

August 2, 2005

Hon. Wesley Chesbro, Chair
Senate Budget and Fiscal Review Committee
Room 5035, State Capitol
Sacramento, California 95814

Dear Senator Chesbro:

This letter is in response to your request for an analysis comparing the projections of Medi-Cal Program expenditures recently released by the Public Policy Institute of California (PPIC) with those prepared by our office. Specifically, you have requested that we identify the differences between the PPIC and Legislative Analyst's Office (LAO) projections and shed light on the reasons for those differences.

Our responses to your questions are based on our review of the final published version of the PPIC report, as well as discussions with PPIC staff while they were preparing their projections and after the report was released. Our projections referred to throughout this letter are contained in our *California Fiscal Outlook* report issued November 2004. A full reconciliation of our projections and approach with those of the PPIC is beyond the scope of this analysis. Also, we have not attempted to validate the specific calculations represented in the PPIC report.

Our key findings are summarized below:

- ***Medi-Cal Expenditures.*** The PPIC report projects that by 2009, General Fund expenditures for Medi-Cal will reach \$19.7 billion (or 18.7 percent of General Fund revenues) while we project those expenditures to be \$16 billion (15.2 percent of General Fund revenues).
- ***Medi-Cal Growth Rates.*** The PPIC report projects that the Medi-Cal Program will grow at an average annual rate of 8.5 percent, while we have projected an annual growth rate of 5.4 percent. (As we discuss later, these growth rates cover similar, but not identical, time periods.)
- ***Reasons for Different Projections.*** The projections differ for two primary reasons: (1) the PPIC did not adjust its projections to reflect recent policy changes adopted at the state and federal level, while we did, and (2) the PPIC used growth rate estimates for the nation and applied them to California, while we used historical growth rates experienced by the Medi-Cal Program.

The remainder of this letter provides general background information on the projections, discusses how the two forecasts differ, and assesses the key reasons for differences in the projections.

BACKGROUND

LAO Projections

As you know, the LAO has annually prepared multiyear projections of state General Fund revenues and expenditures in order to assist the Legislature with its fiscal planning. Our projections have been published each November since 1995 in a report titled, *California's Fiscal Outlook*. This publication includes separate expenditure projections for major programs, including the Medi-Cal Program. Our most recent Medi-Cal projections were included in our November 2004 *Fiscal Outlook*. These estimates include the General Fund costs of Medi-Cal benefits, county administration, and the fiscal intermediary.

PPIC Projections

Last year, the PPIC, a private foundation, was commissioned by the administration to develop projections of Medi-Cal expenditures. The PPIC's report, published in June, is titled, *Medi-Cal Expenditures: Historical Growth and Long Term Forecasts*. As the PPIC prepared its report, we provided the staff of the foundation, at their request, with general information about how our office prepared our projections. We also discussed with them the approach they proposed in preparing their own projections of Medi-Cal expenditures. Our assistance to the PPIC was limited and we were not asked to review the final version of the projections prior to its release in June.

As we did with our projections, the PPIC prepared Medi-Cal projections for benefits, administration, and the fiscal intermediary. However, PPIC's projection time period differs somewhat from ours. Our forecast period runs five years from 2005-06 through 2009-10, with projections presented for each of the years during this period. The PPIC forecast is based on 2002-03 fiscal and caseload data with projections reported for only two points in time during this period—2009-10 and 2014-15. The PPIC does not identify in its report the amounts that it projects would be spent for the Medi-Cal Program in any other years.

HOW DO THE PROJECTIONS DIFFER?

Because of the different projection periods and the limited number of years for which PPIC published its projections, there are only a few data points to compare between our projections and those of PPIC. The three most notable points of comparison are shown in Figure 1. As the figure shows, we project that Medi-Cal General Fund costs will reach \$16 billion by 2009-10, while PPIC forecasts that such

costs will be \$19.7 billion. Our projected costs represent 15.2 percent of General Fund revenues (using our revenue estimates as of November 2004). The PPIC projection of Medi-Cal costs is equivalent to 18.7 percent of General Fund revenues. Finally, we projected that Medi-Cal expenditures to grow by 5.4 percent during our projection period. This compares to an 8.5 percent growth rate forecast by PPIC for its forecast period.

Figure 1 Comparison of Selected Medi-Cal Projections		
	LAO	PPIC
Medi-Cal forecast for 2009-10		
Amount (in billions) ^a	\$16.0	\$19.7
As share of General Fund revenues	15.2%	18.7%
Average annual Medi-Cal growth rate	5.4% ^b	8.5% ^c
^a General Fund. ^b 2005-06 through 2009-10. ^c 2004-05 through 2014-15.		

WHY DO THE PROJECTIONS DIFFER?

As discussed below, we believe that there are two important factors that help to explain the differences between our projections and those of PPIC.

LAO Projections Reflect Recent Policy Changes

The PPIC projections reflect current law and current policy up to fiscal year 2002-03. In contrast, our projections capture recent policy changes that are not reflected in the PPIC forecast. For example, we factored in the potential fiscal impacts on the Medi-Cal Program of the new Medicare Part D drug benefit. Starting in 2006, this federal policy change will shift prescription drug costs from Medi-Cal to Medicare for about 1.1 million “dual eligibles” who are enrolled in both programs, thereby reducing state costs. However, other aspects of this policy change will increase state costs. Recognizing these fiscal impacts, and adjusting for them, could affect the PPIC projections. Without such an adjustment, the PPIC forecasts that prescription drug costs will increase at an average annual rate of 11.9 percent during its projection period. While we do not know what the exact impact of such an adjustment would be on PPIC’s estimates, their report indicates that if drug costs actually grew by a more modest 9.8 percent annually, its forecast for Medi-Cal costs would drop by \$1.3 billion (combined state and federal funds). By not adjusting its projections to reflect this known policy change, the PPIC forecast excludes a significant policy change, which will affect future Medi-Cal expenditures.

Our projections also capture the fiscal impact of dozens of other recent policy changes in the program that have occurred since 2003 that the PPIC projections do not attempt to take into account. These include the fiscal effect of expanded anti-fraud efforts, efforts to reduce reimbursements to pharmacies for drug costs, and several initiatives to maximize the use of available federal funding in lieu of General Fund resources. These adjustments are significant, with some specific policy changes potentially involving tens of millions to hundreds of millions of dollars in projected costs or savings to the program.

LAO and PPIC Used Different Growth Rates

PPIC Assumed National Rate of Growth. The PPIC projections for Medi-Cal are based on national estimates of future growth in the cost and utilization of services for Medicaid programs across the nation. These estimates of future nationwide growth are prepared by the Federal Centers of Medicare and Medicaid Services (CMS). In preparing its forecast, the PPIC applied CMS growth factors to six major categories of health services, including the major expenditure categories of prescription drugs, hospitals, nursing home, and physician services. In so doing, the PPIC assumes in effect that the cost of these services in California will grow at the same rate as has been projected for these factors in other state Medicaid programs across the country.

Implicit in PPIC's assumptions is that California's Medi-Cal Program will grow more rapidly in the future than it has in the past. The PPIC report states that prior efficiencies that have permitted California's program to grow at a slower rate in the past than other states' Medicaid programs (such as enrollment in managed care) will, on the whole, no longer be able to hold down the growth of Medi-Cal costs in the future. For example, PPIC contends that actions by state policymakers to hold the line on provider rates would not be sustainable in the future because access to care for Medi-Cal beneficiaries would be significantly diminished.

LAO Projections Based on Historical Trends. Our assumptions about future costs and utilization of Medi-Cal services are not based on the CMS national forecast. Rather, they are based primarily on historical growth trends in these costs, adjusted for any anomalies during the historical period. Also, where appropriate, further adjustments are made, either upwards or downwards, to these growth trends reflecting our estimate of the impact of any significant, specific policy changes adopted by the Legislature and Governor, but not already reflected in those historical trends. This approach is used to separately estimate the costs and utilization for various specific groups of Medi-Cal beneficiaries.

In its report, PPIC argues that, "the volatility of the California growth rates of the past makes them inappropriate as a basis for projecting future growth rates." Unlike PPIC, we believe that historical expenditure growth trends in the program are a

reasonable predictor of future program expenditures *when* appropriately adjusted for anomalies and adopted policy changes not embedded in the historical trend.

The PPIC's contention that the program cannot sustain a slower rate of growth than 8.5 percent without impairing access to services deserves careful policy discussion and consideration. However, we believe a reasonable argument can be made to the contrary that slower growth rates than those forecast by PPIC are possible and sustainable even without changes in current law. While some features of the Medi-Cal Program, such as eligibility rules, are largely fixed by statute, administrators of the program have significant operational discretion in a number of other areas. For example, further voluntary expansion of managed care for the aged and disabled, tighter management of pharmaceutical utilization and other cost-cutting actions could occur without changes in state law. Therefore, the opportunity exists to continue slower growth in program costs, so that those costs fit within the available General Fund revenues.

SIGNIFICANT UNCERTAINTY REMAINS WITH BOTH SETS OF PROJECTIONS

While we believe our forecasting approach is reasonable, we have regularly noted in our published projection reports that our health care cost assumptions are subject to uncertainty. We have emphasized to the Legislature that small changes in the assumed rate of medical costs could have significant fiscal effects. The PPIC report likewise cautions that its projections are subject to uncertainty, particularly due to its health care cost assumptions.

CONCLUSION

This letter responds to your request that we compare and contrast our projection methods with those of PPIC for forecasting future Medi-Cal Program expenditures. As we have noted above, we believe our approach to the projection of these future costs is a reasonable one. We would also note, however, that we believe the PPIC report and projections provide valuable additional information the Legislature should consider in its future policy making.

In our view, the PPIC report highlights the potential fiscal risk to the state if medical inflation and utilization of services were to grow at a significantly faster rate than is assumed in our projections. The data presented by PPIC also provides additional information about the projected growth of specific components of the Medi-Cal beneficiary population who are most associated with expected increases in program costs, particularly the aged and disabled and persons with chronic diseases.

Next year, the Legislature will again face a state budget deficit of as much as \$4.8 billion, even assuming our lower growth rates in the Medi-Cal Program.

Addressing this shortfall will require that all options be considered, both those involving revenues and expenditures. As regards expenditures, we have identified opportunities for slowing Medi-Cal growth through such strategies as disease management and expansion of managed care for certain aged and disabled beneficiaries.

Please contact Dan Carson or Shawn Martin of my office if we can provide you with additional information in regard to this letter.

Sincerely,

Elizabeth G. Hill
Legislative Analyst