kaiser commission medicaid and the uninsured

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Background

California is a large state in which about 6.3 million people – about 1 out of 5 non-elderly residents - lack health insurance coverage at some time during the year.[1] The state's basic strategy for addressing the health care needs of its low-income population has been to maintain fairly broad eligibility for Medi-Cal (the name for Medicaid in California) and Healthy Families (California's State Children's Health Insurance Program), while providing support for a county-based system of indigent care for the uninsured who are not eligible for these programs. To keep broad eligibility affordable, the state has a history of keeping payment rates low relative to national averages. After Governor Gray Davis took office in 1999, the state used increasing state revenues to broaden eligibility in both Medi-Cal and SCHIP, to make enrolling and staying enrolled in the programs easier, and to increase provider payment rates. However, the ability to afford what many viewed as "improvements" in these public programs came into question as state revenues declined.

The decline in income taxes was particularly serious, because they provide about half of the revenues needed to support general fund programs. California's dependence on the progressive income tax as a source of revenue grew because, as capital gains and stock option income surged in the late 1990s, other fees and taxes were cut (e.g., the vehicle license fee). Although tax revenues fell precipitously in state fiscal year (SFY) 2001-02, the state did not cut spending or increase other revenues sufficiently to address the operating shortfall that emerged.

[1] Brown, E. Richard, Ninez Ponce, Thomas Rice and Shana Alex Lavarreda, "The State of Health Insurance in California: Findings From The California Health Interview Survey," Los Angeles, CA: UCLA Center For Health Policy Research, June 2002.

By the time the SFY 2002-03 budget agreement was adopted - 67 days into the fiscal year - the state was forced to close a $24 billion gap between revenues and expenditures that included about $5 billion left from SFY 2001-02 and a projected $19 billion for SFY 2002-03.

The budget that was adopted for SFY 2002-03 relied on a variety of spending and revenue strategies to close the $24 billion gap. However, only about one-third of the gap ($7.5 billion) was closed through reductions in program spending. Borrowing against the state's future payments under the tobacco settlement closed about one-fifth of the gap ($4.5 billion). Nearly one-half of the budget gap was closed through a large number of spending deferrals, loans, funding shifts and time-limited tax increases ($10.5 billion). The budget also assumed that $1.1 billion in additional federal funds will be forthcoming, including a higher Medi-Cal matching rate, reduced child support penalties, and additional assistance to deal with the costs of incarcerating illegal immigrant felon and increasing homeland security. Although federal legislation did send some additional revenues to the states, this did not happen until California was into its next fiscal year.

Going into SFY 2003-04, California was faced with crafting a budget package that would have to close a cumulative two-year shortfall in the general fund budget estimated to be $38 billion.[2] This shortfall represented about one-third of the state's general fund budget from the preceding year. By the summer of 2003, the budget debate was complicated by the fact that a recall petition had put Governor Gray Davis' job on the line. Although the recall election did not move into full swing during the budget debate, California voters removed Gray Davis from office and replaced him with Arnold Schwarzenegger in a little over two months after the deal

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[2] Elizabeth Hill, *California Spending Plan 2003-04: The Budget Act and Related Legislation,* Sacramento, CA: Legislative Analyst's Office, October 2003.

was signed. Some of the issues in the election were directly related to elements of the budget package.

Of the $38 billion shortfall, roughly $14 billion was left from SFY 2002-03 (due to late implementation of the previous year's plan and unmet revenue and cost projections) and $24 billion was projected for SFY 2003-04.[3] Rather than impose significant cuts on state programs near the end of SFY 2002-03 or increase taxes, the state decided to borrow $10.7 billion by selling bonds to generate most of the money needed to close out the 2002-03 shortfall. These deficit financing bonds (that are still awaiting voter approval and have not yet been sold) and other loans and borrowing from state funds filled about 41 percent ($16.3 billion) of the $38 billion dollar budget gap. Another $4.5 billion (about 11 percent) came from new or accelerated revenues, principally from further securitization of the tobacco settlement, increases in tribal gaming revenues and revision of prior revenue forecasts. Shifts from other state funds to the general fund and spending deferrals accounted for $6.1 billion (about 15 percent of the gap).

California also adopted a large number of program changes that led to $9.2 billion in savings, closing about 23 percent of the gap. One of the largest elements of these savings was simply an accounting change that shifted Medi-Cal costs from an accrual to a cost basis (discussed in greater detail below). Otherwise, spending cuts were spread across all areas of the budget. Perhaps the most noteworthy part of the budget package was the cut in higher education spending from the general fund (about 9 percent) that led to tuition increases of 30% or more

[3] The Legislative Analyst's Office (LAO) felt that the $38 billion estimate that Governor Davis used to shape the debate was overstated, and that a better estimate was $30 billion. The reasons given by LAO for this discrepancy were that (1) baseline expenditures had included some of Davis' spending priorities that exceeded current law; (2) baseline expenditures and revenues the budgetary benefits in SFY 2003-04 that accrued from the package of changes adopted for the previous year; and (3) improvements in baseline expenditures and revenues were not used to adjust the baseline but were counted as part of the budget solution package. To avoid confusion, LAO presented the budget package relative to the $38 billion estimate, because the legislature adopted that figure in its budget deliberations.

(varying across the different components of the higher education system). General fund spending on the judiciary and criminal justice was also reduced (by about 15 percent), but 70 percent of this reduction resulted from a decision to allocate federal fiscal relief funds to this area of state spending. Higher court fees offset some of the actual cut in program spending (that was about 4.4 percent). There was an also agreement to reduce state employee compensation costs across all departments by 10 percent through layoffs or unspecified reductions in compensation.

One area of the budget that did not change very much was K-12 education. After some mid-year reductions in K-12 education in SFY 2002-03 that lowered per-pupil spending by less than 1 percent, the budget agreement for SFY 2003-04 allowed for 4 percent growth in the budgeted level of per-pupil spending. However, because some of this budgeted amount was associated with covering spending that was deferred from SFY 2002-03, actual programmatic spending for K-12 education fell by 0.5 percent per-pupil in SFY 2003-04.

The remainder of the gap (9 percent) was filled with $3.4 billion in revenues from the restoration of previous reductions in the vehicle license fee (VLF). The VLF was allowed to increase under an automatic trigger mechanism that was included in the 1998 legislation that cut the fee by two-thirds. The new revenues were collected on all automobiles registered after October 1, 2003. The VLF increase emerged as a major issue in the recall campaign and Governor Schwarzenegger rolled it back after he took office.[4]

Medi-Cal and Healthy Families

The general fund budget for Medi-Cal in 2003-04 was set at $10.5 billion ($28.7 billion if all funds are included). This represented about a 3.3 percent ($363 million out of $10.5 billion)

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[4] Peter Nicholas, Evan Halper and Joe Mathews, "Schwarzenegger Retreats on Key Campaign Vows: The Governor Backs Off Promises To Spare Education Funds And To Cover Local Governments' Loss Of Car-Tax Revenue," *Los Angeles Times,* December 10, 2003.

reduction in general fund spending for Medi-Cal. The net decrease in Medi-Cal spending was due primarily to a shift in the way the state accounts for Medi-Cal program costs. Instead of making appropriations that allow for services to be paid for according to the date they are delivered (on an accrual basis), the state decided to time appropriations to be in line with when a bill was actually paid (on a cost basis). This meant that the state shifted some spending that would have been budgeted for 2003-04 into the next year. This accounting shift was estimated to have created a one-time general fund savings of $930 million in 2003-04. If this accounting change had not been implemented, Medi-Cal spending from the general fund would have grown by 5.2 percent, or about $570 million.

Although the state made a number of changes in Medi-Cal rules and payment policies that led to actual cuts in spending, many of the Medi-Cal cuts that Governor Davis proposed were either reduced or simply not enacted. The extent of these cuts may have been limited because of an additional $890 million in federal payments that the state expected to receive for 2002-03 and 2003-04 as a result of the temporary increase in the federal matching rate. It is impossible to know if, in the absence of this additional federal payment, Medi-Cal cuts would have been $890 million greater or if an additional $890 million in cuts would have been distributed across other areas of the budget. However, what is clear is that the $890 million federal payment reduced the size of the spending gap facing the governor and the legislature.

The greatest actual projected savings within Medi-Cal were associated with policies aimed at reducing enrollment, but these were still small relative to the overall Medi-Cal budget. By requiring that county workers complete annual eligibility redetermination in less time than it has been taking, the state estimates that it will save $194 million in 2003-04 and that average monthly enrollment will be reduced by about 300,000 people, or 5 percent. However, some

analysts felt that this was an over-estimate. In addition, the state imposed semi-annual status reports to verify eligibility of adult beneficiaries and projects that this will save $21 million. The legislature opted for semi-annual status reports instead of the quarterly status reports that Governor Davis proposed, even though the savings were roughly one-quarter as large as those projected for the quarterly reports. It is hard to estimate the effect of the semi-annual status reports because of their interaction with the annual redetermination. Formal cutbacks in eligibility standards were not adopted. When Governor Davis submitted a revised budget in May 2003, he had already dropped a January proposal to rollback a 1931(b) eligibility expansion that provides coverage to parents in families with incomes up to 100 percent of the federal poverty level.

The budget also included targeted provider rate cuts that rolled back some increases that had been implemented in SFY 2000-01. Rates paid to physicians, pharmacies and managed care plans were to be cut by 5 percent as of January 1, 2004. This will produce $115 million in savings for 2003-04, less than half as large as the cut proposed by Governor Davis which would have cut rates by 15 percent and would have applied to nursing homes as well as those providers actually affected. As enacted, nursing home rates will actually increase slightly in 2003-04. In the deliberations over provider rate cuts, hospitals (inpatient and outpatient services), federally qualified health clinics or rural health clinics were exempted. A coalition of providers affected by the rate cuts--led by the California Medical Association--sued the state in an effort to stop them from going into effect.[5] The plaintiffs claim that the 5 percent cut "is illegal because it

[5] Karen Nicos, Ron Lopp and Peter Warren, "California Medical Assn. And Coalition of Health Care Providers File Lawsuit Against State to Stop Illegal Medi-Cal Cuts," Press Release. CMAnet: The Online Resource for California Physicians. November 7, 2003. http://www.cmanet.org/publicdoc.dfm/708/207/PRESS/280.

violates the Social Security Act by ignoring how those cuts would affect access to care … provided by Medi-Cal." A judge has temporarily blocked the rate cuts.

Another area in which the final budget produced smaller savings than Governor Davis had proposed related to the elimination of optional services. For adult beneficiaries living outside of long-term care facilities, there was a proposal to eliminate 18 optional services that would have saved $88 million for the general fund. The legislature refused to cut any optional services, however, they did reduce coverage of adult dental benefits by limiting the types of crowns beneficiaries could get and requiring X-rays to document the medical necessity for dental restorations. The total savings from these changes are estimated to be about $46 million.

Despite the need to close a large budget gap, budget negotiators chose to reinstate $46 million to fund a program that provides supplemental payments to nursing homes. These payments were initiated on the condition that nursing homes use them to increase wages paid to their workers. These supplemental payments had been eliminated during SFY 2002-03 as part of mid-year budgetary changes, but will be continued through SFY 2003-04. However, the SFY 2003-04 budget agreement also included plans to suspend these payments in SFY 2004-05 in order to save an estimated $64 million.

The Healthy Families program did not experience any cutbacks as part of the budget agreement. In fact, total spending for this program (federal and state) is expected to increase by about 37 percent in SFY 2003-04 to a level of $954 million. About $294 million would come out of the state general fund. This technically represents a $268 million increase in general fund spending, because California is no longer able to use tobacco settlement revenues to fund this program. The reason for this is that, during SFY 2003-04, the entire tobacco settlement will be securitized and applied to the general fund. The overall level of funding for Healthy Families

assumes continued growth in enrollment (from roughly 675,000 to 725,000) and payments to counties to support local insurance initiatives for children.

The Future

The assumptions required to be able to include the deficit financing bonds in the SFY 2003-04 agreement highlight the problems California faced. In order to try to sell the bonds, the state agreed to redirect one-half of one percent of local sales tax revenues to begin repaying the bonds in SFY 2003-04.[6] To replenish this loss in sales tax to cities and counties (approximately $2.5 billion), the state shifted property taxes that would have been used for K-14 education (including community colleges). The money lost to the schools was made up through increased state appropriations from the general fund. The success of this three-part approach - dubbed the "triple flip" – hinges on the general fund growing as the economy rebounds. The state believed that the bond houses were unlikely to accept the risk of these deficit financing bonds unless they were backed by a new state revenue source; in this case, local sales taxes. It is not clear how this mechanism will play out if economic growth is not sufficient enough to provide the additional general fund revenues. Although state finance experts believed this approach was legally sound, the fact that this bond issue has not yet received voter approval has led to some legal challenges. The new governor, Arnold Schwarzenegger, decided to go forward with the bond sale, but is first asking for voter approval.

These deficit financing bonds were only part of the set of one-time solutions used to close the budget gap that the state faced going into SFY 2003-04. Overall, this year's budget plan was quite dependent on borrowing, spending deferrals, funding shifts and revenue acceleration. In

[6] California Budget Project, *The 2003-04 Budget and Beyond,* Sacramento, CA: September 2003.

fact, the Legislative Analyst's Office concludes that "the disappearance of such solutions … would leave a large budget hole."[7] The LAO estimated that, if the VLF increase had remained in effect, the state would be facing a shortfall of about $10 billion entering SFY 2004-05. However, the VLF was rolled back in December 2003 shortly after the new Governor was sworn in. If the state fills in the VLF revenues that will be lost to cities and counties, the shortfall for SFY 2004-05 will be roughly $14 billion. However, at present, Governor Schwarzenegger is backing away from his plan to compensate cities and counties for lost revenues due to the VLF roll back.[8] Although economic improvements are leading to higher tax revenue projections, LAO indicates that these gains will be more than offset by higher spending on, for example, education, Medi-Cal, and corrections and lower revenues than had been assumed from tribal gaming. The bottom line, from LAO's perspective, is that the state needs to make further real spending cuts or decide to "enhance revenues" if the budget is to be brought into longer-term balance starting in SFY 2004-05.

The new governor and the legislature have agreed to ask voters to consider a $15 billion bond initiative that would remove potential legal challenges from the deficit financing bonds that were part of the SFY 2003-04 budget agreement.[9] A larger bond initiative that might have helped with projected deficits for SFY 2004-05 was considered by the new Governor's advisors but not announced because of concerns over adverse impacts on the state's credit rating.[10]

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[7] Elizabeth G. Hill, "California's Fiscal Outlook: LAO Projections, 2003-04 Through 2008-09," Sacramento, CA: November 2003.
[8] Nicholas et al., Ibid.
[9] Dan Morain and Carl Ingram, "Revived Fiscal Plan Goes to Ballot: Compromise Clears Senate on Governor's Alliance With Democrats," *Los Angeles Times,* December 13, 2003; Nancy Vogel, Evan Halper and Peter Nicholas, "Assembly Passes Fiscal Plan: Senate OK Would Put Spending Limit, $15-Billion Bond on Ballot," *Los Angeles Times,* December 12, 2003.
[10] Evan Halper and Jeffrey L. Rabin, "Massive Loan For State Weighed: Aides For Gov.-Elect Schwarzenegger Float The Idea Of Borrowing $20 Billion To Balance The Budget As Key Players Reverse Fiscal Stances," *Los Angeles Times*, November 11, 2003.

Governor Schwarzenegger claimed that the $15 billion bond initiative – being called Economic Recovery Bonds - was necessary "to make good for the damage done in the last few years."[11] He and the legislature have coupled the bond initiative with another voter initiative that would impose a constitutional spending limit designed to end future shortfalls. The proposed spending limits require that the state have a balanced budget and that the state gradually build up a reserve fund that would equal $8 billion or 5 percent of the budget, whichever is greater. There would be a predetermined redirection of general funds into this reserve fund – 1 percent in 2006, 2 percent in 2007 and 3 percent in 2008 and subsequent years – until the reserve fund was fully funded.

Even before announcing his proposed budget for SFY 2004-05, Governor Schwarzenegger proposed spending cuts for the current fiscal year. He sent a package of $1.9 billion in cuts for the legislature to consider in a special legislative session. Included in these cuts are an additional 10 percent cut in Medi-Cal provider rates, elimination in SFY 2003-04 of the program that increases rates paid to long-term care facilities so that workers' compensation can be increased, and enrollment caps in a number of health and human services programs (at January 1, 2004 levels) – including Healthy Families and Medi-Cal Non-Emergency Services for Documented and Undocumented Immigrants. In addition, there is a proposal to eliminate the component of the In-Home Support Services (IHSS) Program funded only with state dollars. This program serves the aged, blind and disabled who do not qualify for Medi-Cal but require assistance to continue living in their homes. By far, the biggest component of the health-related cuts is the provider rate reduction, although the IHSS cutback would become large as these proposals carry into SFY 2004-05. Based on the fact that last year's interim budget cuts took

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[11]Evan Halper and Peter Nicholas, "Gov. Proposes Bond Measure of $15 Billion: Under The Plan, The State Would Borrow The Money To Cover The Shortfall In This Year's Budget. He Also Seeks A Cap On Future Spending," *Los Angeles Times*, November 19, 2003.

over four months to be modified and enacted after they were proposed by then-Governor Davis, observers expect these new proposals by Governor Schwarzenegger will also move slowly through the legislature.

Governor Schwarzenegger's budget proposal for SFY 2004-05 attempts to close a projected $15 billion shortfall through a combination of spending reductions, additional borrowing and the retention of some local property taxes by the state. The LAO believes "the proposal has several positive attributes, including realistic revenue and caseload assumptions, as well as real and ongoing solutions."[12] However, it is not without problems. Many program areas would be affected and state services would be reduced. Moreover, LAO estimates that, despite "serious spending reductions," the state will still be facing a $6 billion shortfall in SFY 2005-06.

Prior to the election of Governor Schwarzenegger, California was already preparing for significant budget cuts for SFY 2004-05. The Department of Finance had requested all state departments to develop plans to reduce budgets by 20 percent. Included in that request were suggestions to consider scaling back required programs, eliminating optional programs and shifting responsibilities from the state to local governments. The recent proposals for supplemental cuts and for the SFY 2004-05 budget suggest that the new Republican Governor is willing to go beyond these actions and consider significant cuts in popular programs. His statements clearly indicate that he is set against new taxes as a way to avoid spending cuts. The legislature is still heavily Democratic and has not signaled a change in its fundamental priorities to protect programs that aid lower-income Californians. The recent agreement on the ballot initiative covering the Economic Recovery Bonds and state spending limits suggested that the debate between the legislature and the governor might be somewhat less intense than many had

[12] Elizabeth Hill, *2004-05: Overview of the Governor's Budget*, Sacramento, CA: Legislative Analyst's Office, January 2004.

expected. However, the size of the shortfall that still must be closed and the vocal public dissent from parties that may be adversely affected by the budget process make it difficult to envision how a broad consensus backing the Governor's proposal will be able to emerge.