Federal Reserve Bank of Boston

Fiscal Facts

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Edited by Robert Tannenwald
and Lesley Eydenberg

Medicaid:

Fiscal Ill or Fiscal Cure?

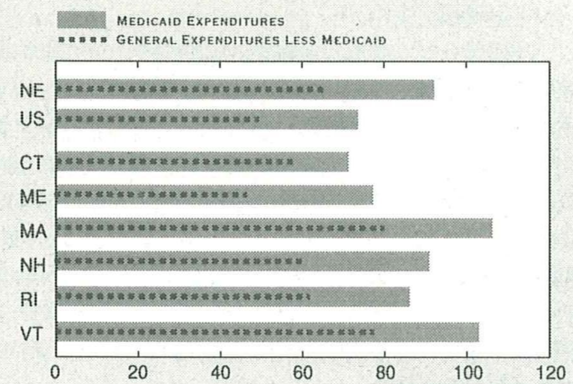
Explosive growth in Medicaid costs has caused budgetary headaches for virtually every state in the nation. In New England, state outlays for Medicaid increased by 92 percent between FY85 and FY90, while outlays for other programs rose by only 65 percent (Chart 1). Medicaid will consume a steadily increasing fraction of state spending if benefit levels are maintained and medical costs continue to outpace inflation.

In the short run, however, Medicaid has been a godsend to the states. It has given them additional federal grants without requiring them to increase the amount of medical care that they provide. In FY92, the federal government will spread an estimated $5.5 billion of these windfalls over 38 states. In New England, they will play an important role in balancing the FY92 budgets of every state except Massachusetts. (Massachusetts has already benefitted; in FY91, a last-minute partly retrospective Medicaid payment paid to the Commonwealth wiped out a projected $460 million deficit.) In New Hampshire and Rhode Island, these windfalls will account for an estimated 22 percent and 8 percent of FY92 general revenue, respectively.

Medicaid windfalls come in two varieties. One consists of extra federal payments to states whose public health care facilities handle disproportionately large caseloads of financially needy patients. Congress made these payments available in 1991 legislation.

Chart 1

Percentage Increase in Medicaid Expenditures
and in Other General Expenditures, FY85-FY90



Source: U.S. Bureau of the Census, *Governmental Finances 1984-85* and *Government Finances 1989-90*; data tables from the Health Care Financing Administration.

The other variety, not intended by Congress, arises from a loophole in federal Medicaid regulations. The loophole enables a state to obtain additional federal Medicaid funding by simultaneously taxing health care providers and increasing the compensation that they receive for treating Medicaid patients. This arrangement is illustrated in the following hypothetical example: a state imposes a 10 percent tax on the gross receipts of the 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 a higher 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 in federal grant money 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 $50,000.

Table 1

Governors' Revised Budget Recommendations

for FY92 and Initial Recommendations for FY93

Billions of dollars unless otherwise noted

	Spending[a]			Revenues					
				Tax			Total[b]		
	FY92	FY93	% Change 92-93	FY92	FY93	% Change 92-93	FY92	FY93	% Change 92-93
CT	6.33	6.53	3.2	5.14	5.21	1.4	6.70	6.52	-2.3
ME	1.72	1.76	2.4	1.33	1.35	1.5	1.72	1.76	2.4
MA	11.11	11.42	2.8	9.23	9.15	-.8	10.99	11.38	3.5
NH	.85	.90	5.9	.63	.65	3.2	.87	.90	3.4
RI	1.87	1.57	-16.0	1.26	1.33	5.8	1.84	1.57	-15.7
VT	.78	.78	-.0	.66	.70	5.9	.80	.84	5.0

[a]Includes spending out of general fund and transportation funds. Excludes expenditure of federal grants.
[b]Includes general revenues (including transfers from other funds) and transportation fund revenues. Excludes federal grants.
Note: The governors of both Massachusetts and Rhode Island plan on using surpluses carried over from FY91 to balance future budgets.
Source: Official budget documents, state financial statements, and conversations with state budget officials.

Many state officials claim, with some justification, that both varieties of windfall have partially compensated the states for the costs of Medicaid mandates imposed on them by the federal government over the past decade. Moreover, the rising cost of medical care has justified some increases in reimbursement rates.

Congress enacted legislation in November that sharply curtails the ability of states to obtain both these windfalls. Grandfathering provisions will permit the New England states to receive them until the end of FY93, however. The region is expected to be in economic recovery by then, about 15 months from now. Will the windfalls ease the symptoms of fiscal stress until the resumption of economic growth cures the region's fiscal ills? Or will they mask, and perhaps even exacerbate, structural problems that will get worse with time?

Overview

All of the New England states have struggled to balance their FY92 budgets. Maine had to enact extensive midyear spending cuts in order to make ends meet. Vermont, the only state without a balanced budget requirement, will end the year in the red because of deficits carried over from previous years. Connecticut, New Hampshire, and Rhode Island are relying mostly on Medicaid windfalls to stay in the black. Only Massachusetts will achieve a surplus without making mid-course budgetary corrections or relying on Medicaid windfalls. The Commonwealth is in relatively good fiscal shape because its spending plans for the current fiscal year intentionally were based on a very pessimistic revenue forecast.

All six states face large deficits in FY93 in the absence of further reductions in service levels, increases in taxes and fees, or, in the case of New Hampshire, a continued large federal Medicaid windfall. In order to avert these projected deficits, most of the region's governors have recommended restraining growth in spending rather than enacting tax increases, an understandable preference given the sizable tax increases that each of the six states has passed in recent years. Proposed changes in spending range from a decrease of 16.0 percent by Governor Bruce Sundlun of Rhode Island to an increase of 5.9 percent by Governor Judd Gregg of New Hampshire (Table 1).

Connecticut

The ongoing debate over the state's controversial new income tax has centered on the "Three Rs": repeal, repair, or referendum. Although a move to repeal the tax passed both houses of the state legislature, Governor Lowell Weicker vetoed it. Attempts to override his veto failed. The focus of the debate has since shifted to how to repair the tax to make it more palatable to voters. Most proposals advocate a tax reduction for middle-income households. The central issue is whether to pay for this reduction by cutting spending or by raising taxes on high-income households. Some legislators would like to let the voters express their opinion in a nonbinding referendum this November.

Governor Weicker's proposed budget for FY93 has generated less controversy than the income tax. His recommended spending increase of 3.2 percent represents a sharp cut in the state's "current services" budget, the amount of spending required to maintain state services at current levels. Spending would have to increase by an estimated $1.5 billion in FY93 in order to satisfy this requirement. Spending categories cut most severely in the governor's budget are state aid for schools, public employee benefits, welfare, Medicaid assistance to nursing homes, and higher education.

Maine

In November and December, Maine's state government debated and ultimately adopted a plan to eliminate a projected FY92 deficit of $125 million, or approximately 8 percent of appropriations. Since January, the state has been searching for ways to eliminate a projected FY93 revenue shortfall of $115 million and to fund $15 million to $20 million in proposed supplemental spending.

The FY92 gap was closed in two stages. First, responding to legislative inaction, Governor John McKernan invoked emergency powers to cut $22.5 million. Then, under the threat of more unilateral reductions, the legislature enacted further cuts of $105 million. The two spending reductions cut local aid by $33 million. Other spending categories bearing a disproportionately large share of the cuts were higher education and social services.

The legislature was close to agreeing on a plan to eliminate the projected FY93 deficit as this newsletter went to press.

Massachusetts

Massachusetts is in the best financial shape of any state in the region, at least in the short run. With tax revenues to date running 8 percent above the FY91 level (Table 2), Governor William Weld has raised his FY92 tax revenue forecast to $9.3 billion, more than $1 billion above last June's forecast. Nevertheless, the surplus for the current fiscal year is likely to be under $150 million. The income tax rate was reduced on January 1 from 6.25 percent to 5.95 percent. During the first half of the fiscal year, revenues from fees and charges were running $375 million below expectations. Supplemental appropriations worth approximately $170 million had been enacted as of January 1; another $200 million to $400 million are under consideration.

Governor Weld has projected a $1.6 billion "current services" deficit for FY93. To eliminate it, the governor is relying on an increase of $600 million in nontax revenues from sources that have proved unreliable during the current fiscal year. In addition, he has recommended a cut in general fund spending of approximately $500 million, including reductions in state workers' health insurance benefits, general relief, and net outlays for higher education. He has also recommended tax cuts worth $192 million: these include a reduction in the personal income tax rate to 5.75 percent; a cut in the effective tax rate on capital gains; tax credits to businesses for investment, job creation, job training, and the provision of child care services; and tax benefits for start-up manufacturers.

New Hampshire

In November, New Hampshire was facing a $100 million deficit for FY92, about 5 percent of total projected spending. The deficit has since vanished, thanks to a Medicaid windfall of $156 million. Officials are counting on an equally large windfall to balance the FY93 budget.

Despite this year's windfall, Governor Gregg announced in January that the state still might end FY92 slightly in the red, depending on the amount of supplemental funds appropriated this spring. The governor asked for $21 million in supplemental appropriations to deal with rising welfare case loads. The legislature, with the governor's acquiescence, is currently considering a bill providing $29 million. Furthermore, in February the legislature revised its revenue forecast for FY92 downward by $2 million.

Governor Gregg is attempting to curb the cost of health care for public employees, a long-standing and growing burden on the state budget. In January, he proposed that 9,000 state workers pay a $250 deductible and 20 percent

Table 2

Percentage Change in Year-to-Date State Tax Revenues

FY91-FY92, by New England State

	Results from 7/1/91 through	Tax: Income	Sales	Corporate Income	Other	Total
CT	1/31/92	n.a.	-14.8	-14.8	-36.0	21.5
ME	1/31/92	8.0	13.1	-44.0	36.4	8.7
MA	2/29/92	10.5	2.4	12.9	5.6	8.0
NH	12/31/91	n.a.	n.a.	-38.2	7.0	-2.3
RI	1/31/92	13.8	-16.0	111.2	10.6	1.9
VT	1/31/92	5.9	23.4	-8.8	16.5	12.0

n.a.: not applicable.
Source: See Table 1.

of the next $2,000 of covered expenses per person up to a limit of $1,700 per year per family. In support of his proposal, the governor noted that in 1991 New Hampshire paid more per worker for health insurance than any other state in the nation. The State Employees Association has temporarily blocked the proposal in court and Governor Gregg is appealing the court ruling.

Rhode Island

Rhode Island's fiscal fortunes over the past several months have followed a pattern similar to that of Connecticut and New Hampshire. In December, state officials projected a $70 million budget deficit for FY92, despite an increase in federal Medicaid grants awarded for the high incidence of needy patients in the state's public health care facilities. In January, however, the state received an unexpected additional federal grant for the same reason, virtually wiping out the projected deficit.

Most of the large Medicaid windfall enjoyed in FY92 will not reoccur in FY93 because it included retroactive payments of unclaimed grants that Rhode Island had been accruing since FY90. Consequently, Governor Sundlun has proposed a 16 percent reduction in total spending in FY93, highlighted by a 37 percent drop in funding for human resources. His recommended cut in total spending is about 7 percent after controlling for the one-time impact of the FY92 Medicaid windfall.

Governor Sundlun is the only New England governor to recommend broad-based tax increases to help balance next year's budget. The centerpiece of his tax plan is a broadening of the sales tax base, designed to raise $44 million. Other major tax proposals include an acceleration of the timetable for payment of bank deposit taxes, postponement of scheduled reductions in taxes on public utilities and corporate profits, and an increase in the minimum business tax from $100 to $250. The governor's proposed spending cuts are targeted largely on Medicaid, general welfare assistance, and higher education. The budget also reflects the recent dedication of 0.6 percentage point of the state's 7 percent sales tax to pay off the depositors of the state's bankrupt credit unions.

Vermont

Vermont faces a $61 million general fund deficit for FY92. In January, Governor Howard Dean released a plan to reduce the deficit in two stages, by $7 million in FY92 and by an additional $46 million in FY93. His FY93 budget calls for a surplus of $7 million—a general fund deficit of $12 million offset by a transportation fund surplus of $19 million.

Governor Dean's reliance on spending cuts rather than tax increases is understandable, given that Vermont has enacted tax increases during the past two years totaling approximately $150 million. His proposed spending cuts target the public payroll, property tax relief for farmers, general government administration, and aid to municipal school districts. To soften the resulting stress on cities and towns, he would increase spending for the improvement of local infrastructure with funds from the state transportation fund. These payments would presumably free up local tax revenue for other purposes.

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Federal Reserve Bank of Boston
P.O. Box 2076
Boston, Massachusetts 02106-2076

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