

New England Fiscal Facts

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New England Has Relied Heavily on Vulnerable Medicaid Financing Arrangements

by Jeannette Hargroves and Robert Tannenwald

The New England states sharply increased their outlays for Medicaid during the early 1990s (Chart 1). Forces beyond their control were partially responsible. The cost of health care rose steeply. Caseloads grew as the regional economy weakened and federal mandates broadened eligibility for Medicaid. Furthermore, some states decided to make their programs more generous than federal mandates required.

To some extent, however, the surge in Medicaid spending reflected a decision by the federal government to help states cope with the fiscal stress prevalent during the early 1990s. Congress did not explicitly appropriate additional assistance to the states. Rather it temporarily permitted them to take advantage of regulations enabling them to garner more federal Medicaid money without committing matching funds. Through special financial arrangements, states used much of this additional aid for general fund purposes.

To some, these arrangements were a questionable, albeit legal, manipulation of regulatory loopholes. To others, they were a creative policy response that permitted states

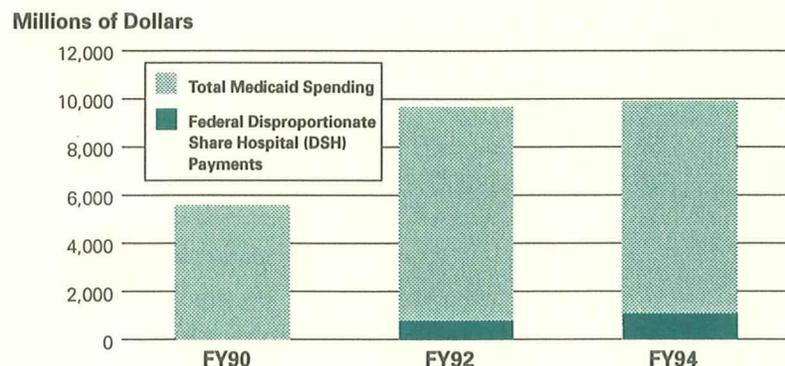
to maintain needed public services during a severe fiscal crisis. The purpose of this article is to describe these arrangements and discuss the degree to which they may have distorted figures for Medicaid spending in New England.

All of these financing arrangements were designed to obtain more federal payments known as Disproportionate Share Hospital (DSH) payment adjustments, grants to hospitals that provide a disproportionate share of medical care to low-income, uninsured patients. DSH

Chart 1

After Explosive Growth in the Early 1990s Medicaid Expenditures Started Slowing in FY94

Medicaid Spending in New England (State and Federal)



Note: Data are for federal fiscal years.
Source: The Urban Institute. Based on HCFA 64 and HCFA 2082, Health Care Financing Administration, December 1995.

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The views expressed in this publication do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System. This publication is available without charge. We welcome your ideas and comments; contact Jeannette Hargroves at 617/973-3096. Send requests to be placed on our mailing list to Federal Reserve Bank of Boston, T-8, Attn: *Fiscal Facts*, P.O. Box 2076, Boston, MA 02106-2076.

**State
Budget
Timetable**

Annual Budgets

Massachusetts
Rhode Island
Vermont
FY96: July 1, 1995
to June 30, 1996

Biennial Budgets

Connecticut
Maine
New Hampshire
FY96-97: July 1, 1995
to June 30, 1997

Table 1

Federal DSH payments Were a Major Factor in Medicaid's Growth in the Early 1990s

Federal Disproportionate Share Hospital (DSH) Payments

Millions of Dollars and Percent of Total Federal Medicaid Spending in State

	FY90		FY91		FY92		FY93		FY94	
	Dollars	Percent								
New England	2.3	0.1	630.4	16	766.6	17	807.0	17	829.9	16
Connecticut	0.8	0.1	0	0	197.6	19	208.7	18	204.5	17
Maine	1.3	0.5	28.9	8	86.9	19	101.4	19	102.4	18
Massachusetts	0.2	0	530.2	24	228.7	11	242.2	12	270.6	12
New Hampshire	0.0	0	25.4	13	196.0	52	191.5	50	190.1	46
Rhode Island	0.0	0	45.1	13	43.3	10	52.1	12	51.0	12
Vermont	0.0	0	0.9	1	14.2	9	11.1	7	11.2	7

Note: Payment to Massachusetts in FY94 includes bills incurred in FY92 and FY93.
Source: The Urban Institute. Based on HCFA 64 and HCFA 2082, Health Care Financing Administration, December 1995.

payments were sought because federal laws used to give states considerable discretion in administering them.

The design of these financing arrangements varied enormously from state to state. In FY91 and FY92,¹ when the special financing arrangements were most prevalent, states typically assessed a tax on hospitals, nursing facilities, physicians, and other providers of health care. These taxes were not always uniformly applied; sometimes the definition of the tax base and the rate of tax varied from provider to provider.

States would place a portion of the receipts from these "provider" taxes into their general fund and devote the remainder to DSH payments. The federal government matched these state payments at a rate varying inversely with the average personal income of a state's residents. The states had considerable leeway in determining the amount of their DSH payments qualifying for federal matching grants and how both the state and the federal shares of these payments would be distributed among providers. Using their discretion in distributing both provider tax burdens and DSH payments, states gave many providers payments roughly equal to their hospital tax liability, holding them "harmless." In some states, practically all providers in the state were held harmless, and the state gained general revenue almost entirely at the expense of the federal government. The following is a hypothetical example of a typical financing arrangement:

Example: A state imposes a 10 percent tax on the gross receipts of hospitals within its borders. Hospital A pays a tax of \$100,000. The state puts \$50,000 of this tax revenue into its general fund and refunds \$50,000 to the hospital in the form of higher DSH reimbursement per Medicaid patient treated. The federal government matches these higher payments on a dollar-for-dollar basis, giving the state an additional \$50,000. The state funnels this additional \$50,000 through to the hospital. The hospital is "held harmless" because its total increased reimbursement of \$100,000 is exactly the amount that it pays in taxes. Meanwhile, the state increases its general revenue by

¹ In this article, Medicaid expenditure data are for federal fiscal years, unless otherwise noted.

\$50,000, the amount of the additional federal matching grant that it received.

States also channeled additional federal Medicaid funding into their general fund by making DSH payments to state-owned hospitals. Such payments qualified for federal matching grants that, under federal regulations, could be used for other parts of state Medicaid programs, in turn freeing up general funds for other purposes. Then, in a paper transaction, the state-financed DSH payments immediately reverted back to state general funds, never having been spent on medical care for anyone.

Surge in DSH Payments

As a whole, the New England states, under severe fiscal distress, were not shy in using DSH payments to gain additional federal funding. Federal DSH matching grants to the New England states mushroomed from \$2.3 million in FY90 to \$767 million in FY92 (Chart 1 and Table 1). Federal DSH payments as a percentage of total federal Medicaid grants rose from 0.1 percent to 17 percent.

Within the region, states differed widely in the extent to which they garnered additional federal DSH funds. New Hampshire was by far the most aggressive state in this regard. From a base of no federal DSH funds in FY90, New Hampshire's federal DSH payments soared to 52 percent of the state's total federal Medicaid grants in FY92. Massachusetts, the next most aggressive state, saw its DSH payments peak at 24 percent in FY91. The comparable peaks for the four remaining New England states, all attained in FY92, ranged between 9 percent and 19 percent.

In response to the ballooning in federal DSH payments in many states, in 1991 and 1993 Congress enacted legislation restricting the use of the special financing arrangements. Among other restrictions:

- State spending for DSH payments was limited to 12 percent of the state's total Medicaid spending in any

Table 2

DSH Payments in Two Categories May Have Been Used for Non-Medicaid Purposes

Maximum Possible Amount of DSH Payments Used for Non-Medicaid Purposes in FY93

	Millions of Dollars			Percent of All Medicaid Spending in State
	DSH Payments to State-Owned Facilities	Provider Tax Paid Up to Amount of DSH Payments Received	Total	
Maine	47.9	100.6	148.5	17
Massachusetts	1.9	310.9	312.8	8
New Hampshire	22.4	346.0	368.4	48
Rhode Island	95.3	0	95.3	11
Vermont	8.4	9.5	17.9	7

Note: Connecticut data not available. DSH payments and provider taxes for state fiscal year. Total Medicaid spending for federal fiscal year.

Source: Leighton Ku and Teresa Coughlin: *Medicaid Disproportionate Share and Other Special Financing Programs: A Fiscal Dilemma for the States and the Federal Government* (The Urban Institute, December 1994).

given year, with the 12 percent limit being phased in over time. (Because of the phase-in, including grandfathering provisions, some states are not expected to see major reductions until the second half of the decade.)

- In general, explicit hold-harmless arrangements were disallowed. States could not guarantee that a provider would receive back some or all of the amount of the tax that it paid.

- Provider taxes had to be broad-based and applied uniformly within any given class of providers. For example, they could not be imposed on some hospitals and not others.

The imposition of these restrictions slowed the growth in federal DSH grants in New England. By FY93, Massachusetts, Rhode Island, and Vermont were at or under the 12 percent cap. As of FY94, Connecticut, Maine, and New Hampshire were still well above it. With its DSH payments at 46 percent of total state Medicaid spending as of FY94, New Hampshire still faces major cutbacks. New Hampshire's level of federal DSH payments remained high in FY94 in part because New Hampshire extended its room and meals tax to medical care providers, thus avoiding some of the restrictions on provider taxes set by Congress. (See *Fiscal Facts*, Winter 1994.)

Continued on last page

Across the Region

Four of New England's governors plan to cut current general fund budgets because of weak revenues in the first four months of FY96. In Maine, Rhode Island, and Vermont, income tax collections have fallen below projections. In much of the region, sales tax receipts have shown only modest year-over-year growth (Chart 2). Rooms and meals tax revenues in New Hampshire and Vermont missed their projected targets, despite reportedly strong summer and fall tourist seasons. By contrast, Massachusetts' personal income and sales tax receipts grew much more rapidly than those of other New England states. With some fiscal breathing room, the Commonwealth's lawmakers modified the formula for apportioning taxable corporate income in a manner that will reduce the tax bur-

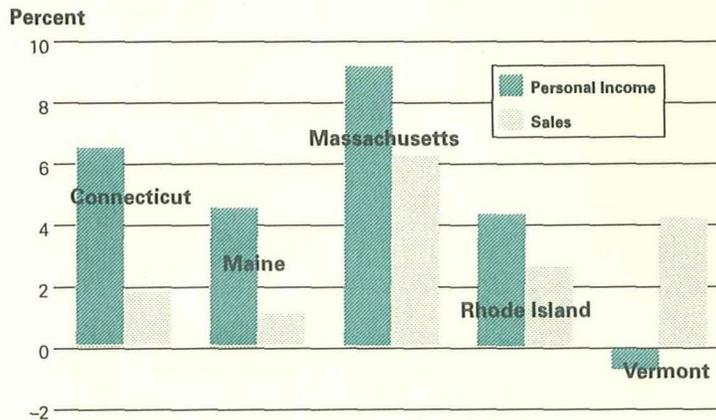
den on most multistate manufacturers.

The spread of casinos in the region appears to have slowed for the time being. After several years of debate, the Connecticut legislature turned down a proposed casino in Bridgeport, which would have established a new legal precedent for casino gambling outside the state's reservation land. Massachusetts' legislature postponed voting on Governor William Weld's compact with the Wampanoag tribe, which would allow a casino in New Bedford and one in the western part of the state. The Rhode Island Supreme Court ruled in early December that the compact between the Narragansett tribe and the former governor of Rhode Island was illegal because it lacked legislative approval. **FF**

Chart 2

Income and Sales Tax Revenues Grow Slowly in Most New England States

*Growth in Personal Income and Sales Tax Revenues
First 4 Months of FY96 Compared with First 4 Months of FY95*



Note: New Hampshire has no sales or personal income tax.
Source: Official budget documents, state financial statements, and conversations with state budget officials.

Six-State Review

Connecticut

Four months into FY96, Connecticut's tax revenues were a modest 3 percent above year-ago levels. Personal income tax receipts were up 6 percent; however, sales tax revenues were only 2 percent higher. Collections from corporate business taxes were on target but, as anticipated, slightly below year-ago levels because of tax rate reductions passed by the legislature in FY95. (See *Fiscal Facts*, Fall 1995.) As of October 31, 1995, the comptroller was projecting a \$35 million general fund deficit in FY96.

Officials anticipate Connecticut's fall tax amnesty program will boost FY96 revenues by at least \$40 million, almost one-third more than initially projected. The tax commissioner promised not to penalize Connecticut's delinquent taxpayers who filed between September 1 and midnight, November 30, 1995. As of December 1, 1995, the state had collected \$34 million in back taxes.

Nonresident entertainers were also eligible for the tax amnesty effort. Connecticut recently decided to enforce the 4.5 percent tax on income earned in the state by non-resident entertainers. The entertainment tax has been on the books since 1991. Lawmakers anticipate stricter enforcement of this tax will generate an additional \$4.5 million a year for the state. Collections will help fund college scholarships, meals for the homeless, and counseling for drug addicts.

After several years of debate, the state senate turned down a proposal by the Mashantucket Pequot tribe to build and operate a \$875 million casino resort on the Bridgeport waterfront, despite the overwhelming vote of approval by Bridgeport residents.

Lauren Fine

Maine

Maine's general fund revenues, sluggish in the first quarter of FY96, picked up in October. Nevertheless, in mid-December officials revised down-

ward their revenue estimates for FY96, anticipating a potential shortfall of \$14.8 million.

Total tax revenues for the first four months of FY96 were slightly below projections, growing 3 percent over year-earlier levels. Personal income tax receipts performed moderately well (Chart 2); however, revenues from sales taxes were 3 percent below plan and barely 1 percent over a year ago. Collections from corporate income taxes compounded revenue worries, missing their target by 8 percent, because of two unexpectedly large tax refunds. Faced with precarious revenues, Governor Angus King ordered state agencies to cut discretionary spending by almost one-third, hoping to save the state \$10 million to \$15 million in this fiscal year.

Governor King is moving forward on his promise to downsize state government. The FY96-97 biennial budget gives the governor the authority to reduce general fund outlays by \$45 million over the next two years as a step toward balancing the budget. The governor and the legislature have agreed on \$25 million in savings, which would eliminate over 800 state jobs, reshape eight departments, and overhaul the state's correctional system. But the governor still needs to find another \$20 million to reach his goal of \$45 million by the end of FY97.

Wei Sun

Massachusetts

Four months into FY95, Massachusetts' revenues appeared to be in excellent financial shape. Total revenues were running 5 percent above year-ago levels, slightly above the midpoint of the state's predicted range. Sales and income tax collections posted year-over-year rates of growth of 6 percent and 9 percent, respectively, the highest in the region.

The state legislature, confident about the state's revenue projections, approved a tax relief measure for multistate manufacturers that alters the formula for determining the Commonwealth's share of their total taxable income. According to the new formula, this

share will depend solely on the ratio of the manufacturer's sales in Massachusetts to its total sales. Currently, the Commonwealth determines its share of the taxable income of manufacturers according to a formula that takes into account in-state-to-total ratios of a company's payroll and property owned as well as its sales. For defense contractors, the measure takes effect January 1, 1996; for other manufacturers, it will be phased in over five years. Multistate *non*-manufacturers will continue to be subject to the three-factor formula. Administration officials estimate the tax break will cost the Commonwealth \$80 million to \$120 million a year once fully implemented.

The legislature ended its 1995 session in mid-November without approving Governor William Weld's agreement with the Wampanoag Indian tribe, which spells out details for the development of a casino in New Bedford. Under the agreement, the tribe would pay the state \$90 million a year for the next six years for the exclusive right to operate a casino. The compact allows for 700 slot machines at each of the state's four racetracks and the construction of a casino in one of three western Massachusetts towns. Voters in Springfield and Chicopee defeated gambling referenda in November, leaving Holyoke the only one of the three to approve casino development.

Approval of the New Bedford casino faces two hurdles when lawmakers return in January. The legislature must approve both the tribal-state compact and the transfer of the New Bedford site — formerly a public golf course — from eminent domain to private ownership. The U.S. Department of Interior has deferred approval of the compact until legislative approval is obtained in both of these areas.

Jeannette Hargroves

New Hampshire

For the first four months of FY96, New Hampshire's general fund unrestricted revenues were 5 percent below year-ago levels and 4 percent below expectations. Collections from the meals and rooms tax and uncompensated care pool tax were especially weak, falling 5 percent and 17 percent, respectively, below target. Shrinkage in the latter tax, which is levied on gross hospital receipts, is attributable to an unexpected decline in patient services. Other revenue sources, especially the business profits tax and lottery

sales, generally fared well. Business profits tax receipts grew 14 percent over year-ago levels and stood 11 percent above projections. Sweepstakes commission sales were higher than expected by 4 percent. The introduction of the multi-state powerball lottery in November 1995 is expected to generate \$6 million in FY96. The state education fund projects \$48 million in overall sweepstakes earnings over the next fiscal year.

The legislature gave the go-ahead for a welfare reform plan that includes a "workfare" program for welfare recipients and the reorganization of the Department of Health and Human Services. Under the new "workfare" program, individuals can receive welfare for only 26 weeks. After this period, individuals seeking assistance must have a job or participate in a mandatory work-for-benefits program. The state will encourage work by deducting only 50 cents from welfare payments for every dollar of income earned on the job. Lawmakers anticipate that this change will increase the family income of welfare recipients by \$100 to \$200 a week. The reorganization of the department includes a \$32 million cut in department expenditures, accomplished through a hiring freeze, reduced payments to nursing homes, and layoffs of roughly 35 state hospital workers.

Lauren Fine

Rhode Island

Like revenues of many other states, Rhode Island's revenues performed poorly during the first four months of FY96, causing state revenue estimators to revise downward their projections for FY96. As of October, total tax estimates were revised downward by \$22.8 million from the original budget of early August. Much of the erosion came from lowered estimates of personal income and sales taxes, which dropped by \$10 million and \$4 million, respectively. Four months into FY96, year-over-year growth of 4 percent in personal income tax receipts was, in large part, attributable to one large one-time tax payment. Without this one payment, officials estimated a 2.6 percent growth in income tax collections. Similarly, sales revenues were up only 2 percent compared with year-earlier levels.

Weak revenues as well as higher-than-anticipated outlays portend a \$58 million deficit in the current fiscal year, 3 percent of the \$1.7 billion FY96 budget. In response, Governor Lincoln Almond has asked state agency

directors to identify programs for possible elimination. He has also announced plans to withdraw appropriations totaling \$11.4 million; however, these withdrawals, primarily accounting measures, are not expected to affect services.

Fiscal worries have prompted the Division of Taxation to strengthen enforcement of the state's use tax, a 7 percent tax on goods purchased by Rhode Island residents outside the state. (All states with a sales tax impose a complementary use tax in order to deter residents from purchasing goods in border states that tax sales more lightly.) The recent intense public criticism of the tax has motivated the governor and some legislators to consider lowering the use tax rate, applying it only to expensive purchases, or repealing it entirely.

Fiscal pressures have not deterred the governor from opposing casino development. In early December, the Rhode Island Supreme Court ruled that the former governor did not have the constitutional right or statutory authority to bind the state to a casino compact with the Narragansett tribe without the approval of the General Assembly. Accordingly, the tribe has asked Governor Almond and legislative leaders to resume negotiations over a compact; however, the governor has stated he would only negotiate a compact that involved casino games currently allowed under state law. He remains opposed to a "full-blown" casino that would involve table games and casino-style slot machines.

Jeannette Hargroves

Vermont

Vermont's first-quarter FY96 tax receipts were extremely weak, although they strengthened somewhat in October. Total revenues for the first four months of FY96 grew a meager 1.4 percent over their year-earlier level, standing \$10 million below the state's projected target. Disappointing personal income tax receipts, the chief culprit, posted a year-over-year decline of 0.6 percent.

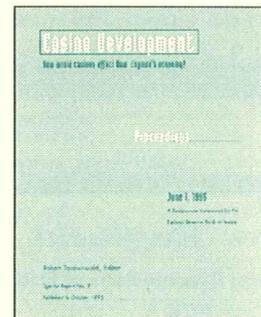
One note of encouragement came from October's sales tax receipts and collections from rooms and meals taxes, which were up 6 percent and 8 percent, respectively, from the previous October. These gains, largely driven by a strong fall tourist season, unfortunately did not carry over to the transportation fund's gasoline tax receipts, which fell 22 percent in that same month compared with a year earlier.

In anticipation of a weak revenue performance and cuts in federal aid, budget officials lowered their FY96 revenue estimate by \$30.1 million in July. Vermont already has a \$14.5 million cumulative deficit on its books carried over from last fiscal year. In mid-November, under the shadow of a bond-rating review, Governor Howard Dean and legislative leaders agreed to eliminate the state's projected cumulative deficit by fiscal year's end. In order to balance the FY96 budget, they would reduce spending by an estimated \$23.3 million. On the revenue side, they would, among other things, draw on designated funds, including \$5 million from the Health Care Access Trust Fund, and hope to collect an additional \$4 million in revenues from the enhanced delinquent tax collection program. These steps along with other transfers are expected to generate a current year surplus of \$9.5 million. The surplus combined with a proposed \$5.0 million transfer from Vermont's transportation fund would eliminate the \$14.5 million deficit.

Jeannette Hargroves

Casino Development: *How would casinos affect New England's economy?*

In 1992, Connecticut became the first New England state to allow casino gambling within its borders. Since then, the region's other states have seriously considered whether to follow Connecticut's example. One of the most controversial, unresolved issues in these debates has been the economic effects of casino development. While interest in this issue is intense, relevant empirical evidence is scant. For this reason, the Federal Reserve Bank of Boston held a one-day Symposium on Casino Development on June 1, 1995, bringing together experts from academia, government, Native American nations, and the gaming industry. This special report summarizes the participants' remarks.



Copies of *Casino Development: How would casinos affect New England's economy?* may be obtained without charge by writing to Research Library - D, Federal Reserve Bank of Boston, P.O. Box 2076, Boston, MA 02106-2076. Or telephone (617) 973-3397.

Whither the Dollars?

The extent to which dollars counted as Medicaid spending may have been used for other purposes is not clear. Two hypothetical scenarios bracket the range of possibilities:

- At one extreme, Medicaid spending figures have dramatically overstated the amount of money actually spent on medical care for the poor and uninsured. Private providers have used their DSH payments exclusively to offset their provider tax liability, not to expand health care to individuals eligible for Medicaid. In addition, DSH payments, both state and federal, to state-owned hospitals have immediately reverted to state general funds, without having been spent on medical care for anyone. A study conducted by the Urban Institute, based on a FY93 survey, suggests that most DSH payments to state-owned facilities were, in fact, channeled in this manner.

If this scenario is correct, then two types of DSH payments should be subtracted from each state's total Medicaid spending to obtain a more accurate estimate of how much Medicaid money the state actually spent on health care for the poor and uninsured:

- (1) DSH payments to state-owned facilities; and
- (2) DSH payments to private health care providers up to the amount they paid in provider taxes.

The Urban Institute has obtained the figures needed to make these adjustments in FY93 for 39 states,

including all New England states except Connecticut. The impact of these adjustments for the other states within the region is shown in Table 2. In New Hampshire, up to 48 percent of reported Medicaid spending in FY93 may have been for other purposes. The comparable percentages for the other four states range from 7 percent in Vermont to 17 percent in Maine.

- At the other extreme, all Medicaid outlays were used to provide care to patients eligible for Medicaid. Rather than return DSH payments to their state's general fund, state hospitals spent them on care for the poor and uninsured. Rather than always hold providers harmless, provider tax schemes redistributed funds in favor of institutions with heavy Medicaid caseloads, enabling them to provide care for Medicaid patients that otherwise would not be feasible. Institutions that were held harmless nonetheless used their additional DSH payments to expand care for the poor rather than to offset their provider tax liability. They passed the burden of their provider taxes on to paying patients, in the form of medical fees.

Implications for the Future

Medicaid financing arrangements have demonstrated the difficulty of ensuring that all of the funds for a given program are spent on their intended purpose. Congress is likely to take this lesson into account as it considers how the financing of Medicaid should be changed. Future issues of *Fiscal Facts* will discuss the implications for the New England states of alternative federal Medicaid reform proposals. **FF**

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