

***Investing in Texas: Financing Health Coverage Expansion
Conference Proceedings***

National Perspective

Jed Perry: Over the past several decades, many of the innovative policies that have received national attention have come from the offices of state governors. Since states often function as the nation's laboratories, state governors have had the opportunity to explore new ideas in their states and enact bold, new policies. As the forum for governors to exchange ideas and promote innovation, the National Governor's Association, the NGA, has been the conduit between state models and national reform.

As NGA's Executive Director, Raymond Scheppach has spent almost 20 years helping to facilitate these efforts at the state level among governors and advocating for their adoption on the national level. Mr. Scheppach has been at the forefront of innovation in numerous areas, including Medicaid, welfare reform, and the new economy, to name but a few. As an advocate for federalism, Mr. Scheppach has testified before Congress on behalf of the nation's governors on numerous occasions.

Under his leadership, NGA has risen to become one of the most powerful groups in Washington. NGA was ranked 12th by *Fortune* magazine in its 1999 annual survey of the most influential trade associations, labor unions, and interest groups. It's easy to see the impact governors now have on national policy. The past two United States presidents have been former governors. And President Bush's cabinet includes four former governors, including Secretary of Health and Human Services, Tommy Thompson.

Mr. Scheppach was appointed executive director of the National Governors Association in January 1983. In this position, he oversees the day-to-day operations of the association and works closely with NGA's chair and vice chair and their staffs to help identify priorities for the nation's governors.

He has written numerous professional articles on various public policy issues and has authored or co-authored four books on economics, including co-writing the 1984 book *New Directions in Economic Policy: An Agenda for the 1980's*. He received his bachelor's degree in business administration from the University of Maine, and his master's and doctorate degrees in economics from the University of Connecticut.

It is my pleasure to introduce to you Ray Scheppach.

Raymond Sheppach: Thank you for that introduction and I very much appreciate your invitation to be in Austin with you today. In my comments today I would like to cover four issues as follows:

1. The magnitude of the current fiscal problem in states.

2. How do we get Medicaid on the national agenda for reform?
3. Potential short-run solutions for Medicaid, and finally
4. A Medicaid commission.

Current State Budget Shortfall

The current budget shortfall for all states is about \$40 billion, which should increase to about \$45 billion as states are forced to absorb additional homeland security costs post-September 11. This represents about 8 percent of state spending. The problem is not isolated among a small number of states; about 44 states are cutting previously enacted budgets.

It is already worse than what we witnessed during the 1990-1992 downturn when the state problem peaked in 1992 with a \$19.5 billion shortfall, which was about 6.5 percent of state revenues. At that time the gap was closed by two-thirds on raising taxes and one-third by reducing spending.

One might ask why the state fiscal problem is so bad now when the economic downturn is rather modest by historical standards. The answer is that there are two major structural problems that have been camouflaged during the last half of the decade of the 1990s by the phenomenal strength of the economy. The first problem is that we have a deteriorating tax base. Unfortunately, at this time states have a tax base for a manufacturing economy of the 1950s and not for a high-tech, service-oriented, international economy of the 21st century. State sales taxes represent 40 percent of state revenues and with the exception of four to five states, most do not tax services, which constitute most of the growth in the economy.

Revenues are also declining due to the inability of states to tax most mail order or Internet sales, which are growing rapidly. Unfortunately, we have been increasing tax rates on a shrinking base, which is the exact opposite of good tax policy, where we should be decreasing the rate on an expanding base. The corporate tax base is also eroding due to corporations moving offshore and becoming more sophisticated in generating profits in states with low or no corporate profit taxes.

The other major structural problem is the fact that health care is increasing at a double-digit rate and it represents 27 percent of the average state budget. Medicaid represents 20 percent of state budgets and is currently growing 14 percent annually, with pharmaceuticals growing 18 percent a year.

It is the combination of a deteriorating tax base and exploding health care costs that are causing most of the problems. However, they are made worse by the current economic slowdown. So, the problem is not going to get much better even when we have economic recovery—we are still going to have these two fairly major long-run structural problems.

How do we get Medicaid on the National Agenda?

Let us turn now and look at Medicaid. Most people do not know that Medicaid is now larger than Medicare, since we have almost 45 million people on Medicaid and 40 million on Medicare. It is also now growing faster. In fact, over the last two years, if you just look at the eligibility of Medicare versus Medicaid, Medicare is increasing 1.1 percent and Medicaid is increasing 2.2 percent per year. And if you look at dollars, Medicaid is about \$15 billion of public money larger than Medicare, i.e., \$245 billion vs. \$230 billion. If you ask the average congressman in Washington, he or she would very likely not be aware of that fact.

A big problem of course is that the disabled and long-term care (aged 65 years old and over) populations of the elderly and disabled are about 30 percent of the caseload, but about 70 percent of the cost. Medicaid now covers one-third of the births in United States, one-half of the AIDS cases, and about one-half the cost of all nursing homes. The so-called “dual eligibles” which represent about 17 percent of the caseload of Medicaid and represent about 35 percent of the total cost. That is essentially the pharmaceuticals, long-term care, and deductibles, premiums, and copayments that Medicaid pays for the low-income Medicare population.

Drugs are also driving the cost, and are very difficult to control. Elderly Americans take about 29 prescriptions annually. This is about \$21 billion, about 10 percent of Medicaid expenditures, and it is that component that most analysts expect to continue to grow in the double digits, 18 to 20 percent per year. Here we are getting increases in the numbers of prescriptions and the unit cost. We are beginning to see a consumer backlash there but not large enough yet. If we look at Medicaid and Medicare from a federalism standpoint, I would argue that a long time ago, the states cut a deal with the federal government, and told the federal government that “you take the elderly, and we will take everything else—we will take care of the working poor, health, employment and training, and education needs.” And to some extent, the federal government agreed.

The federal government runs Social Security and Medicare. Medicaid really started off as primarily a program for women and children. But over time, it has been expanded and expanded. So there is a real problem, as the long-term care and the disabled populations have increased, which is not a traditional state responsibility, but was happenstance essentially over time as states took over these populations. It is also true that from the federalism standpoint, populations like the elderly that tend to allocate or concentrate themselves in certain states ought to be a federal responsibility. As the elderly concentrate in Florida, California, and Arizona, there are reasons for income redistribution across states through the tax system and federal spending to take care of those populations.

Potential Short-run Solutions for Medicaid

So, given the problems in Medicaid, where do we go in the short run and the long run? I think the first thing is to get the whole program of Medicaid on the national agenda. We have got to push it on to the national agenda because essentially people do not want to

deal with it in Washington, D.C. They want to focus on Medicare. Medicare is on the national agenda every year although it never gets done. But if you would survey any administration or any member of Congress, they always say “we need to do Medicare reform this year.” We have got to get Medicaid up on the national agenda and put the spotlight on it.

Now, what are we doing in the short run? First, the nation’s governors adopted a policy a year ago in February that basically said the core populations should essentially continue the way they are, i.e., the mandatory populations. But about 55 percent of the money for Medicaid is actually involuntary or optional benefits and optional populations. So, what we really wanted was a lot more state flexibility to change benefit levels accordingly. Essentially, what happened was that Secretary Tommy Thompson decided to follow our policy and create the HIFA waivers, which are a pretty good approach that allows states a lot of flexibility with those optional populations. It allows flexibility in both Medicaid and SCHIP and tries to integrate them more into the private sector. It needs to be statewide, but you have a lot of flexibility in the benefits, copayments, and so on.

So, I encourage states to move forward on these waivers. It is a good approach. HHS has already essentially approved Arizona and California. They have pending waivers for Michigan, Illinois, and Maine. The problem is that Capitol Hill is beginning to push back now, so I think any support you can create in terms of the Hill so that we can do more of these waivers is important.

I view welfare and Medicaid in a similar light. We could not get reform straight away; the only way we got reform in welfare was through a lot of state waivers. The fortunate thing about President Clinton was early in his administration he actually allowed a lot of waivers. They really pushed the envelope for welfare time limits and other types of innovations. What happened after 4 or 5 years is that a number of independent evaluators went back and evaluated what happened and that led to welfare reform, and I believe the same thing essentially has to be done in Medicaid. We need to push the envelope on the HIFA waivers and get aggressive. I also think that we have toyed with the idea of trying to make waivers slightly more comprehensive. In other words, there are some restrictions such as budget neutrality, so there are some limits on it, and we have toyed with the idea of pushing legislation that is even more aggressive than the HIFA waiver to give the agencies and administration a little bit of cover to get more aggressive on waivers. But I do think that this waiver approach is a good way to begin to build a track record so that states can have more flexibility on optional populations.

The other short-run policy that we continued to push is to increase the federal share of Medicaid as a temporary fiscal relief option. We did it primarily because in the stimulus package going through Congress, there is about a \$15 billion worth of revenue loss to states because of the accelerated bonus depreciation, and so what we are trying to do is say “all right give us some money back to offset this. We pushed a number of proposals such as a hold harmless for any state that was supposed to get an increase in their share, a 1.5 percent increase across the board and then 1.5 percent increase for those states facing higher than average unemployment.

Unfortunately, we got caught in an ideological difference between Republicans and Democrats. Republicans wanted tax credits, maybe a voucher approach, to expansions in health care, or a block grant, where Democrats really wanted to expand public programs and expand entitlements. At the end of the day, Congress scaled back the stimulus package. Republicans got their tax cut and Democrats got unemployment insurance, but anything in health care brought up this ideological battle, so they basically dropped all those provisions and went forward. We still think that there is some possibility that we can get fiscal relief. So we are trying to work on a hybrid that takes some of the components that were initially in the house bill, which are more of a block grant to states in combination with an increase in the federal share, and see whether we can create some kind of a hybrid so that we could maintain enough Democratic support and pick up enough Republican support to get it done. We are also looking at various vehicles; my understanding is that this morning the President sent up the supplemental appropriations bill which is a must pass.

There are two to three other bills that essentially have to go this year to which we may be able to attach our fiscal relief package. There seems to be a lot of sympathy on the Hill for short-run fiscal relief. If we can somehow walk a balance between Republicans and Democrats, we may be able to get it done.

Medicaid Commission

There is one other policy option in terms of the long run. We had our last NGA meeting in February 2002 and again we are trying very hard to somehow nudge Medicaid on to the national agenda. We adopted the policy for NGA to create a Medicaid commission, and we are now moving forward on that. The concept is to get four members of the house on a bipartisan basis, four members of the senate, four or five outside people, and two co-chairs that are former congressional members and to take the next year to try to make some recommendations to Congress on major reform. There are a number of areas we are looking at, such as the "dual-eligibles," which we think need to be reformed, and the integration between Medicare or Medicaid.

The so-called optional benefits and optional populations flexibility would help states and also the basic financing area. We are getting a fair amount of positive feedback. We have now met with Senate Republicans who seem to be pretty supportive, and it looks like the Administration is supportive. The senate passed a resolution yesterday that supported the Commission. So we are going to try and put this together in the next two to three months and have it meet for probably a year and make recommendations to Congress. It is going to be independent of the National Governors' Association. We will try to get some foundation money and have the Commission essentially hire its own staff and move forward. So the short-run strategies are fiscal relief and the HIFA waivers. The longer run strategy is to get a Commission to look at this issue pretty seriously because in final analysis, states do not have the tax base to continue to fund this program. Even when we come out of this short-term economic problem, we are going to be in crisis. We will make year-to-year adjustments, but unless the economy rebounds at 50 or 60 percent above its average long-run growth and stays there like it did in the latter part

of the 1990s, that is not going to happen. So we need long-run relief. Thank you, and I will be happy to answer any questions.

Kenneth Apfel: We have time for two or three questions right now before we move to our next speaker. Questions?

Ann Dunkelberg: I work for a nonprofit here in Austin called the Center for Public Policy Priorities. I just wondered if you could comment on the impact of the ___ deficit in states' revenue systems as well as the fairly substantial tax cuts enacted in the last five or six years on the shortfalls states are now experiencing. I know in Texas, according to the state's own estimates and our current two-year expenditure period, had we not taken tax cuts that we did in 1997 and 1999 we would have had \$2.6 billion additional dollars to distribute, and I believe, also if we were still collecting revenues at the same percentage of personal income now that we were in 1994 in Texas that we would have had something like \$9.6 billion more dollars, which is perhaps a better measure of the structural deficit or the fact that the revenue generating system is not keeping up with the growth in personal income. So I wonder if you could comment on how that system fits into this picture.

Ray Sheppach: Well, it is true, I think, states during the last half of the 1990s cut taxes in the \$35 billion range. But to put that in perspective, they had to increase them by \$25 to \$30 billion in the early 1990s, so really they were sort of back at the previous levels. I also think states during this boom period acted relatively responsibly. If you compare the average rate of growth in spending over the last 20 years, it is about 6.5 percent, and the last time I looked at the statistics for the last five-year period, state spending was still under 7 percent even in that boom period. Compare that to some of the periods in the 1980s when state spending grew at 12 or 14 percent. So, what they did during this process is they kept the rate of growth of spending down and cut taxes, and they actually built pretty good rainy-day funds. I think overall they acted responsibly.

It is true that the measurement of tax cuts is sometimes difficult too, and it depends upon the growth of the underlying economy, therefore, you may be off somewhat. The level of taxes to some extent is a political decision. My biggest problem is that you have got this tax-base erosion, and if we could get the tax system better, then they could make their own decisions whether they want to cut taxes or raise taxes, but what is going on now is just that year-to-year pretty serious erosion. In fact, I have to raise serious questions about the long-run viability of sales taxes because you are going to reach a point around fairness here. Local merchants are getting upset that they are paying 6 percent sales tax and people purchasing out-of-state on the Internet are tax-free, and you see bills in some legislatures saying let us get rid of the sales tax now. If I have to start over again, I would turn the sales tax back to federal government and make them worry about how to synchronize it with value-added taxes in Europe and so on, and states would take the income tax.

The whole tax problem is another discussion, but it is really hard now because we are in a world without boundaries, and a lot of these transactions are taking place in cyberspace, and therefore the one good thing about income tax is that you can divide it among states.

If you live in five different states, you can still split that up, but the sales tax is going to be a bigger problem, so I am worried about the long-run erosion.

Kenneth Apfel: Second question.

Chuck Begley: I'm from the School Public Health in Houston. The criticism, I guess, that I have heard about HIFA is that it is a "no new money policy" wrapped up in the clothes of health care reform. Can you give us a feeling of how sincerely the governors and Secretary Thompson are about using this to reform the Medicaid program and what kind of reform are we really looking for?

Ray Scheppach: I think one of our major reforms is to give states almost total flexibility in setting copayments, deductibles, and benefit packages for that optional population. I can see where states might want to tailor a catastrophic package to a certain population or a very minimum basic benefit package to another one, and maybe some populations might not even have some of the components of the package, so we need to move in that direction. I believe the feeling is how can you get more efficient, how can you cut some benefits, so that you can, in fact, expand to additional populations? The governors are very serious about that, and we spent nearly eight or nine months trying to develop policy on this.

Secretary Thompson, being a former governor, is pretty serious about it too, and I think what he has done is that he has pushed the envelope because these are 1115 waivers and the flexibility that any agency has is limited. And of course, OMB is going to play their role on the budget neutrality issue, which is a big problem. If we could move a bill that expanded that authority, for example, with budget neutrality over five years as opposed to every year, it gives you a lot more flexibility. Also in welfare reform the house is looking at what they call super waivers so that you could look across programs. It is very hard to get major comprehensive reform in Washington. You have to do some incremental changes and then get a track record to move into a broader reform.

Kenneth Apfel: I would just add as the former Assistant Secretary for Management and Budget at the U.S. Department of Health and Human Services during the Clinton administration that there were efforts to liberalize the concept of cost neutrality in the welfare area and also in the Medicaid area so that some of these experiments could take place, and so that we could see more people get covered. My question to our speaker would be if you are going to look out four and five years from now, looking into your crystal ball on, do you think a number of states will pick up this HIFA notion and expand coverage for groups, and will it be with a reduced benefit package?

Ray Scheppach: Yes, I would think that you get 35 or 40 states doing that in four or five years. Our attitude is to push them to because again we see it as a step towards broader reform, and I think, what states have got to do is to see if they can control costs and expand coverage under waivers. Again, I draw the analogy to welfare. I do not believe that we would have broken the entitlement on welfare if we did not have 35 states over a five-year period doing a lot of experimentation and having third-party evaluators evaluate it. You went with a lot of evidence that said "look, we got people off of welfare, we got

them into work, and you know, they now have private sector wages.” It was hard at some point for Congress to say no, if they looked at the evidence. Thank you very much.