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Thank you, Mr. Chairman, Mr. Ranking Member, and all of the members of the subcommittee. It is an honor to appear before you today to discuss the financial condition of the Medicare program and the issuance of a "Medicare funding warning" in the 2011 Trustees' Report. My testimony will begin with some basic background of Medicare financing before explaining the details of the Trustees' warning.

Medicare Trust Funds and Financing

A primary responsibility of the Medicare Trustees is to report annually, usually each spring, on the current and projected condition of the Medicare Trust Funds. Medicare has two trust funds, the Hospital Insurance (HI) Trust Fund (sometimes known as Part A) and the Supplementary Medical Insurance (SMI) Trust Fund (which includes both Part B, a voluntary enrollment program of physician, outpatient hospital and home health services, and Part D, another voluntary program that provides prescription drug benefits). Medicare also has a Part C, the "Medicare Advantage" program, whose costs are paid from both the HI Part A and SMI Part B Trust Fund accounts. As is the case with Social Security, the HI and SMI Trust Funds contain special-issue Treasury bonds, which earn interest and provide a financing reserve that can be drawn upon whenever incoming dedicated revenues fall short of outgoing expenditures.

The Trustees' projections for the HI (Part A) Trust Fund are somewhat analogous to those made for the Social Security program. For each of these, the majority of program revenues are provided by a payroll tax imposed upon worker wages and self-employment earnings. For Medicare HI, also as with Social Security, the Trustees determine whether there is an aggregate imbalance between projected program income and expenditures, as well as the date (if any) by which Trust Fund assets are projected to be exhausted.

By contrast, the finances of Medicare's SMI Trust Fund operate somewhat differently. Part B and Part D premiums and contributions from general revenues are re-established annually to match expected costs. SMI is thus kept solvent essentially by statutory construction. Financial strains on the SMI side, therefore, are manifested not in a projected actuarial imbalance or a date of trust fund depletion, but in rising requirements of general government revenues and enrollee premiums.

Altogether, Medicare receives income from a variety of sources, some of which are dedicated revenues incoming from sources outside of the federal government. It also receives a significant amount of general revenues, which are in effect a draw on the general government accounts for which there is no dedicated financing source. To the extent that the future solvency of the Medicare Trust Funds depends on general revenues (and interest payments), these represent cost obligations facing the federal government with the important question fully open as to where the financing will come from.

There is naturally a great deal of public and press interest each year in the Trustees' evolving projections for the duration of solvency of the HI (Part A) Trust Fund. This important information, however, represents just one component of overall Medicare financing. Because the other parts of Medicare are kept solvent basically by statutory design, and are simply provided with general government revenues as needed to meet costs, a fuller picture of Medicare financing must account not only for the financial health of the HI Trust Fund but also the extent of reliance upon general revenues to fund Medicare as a whole.

For Medicare HI (Part A), the largest source of income is a 2.9% tax upon wage earnings, nominally split between employer and employee. Starting in 2013, single taxpayers with earnings above $200,000 and married couples over $250,000 will also pay an additional 0.9% tax to the HI Trust Fund. Medicare HI (Part A) also receives income from the taxation of Social Security benefits (up to 85% of such benefits are subject to the income tax, with taxation on 50% dedicated to Social Security and the remaining 35% to Medicare HI).

In Parts B and D, general revenues provide the vast majority of financing (74% of total revenues for Part B, 83% for Part D). Another significant portion of Part B revenues comes from beneficiary premiums. For Part D, another smaller portion of revenues is provided via payments by States, these latter revenues representing a partial payment of foregone drug costs for dual beneficiaries as such costs were transferred from Medicaid to Part D.

Medicare Income Sources, 2010 ($ Billions)

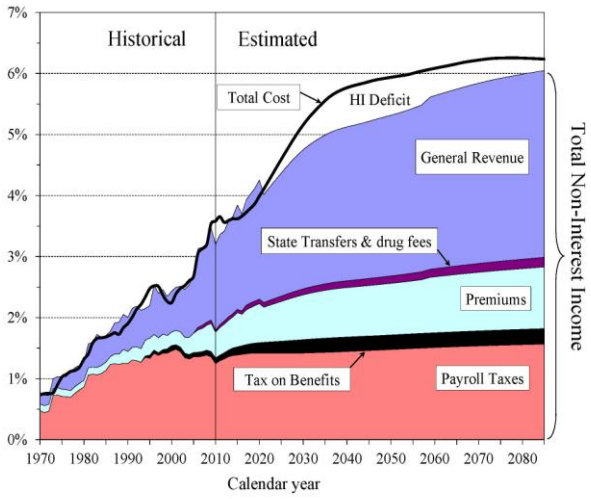
	Part A	Part B	Part D	Total
Payroll taxes	182.0	0.0	0.0	182.0
Taxation of benefits	13.8	0.0	0.0	13.8
Premiums	3.3	52.0	6.5	61.8
Transfers from States	0.0	0.0	4.0	4.0
General revenue	0.1	153.5	51.1	204.7
Interest	13.8	3.1	0.0	16.9

Other	2.7	0.2	0.0	2.9
Total	**215.6**	**208.8**	**61.7**	**486.0**

Total Medicare expenditures in calendar year 2010 were roughly $523 billion, of which roughly $516 billion were benefit payments and the remaining $7 billion administrative expenses.

As Medicare costs are projected to grow over time, one consequence of this growth (particularly within SMI) will be increased pressure on the general federal budget. SMI costs equaled roughly 1.9 percent of GDP in 2010, are projected to rise sharply to 3.4 percent of GDP in 2035, and to continue to rise beyond then. General revenue requirements for SMI are projected to rise from 1.5 percent of GDP in 2011 to 3.1 percent of GDP in 2085, as shown on the graph below. Costs for Medicare as a whole are projected to rise rapidly from 3.6 percent of GDP in 2010 to about 5.6 percent of GDP by 2035, and to increase gradually thereafter to about 6.2 percent of GDP by 2085.

Medicare Costs and Non-interest Income by Source as a % of GDP



An important caveat about these projections should be added. The Trustees' report indicates in several places that actual costs are likely to be higher in practice than shown in that report. The main reason for this has to do with the lack of certainty that current law will be implemented as written. Early next year, for example, physician payments would be reduced under current law by about 29% under an SGR formula that Congress and the Administration have repeatedly overridden in recent years. Also, as members of this subcommittee are well aware, there is a vigorous ongoing debate about whether certain cost-saving provisions of the Affordable Care Act (ACA), most especially the annual downward payment adjustments for multi-factor productivity growth, will be successfully implemented over the long term. We as Trustees are

not in a position to predict how these political economy dynamics will play out, so the main report thus simply projects current law as written. At the same time, the CMS Medicare Actuary publishes an "illustrative alternative scenario" in which the SGR payment adjustments are overridden and the ACA productivity adjustments phased out over 2020-2035. This scenario shows eventual total program costs as being much higher --10.7% of GDP in 2085, rather than the 6.2% shown in the main report. Under this alternative scenario, general revenue pressures would be considerably higher than shown on the preceding graph.

The Medicare Funding Warning

The Medicare Modernization Act (MMA) of 2003 requires that the Board of Trustees determine each year whether the annual difference between program outlays and dedicated revenues exceeds 45 percent of total Medicare outlays in any of the first seven fiscal years of the projection period. When that determination is made in two consecutive reports, a "Medicare funding warning" is triggered. This year's report projects the difference between outlays and dedicated financing revenues to exceed 45 percent of total Medicare outlays during fiscal year 2011, prompting a determination of "excess general revenue Medicare funding" for the sixth consecutive report, triggering another "Medicare funding warning."

The MMA essentially defines "dedicated revenues" as those coming in from HI payroll taxation, Social Security benefit taxation, State transfers, and enrollee premiums (as well as any gifts given to the Trust Funds). In effect, it defines "dedicated revenues" as those that come from a source external to the federal government, as distinct from general revenue obligations that have no such external financing source. These are certainly not the only dedicated revenue sources for Medicare that could theoretically be established, but the law does capture the dedicated revenue sources that now exist within the Medicare system.

The distinction between dedicated revenue sources and others bears significance for the federal government's ability to finance Medicare. To the extent that revenue from a dedicated funding source is increased, it improves both the solvency of the Medicare Trust Fund(s) as well as the government's overall unified budget balance. But to the extent that increased general revenues are provided to Medicare without a dedicated funding source, this improvement comes at the *expense* of the general fund, and without a net improvement in the unified budget balance.

In other words, to the extent that future general revenues are transferred to Medicare, its technical solvency and its authority to pay benefits are increased but there is no corresponding improvement in the government's operative ability to finance the program. Thus, to whatever extent that a "warning" successfully induces changes in law that limit such reliance on general revenue, it also limits the extent to which Medicare financing is provided at the expense of the general government accounts.

The MMA stipulates that whenever the Trustees issue a Medicare funding warning, the President shall submit to Congress during the succeeding year, within 15 days after the submission of his

proposed budget, proposed legislation to respond to the warning. This section of the law includes a sense of Congress that such legislation should be designed to eliminate the "excess general revenue Medicare funding" (i.e., the extent to which general revenue financing exceeds 45 percent of outlays). As a Public Trustee, I am able to present the Trustees' findings with respect to the triggering of the funding warning, but I am not privy to the Administration's deliberations with respect to how to respond to it, nor do I possess expertise on any legal or constitutional issues surrounding these provisions of the MMA.

2011 Trustees' Report Findings

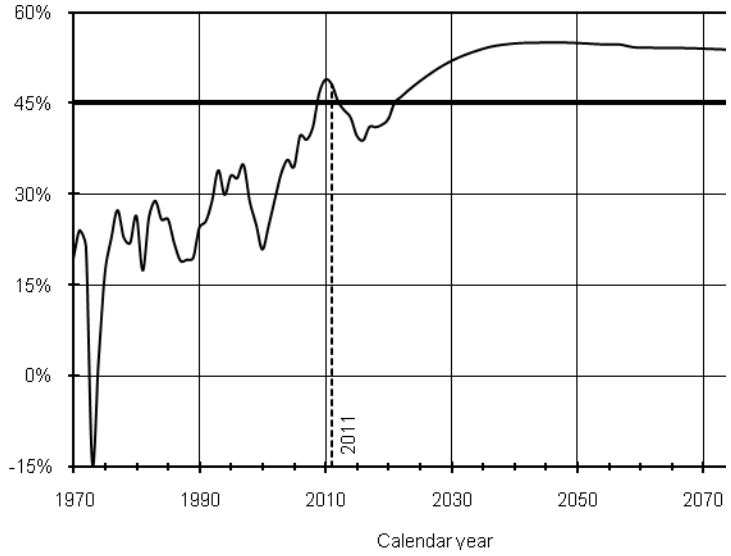
The MMA directs the Trustees to determine whether there is "excess general revenue Medicare funding" in any of the first seven years of the projection period. The 2011 Trustees' report presented a finding that the difference between program outlays and dedicated revenues will indeed exceed 45 percent in fiscal year 2011, the first year of the current projection period.

Such a year of "excess" funding within the first seven years has been anticipated in each of the reports from 2006 to 2011 inclusive, meaning that this is the sixth consecutive report to have made such a finding. Whenever the finding is made in two consecutive reports (as first happened in 2007), the Medicare funding warning is triggered as it was this year. President Bush's FY2009 budget submitted in 2008 proposed $556 billion in Medicare savings over the following ten years, specifying that these proposals were responsive to the 2007 warning. These proposals were not acted upon by Congress. In January, 2009, the House of Representatives passed a resolution waiving the requirement of action in response to a Medicare funding warning in the 111th Congress. The current Congress has not waived these requirements.

Under our latest projections, the 45 percent threshold would be exceeded in fiscal years 2011 and 2012. Revenue increases of $25 billion, benefit reductions of $46 billion, or some combination thereof would be required to reduce the ratio below 45 percent for both 2011 and 2012.

Under current-law assumptions (in which provider payments are reduced by roughly 29% in January 2012), the ratio would again drop below 45 percent in years 2013 through 2021, after which the threshold would be exceeded again. By 2034, the ratio would reach 54 percent and would stay at roughly that level throughout the remainder of the 75-year period, as shown on the following graph. If instead we assume the illustrative alternative scenario (in which the physician payment reductions are overridden) then these ratios would be higher, remaining above 45% through 2014 and dropping below the threshold only in 2015-18 before permanently exceeding 45% in 2019 and beyond.

Projected Difference between Total Medicare Outlays and Dedicated Financing Sources, as a Percentage of Total Outlays



Conclusion

As with the Trustees' annual projections for the duration of solvency of the Medicare HI (Part A) Trust Fund, the Medicare funding warning illuminates a part rather than the whole of the financing challenge facing Medicare. It illuminates a side of Medicare financing that is generally complementary to the Trustees' widely-circulated projection for the HI insolvency date. Whereas the HI Fund solvency projection illuminates program finances from a narrow Trust Fund perspective, and focuses on Medicare's Part A, the Medicare "funding warning" alternatively takes a broader budget perspective and primarily illuminates the financial condition of the Supplementary Medical Insurance program (Parts B and D). In short it represents a complementary facet of the overall Medicare financing picture.

The Trustees find that the gap between Medicare's dedicated revenues and expenditures will exceed 45% of outlays in each of 2011 and 2012 under current law, thereby triggering the "Medicare funding warning" pursuant to the Medicare Modernization Act.