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The Medicaid Spending Slowdown: Is It Unusual? Will It Continue?

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FY 2006 in Context: Historical Medicaid Spending Patterns

Medicaid per capita spending (adjusted for inflation) was lower in Fiscal Year 2006 than in the previous year, only the second drop in the program's history. The only other time Medicaid per capita spending fell was between 1995 and 1996. But the decline between 2005 and 2006 was more substantial than the decrease between 1995 and 1996, as Figure 1 shows (see next page). The fall in Medicaid spending in 2006 represents a significant reversal from recent trends, when growth rates were in the double digits only three years ago. At that time (2001-2003), states were in the midst of a fiscal crisis marked by declining revenues and large increases in Medicaid costs. Prior to 2001, the last time Medicaid grew at a high rate was from 1990-1992.

Causes of the FY 2006 Spending Slowdown

Some of the slowdown in Medicaid spending in FY 2006 may be attributed to state-initiated cost controls, such as provider rate cuts and disease management programs. But the biggest factor driving the slowdown was much lower spending on prescription drug costs — one of the largest Medicaid expenditure categories.[2] Drug costs declined in large part because Medicare absorbed a significant portion of this expense for individuals eligible for both Medicaid and Medicare. In fact, prescription drug costs declined 43 percent between the end of 2005 and the first few months of 2006 when Medicare began to cover this service.[3] The commencement of the Medicare drug bene-

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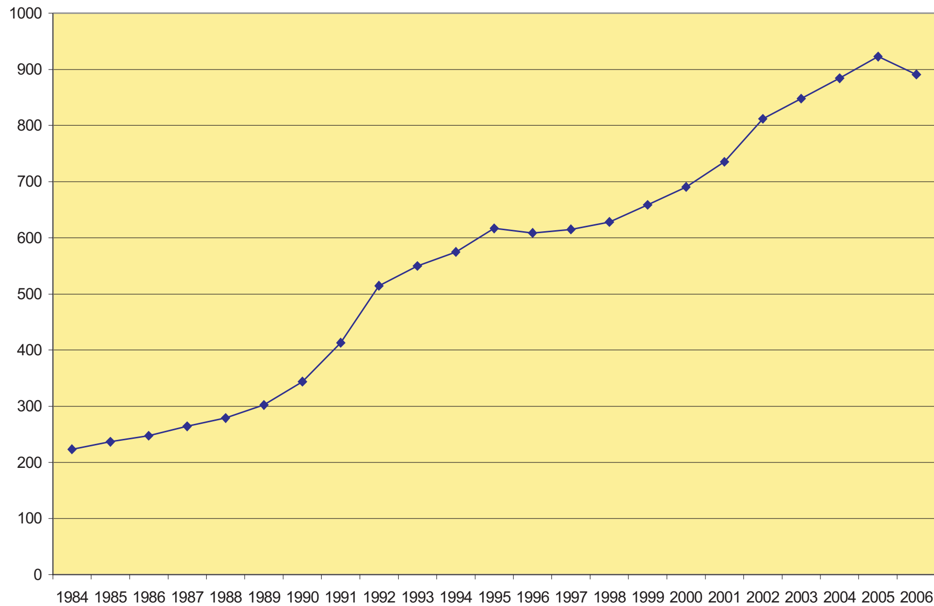
2 Prescription drugs are the fourth largest category of expenditures behind all types of hospital spending, nursing facilities, and managed care.

3 This calculation is based on quarterly service category expenditures for prescription drugs using the Medicaid Form 64 data. The 43 percent decrease is between the first and second quarters of FY 2006 — which is equivalent to the last three months of 2005 and the first three of 2006. Medicare began paying for prescription drugs (i.e., became the payer of first resort) for this population in January 2006.

Figure 1. Medicaid Spending Per Capita in United States
(real 2000 dollars)



Source: Medicaid Form 64 data

fit, combined with a variety of actions by states to contain prescription drug costs under Medicaid, make 2006 an unusual year. Even predictions by the Centers for Medicare and Medicaid Services in early 2006 did not predict the extent of the slowdown in Medicaid spending.[4]

What Made FY 2006 Unusual?

The slowdown in Medicaid spending in FY 2006 is not unprecedented, although the degree of the slowdown was unusual. Also unusual was the statewide reduction in Medicaid prescription drug costs resulting from Medicare's takeover of this benefit for dually eligible individuals.[5] Figure 1 shows that there has generally been a steady increase in Medicaid expenditures since the program's inception, with the exceptions being 2006 and 1995-97. Higher rates of growth in Medicaid tend to coincide with economic recessions, which drive up enrollment and therefore costs, while lower rates of growth tend to correspond with significant policy changes intended to reduce costs such as managed care (as was the case in the mid- to late 1990s).

Also contributing to the recent spending drop was slow growth in Medicaid's two largest expenditure categories — nursing facilities and inpatient hospital expenditures — which grew only 0.4 percent and 0.6 percent, respectively, between 2005 and 2006.[6] These two categories exert great

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4 Borger, Christine, et al, "Health Spending Projections Through 2015: Changes on the Horizon," *Health Affairs*, February 22, 2006.

5 Dually eligible are those individuals eligible for both Medicare and Medicaid.

6 Calculations are based on CMS Form 64 data and are not adjusted for inflation.

influence over total expenditures because they account for one-third of all Medicaid spending.[7] The 1995-1996 spending decline resembled 2005-2006 in that hospital spending slowed in both periods. But the two declines differed with respect to spending on nursing facilities and prescription drugs, both of which contributed much more to the most recent drop in expenditures.

How Did the Slowdown in FY 2006 Vary by State?

The slowdown in Medicaid expenditures in FY 2006 was widespread. Thirty-five states experienced spending declines between FY 2005 and FY 2006, and only 15 saw real per capita growth. Of the 15 states with increases, only one reported growth of more than 10 percent (see Figure 2 on the next page). The largest decrease in per capita expenditures occurred in Tennessee, where the state recently rolled back Medicaid eligibility levels. Iowa was the only state with a double digit *increase* in per capita spending, while Vermont had the next highest percentage increase.[8]

Variation in Medicaid spending patterns among state Medicaid programs is normal because each state has flexibility in administering the program, including determining eligibility levels and covered services. In addition to flexibility with covered services and populations, states may also vary in the amount of services they provide, the amount they pay providers for the service, and the duration of the service. Therefore, in any given year there may be large disparities between states in the rate of growth for the same service. For instance, Tennessee saw prescription drug costs drop dramatically while Iowa did not. In another example, Illinois and New Hampshire had much slower rates of growth in disproportionate share hospital payments than did other states. The most notable similarity between states in 2006 was the decrease in prescription drug costs and a slower rate of growth in nursing facility care and inpatient hospital care in a majority of states.

What Is Likely to Happen in FY 2007?

The decline in Medicaid spending in FY 2006 is unlikely to continue in FY 2007 for three reasons:

First, the initial windfall from the Medicare prescription drug benefit allowed for a one-time reduction in the overall rate of growth in Medicaid. This means Medicaid expenditures are starting FY 2007 at a slightly lower level. But spending is likely to continue to resume the same historical upward trend, which is driven by such long-run factors as increases in health care costs (over general inflation rates), population growth, and the aging of the population.

Second, signs of a slowing economy, combined with several state-level proposals to expand eligibility for Medicaid and SCHIP, are likely to increase Medicaid enrollment, which in the past has increased expenditures. Medicaid enrollment most recently grew as a result of SCHIP expansion and the economic slowdown after FY 2001.[9]

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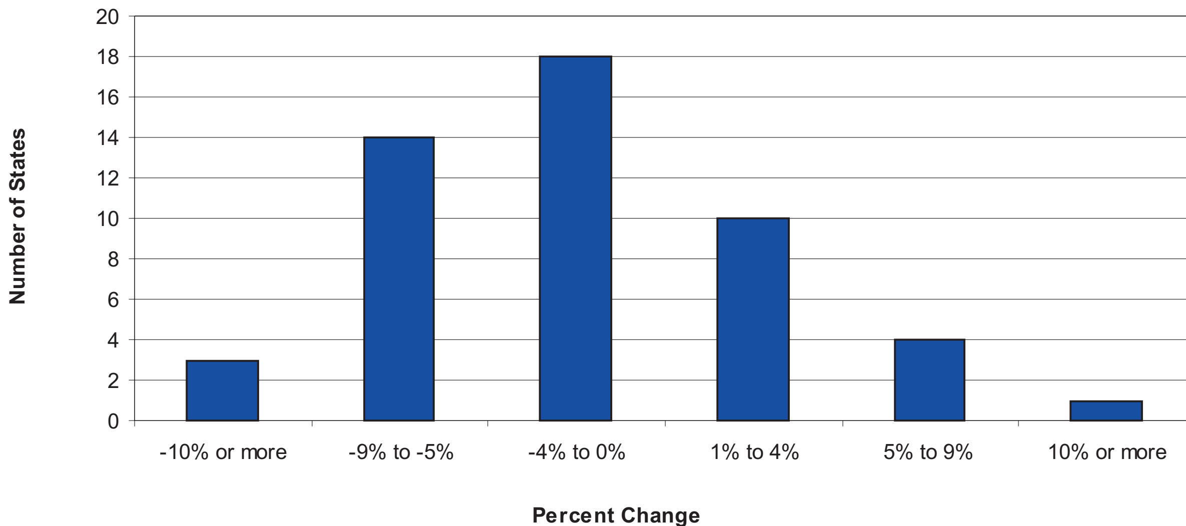
7 Spending on Nursing Facilities was approximately $47 billion, managed care was approximately $46 billion, inpatient hospital was about $41 billion, and prescription drugs were approximately $29 billion out of approximately $295 billion in total spending. CMS Form 64 data.

8 Data are point-in-time and subject to adjustment.

9 Enrollment spiked during this period and was viewed as one of the major drivers of expenditure increases.



Source: CMS Form 64 data. Data obtained from CMS on January 31, 2007.

Third, many of the cost controls that states enacted in previous years, such as provider rate cuts, are temporary and at some point the supply controls will be lifted to reflect market demands, which may cause spending to rise.

How long will the FY 2006 slowdown last? The slowdown in the mid-1990s lasted several years, but it relied on a systemic program change in the way care was delivered — the implementation of Medicaid managed care arrangements. The implementation of managed care drove down many expenditure service categories, but especially all types of hospital care. The slowdown in 2006 was not driven by a systemic change but rather primarily, though not exclusively, by a "one-shot" reduction in state Medicaid prescription drug expenditure obligations due to the Medicare Part D benefit. The most recent expenditure projections by the Centers for Medicare and Medicaid Services do not anticipate that this reduction in costs will continue.[10]

What is less clear about Medicaid spending is how state-level expenditures trends may vary. The new flexibility granted to states to reduce services under the Deficit Reduction Act of 2005, along with the bold proposals of some state governors to expand their Medicaid programs, may lead to greater state-level divergence in Medicaid spending in the coming years.

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10 These projections predict that Medicaid spending would increase by 1 percent in 2006 and by 7.3 percent in 2007. For the next several years, the projections include Medicaid growth rates in the neighborhood of 7.3 percent to 8.3 percent.