	$168.83	$1,494.18	$1,437.57
2015	$1,696.27	$177.82	$1,518.45	$1,432.27

Source: 2011 Medicare Trustees' Report
** For beneficiaries receiving $1,600.00 in 2012

Conclusions

The structure of Part B and Part D premiums has some peculiar characteristics. They are related to income in a discontinuous manner, and the hold harmless provision implies that otherwise similar retirees can end up paying significantly different Part B premiums. The level of premiums and premium increases can be quite painful at the lowest income levels. Premiums do not increase with incomes until income exceeds

$170,000 for a married couple. Very few retirees have an income that high and therefore, premiums cannot be said to vary with affordability except for a very small portion of the beneficiary population.

But the most important feature of the premiums is that they are growing very fast, and that is because health costs are growing very fast. The rapid growth in health care costs is leaving the entire population with relatively less to spend on non-health goods and services, and the elderly are affected most because so much more of their income goes to health care. It might be argued that the improving quality of health care makes it worthwhile to spend relatively more on improving our health at every age, but few would deny that there are profound inefficiencies in the way health care is delivered.

Unfortunately, there is little agreement on how this problem should be tackled. It is essential that we attempt to learn more quickly by experimenting with everything from bureaucratic advisory boards to an application of market discipline. As we wait, net Social Security benefits are rapidly eroding.

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