

GAO

Testimony



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**MEDICAID FORMULA:  
Fairness Could Be Improved**

Statement of  
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Before the  
Subcommittee on Human Resources  
and Intergovernmental Relations  
Committee on Government Operations  
House of Representatives



Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the formula used to share the cost of Medicaid between the federal and state governments.

Medicaid is a jointly funded federal-state program providing health care to qualified low-income people. Under this program, the federal government pays about 55 percent of eligible medical expenses and states finance the remaining 45 percent. The federal share varies from 50 to 80 percent for individual states. In fiscal year 1990 a total of \$71 billion was projected to be spent on health care services for the poor.

The current Medicaid formula, which was adopted in 1965, had two major objectives:

- reducing differences among states in medical care coverage of the poor and
- distributing fairly the burden of financing program benefits among the states.

However, these objectives have not been met. Nationwide, the program covers 75 percent of those below the poverty line. But coverage varies from 37 percent in Idaho to 111 percent in Michigan. Also, states face varying burdens in financing the cost of providing for those in need. This happens, in part, because the formula does not target most federal funds to states with the greatest needs; that is, those with weak tax bases and high concentrations of poor people.

In response to your request, we have analyzed problems with the Medicaid formula.<sup>1</sup> Today, I would like to discuss:

- How the current formula calculates the federal share of benefit costs in each state.
- How the formula could be modified to reflect more directly the relative taxing capacity of each state and the fraction of each state's population that is in poverty.
- The effect of substituting a formula that measures fiscal capacity and the poor more directly.

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<sup>1</sup> The work summarized here is an update of our earlier report Changing Medicaid Formula Can Improve Distribution of Funds to States, (GAO/GGD-83-27, Mar. 9, 1983).

#### CURRENT FORMULA USES PER CAPITA INCOME TO DETERMINE FEDERAL SHARE OF MEDICAID

The legislative history of the Medicaid formula shows that federal policymakers believed that by financing a larger share of total program costs in states with high poverty rates and weak tax bases states would provide comparable benefits. The policymakers thought that per capita income could be used in the formula as a good measure of differences in the abilities of states to finance program benefits. They also thought that per capita income could be used to reflect the greater burden of high poverty rates under the assumption that low-income states experienced a greater incidence of poverty. Since per capita income is serving two functions, it enters the formula with its value squared.

The use of per capita income causes the federal share for each state to vary. Mississippi, with the lowest per capita income, receives 80 cents from the federal government for each dollar it spends.<sup>2</sup> Higher-income states receive a lower federal share. However, current law guarantees that no state will have to pay more than half of the total cost of its Medicaid program. Under this approach, 12 higher-income states receive a higher federal share than they otherwise would.<sup>3</sup>

#### BETTER INDICATORS OF STATE NEED ARE NOW AVAILABLE

When income-based formulas were first adopted in the 1950s, per capita income was probably the best available indicator of both states' ability to finance program benefits and the incidence of poverty. However, in the intervening years, better and more direct measures of states' financing capacities and poverty rates have become available.

#### Per Capita Income Is Not a Comprehensive Measure of All Income

Perhaps the most significant weakness of per capita income as an indicator of a state's ability to finance program benefits is that it does not reflect all the income states are potentially able to tax. For example, corporations retain some of their profits for investment purposes. This business income is not

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<sup>2</sup>Without squaring, the federal share for Mississippi would be 69 percent instead of 80 percent.

<sup>3</sup>Alaska, California, Colorado, Connecticut, District of Columbia, Illinois, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, and New York.

reflected in state per capita income even though states are able to tax it through corporate income taxes. Similarly, significant portions of business income are received by out-of-state residents, such as when dividends are paid to stockholders who live elsewhere. This, too, is not reflected in state per capita income. Yet, states can tax this income through various state business taxes. This means that using per capita income understates the revenue-raising capacity of states with comparatively high percentages of business income.

The Department of Commerce now provides estimates of total income produced within each state, in addition to the income received only by state residents. With this data, the Department of the Treasury estimates states' total taxable resources, called simply TTR. TTR is a more comprehensive measure of states' ability to finance program benefits because it reflects both income produced within the state and income received by state residents, even if received from out-of-state sources. Because TTR is a better measure of states' financing capacity than per capita income, the Congress approved its use as a substitute for per capita income for distributing federal funds under the Alcohol, Drug Abuse and Mental Health Services block grant program. In fiscal year 1990 about \$1.2 billion was distributed under this formula.

Differences in TTR and per capita income are substantial in some instances. Figure 1 illustrates the most extreme cases. The five states where per capita income understates taxable resources the most are Alaska, Wyoming, Louisiana, New Mexico, and Texas. At the other extreme, per capita income overstates taxable resources the most in Maryland, Florida, Rhode Island, Pennsylvania, and New Hampshire. As a consequence, the federal share of Medicaid is too low in states where financing capacity is overstated by using per capita income. Data comparing per capita income and TTR for all 50 states are shown in attachment I.

#### Per Capita Income Is a Poor Measure of Poverty

Per capita income is also a poor proxy for the incidence of poverty because two states with the same per capita income can have very different poverty rates. Because Arkansas and Utah both have almost the same average per capita income, the formula treats them as if they had the same poverty rate. However, Census data show that Arkansas's poverty rate is 32 percent, and Utah's is 20 percent, as shown in figure 2. Similarly, Texas and Iowa have per capita incomes near the national average, but Texas's poverty rate is 25 percent, and Iowa's is 17 percent. Likewise, New York's is 22 percent, and Maryland's is 17 percent. Data for all 50 states are included in attachment II.

Because per capita income does not accurately reflect differences for financing capacities and poverty rates, the burden of financing the needs of the poor is greater in some states than in others. In addition, the guaranteed 50-percent minimum federal share of Medicaid costs also enables states with high taxable resources and low poverty rates to finance the needs of their poor with comparatively low tax burdens.

#### USING BETTER NEED INDICATORS WOULD REDISTRIBUTE FUNDING AMONG STATES

Replacing per capita income with more accurate measures of states' financing capacities and poverty rates would offset the fiscal disadvantage that low-tax-base, high-poverty-rate states face under the existing formula. Coupled with these changes, lowering the guaranteed 50-percent federal share would also help equalize the Medicaid burden facing state taxpayers.

To determine the effect of changing the formula, we conducted an analysis that replaces per capita income with TTR and state poverty rates. We also reduced the 50-percent guaranteed federal share to 40 percent.

We did our analysis using fiscal year 1989 data and kept federal spending the same as under the current formula. This means that, for this analysis, funding increases for gaining states are financed by reducing federal aid for losing states. We made this assumption so that we could provide a quantitative measure of how much fiscal year 1989 funding would be reallocated.

Our illustration shows that, from the standpoint of equalizing the tax burden on state taxpayers, the revised formula would have reallocated \$3.2 billion, or 17 percent, of all federal Medicaid assistance in fiscal year 1989. Figure 3 identifies nine states that would have received an additional \$100 million or more under the revised formula: Arkansas, California, Florida, Georgia, Kentucky, Mississippi, New York, Tennessee, and Texas. The figure also shows the current formula benefits states concentrated in the Great Lakes and Midwest regions of the country. Attachments III and IV provide details for all 50 states.

#### CONCLUSION

Mr. Chairman, we believe a formula that uses better indicators of states' financing capacities and poverty rates and reduces the minimum federal share would more equally distribute the burden state taxpayers face in financing Medicaid benefits for their low-income residents. If the use of such a formula continues to be the intent of the Congress, we believe the Congress should consider revising the formula along the lines I have suggested. Doing so would enhance one of the major objectives of the

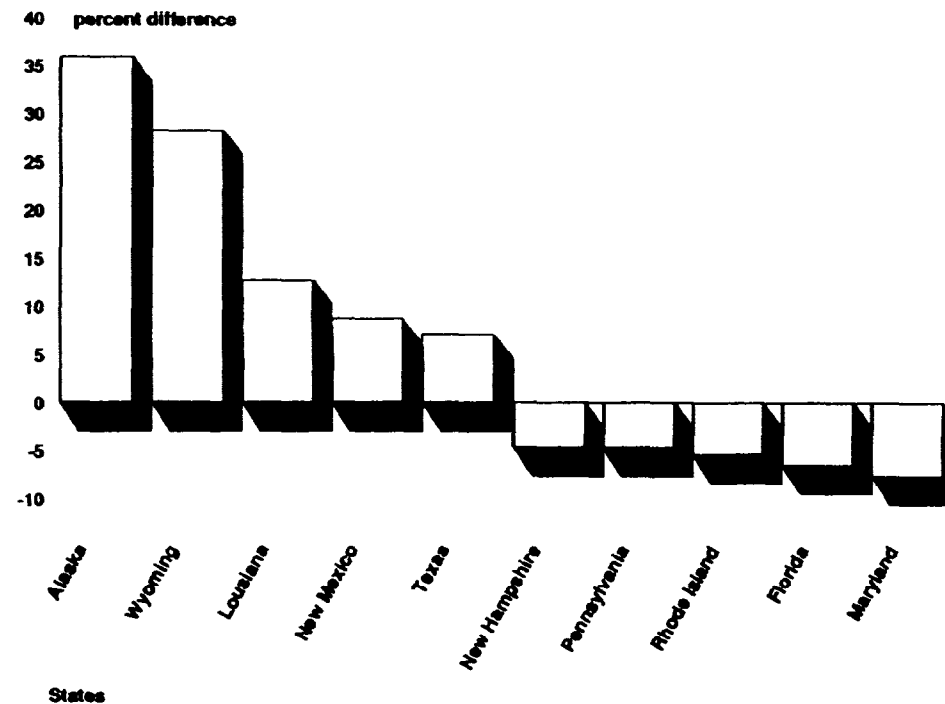
formula: distributing fairly the burden of financing program benefits among states.

However, these changes would substantially reallocate funding among the states, as I have described. A less disruptive approach would be to apply a revised formula only to new Medicaid spending that exceeds the funding level existing before implementation of a new formula.

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Mr. Chairman this concludes my statement. I would be happy to answer any questions you may have. Thank you.

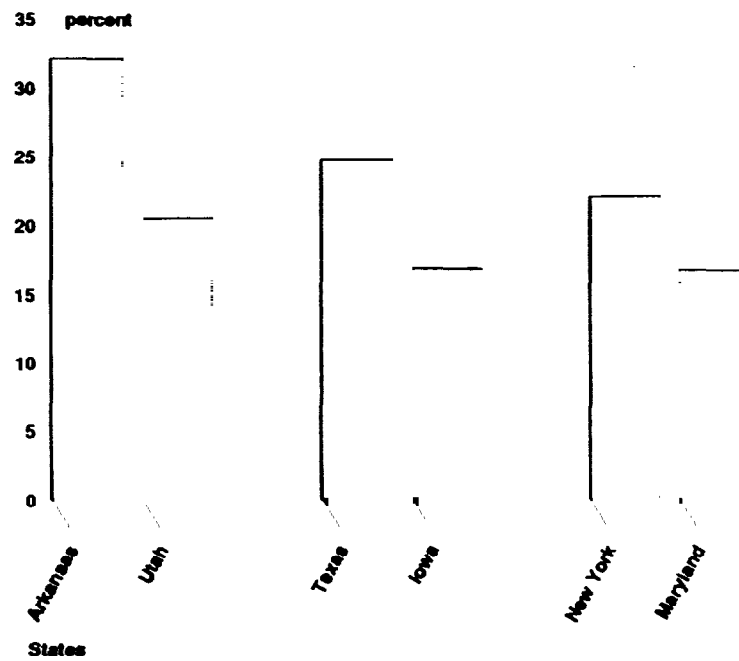
**FIGURE 1: DIFFERENCES IN STATE  
PER CAPITA INCOME AND TOTAL  
TAXABLE RESOURCES**



positive differences denote per capita income understates total taxable resources

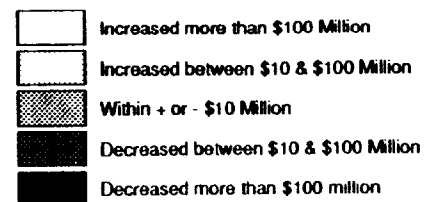
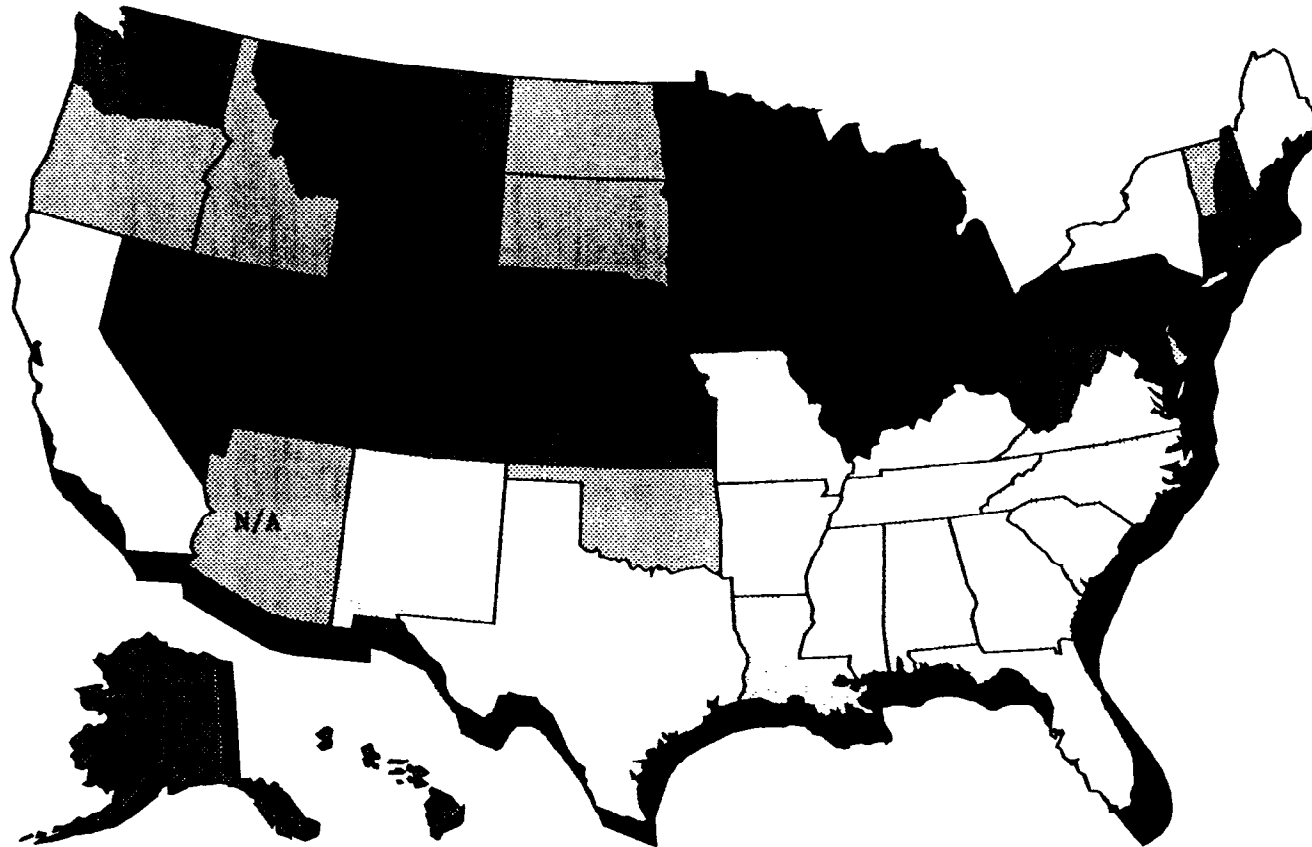
negative differences denote per capita income overstates total taxable resources

**FIGURE 2: COMPARISON OF POVERTY  
RATES FOR STATES WITH EQUAL PER  
CAPITA INCOME**





**FIGURE 3: MEDICAID FUNDING REDISTRIBUTED**



COMPARISON OF PER CAPITA INCOME WITH TOTAL  
TAXABLE RESOURCES PER CAPITA

<u>State</u>	<u>Index No., U.S. = 100</u>		<u>Percent Difference</u>
	<u>Per Capita Income</u>	<u>Per Capita Taxable Resources</u>	
Alabama	79	79	0.2
Alaska	126	171	35.9
Arizona	90	89	(0.4)
Arkansas	75	77	1.3
California	111	110	(0.7)
Colorado	104	104	0.3
Connecticut	137	134	(2.5)
Delaware	103	103	0.8
Florida	96	90	(6.5)
Georgia	91	93	2.2
Hawaii	99	102	2.1
Idaho	77	77	(0.4)
Illinois	108	107	(0.6)
Indiana	91	91	(0.8)
Iowa	93	92	(1.4)
Kansas	99	99	0.0
Kentucky	79	82	3.2
Louisiana	79	89	12.7
Maine	88	87	(1.8)
Maryland	115	106	(7.6)
Massachusetts	124	120	(2.8)
Michigan	103	100	(2.6)
Minnesota	102	102	0.5
Mississippi	68	70	2.8
Missouri	96	96	(0.3)
Montana	83	85	3.2
Nebraska	93	95	1.7
Nevada	96	101	4.8
New Hampshire	111	106	(4.6)
New Jersey	132	126	(4.6)
New Mexico	77	84	8.7
New York	117	119	1.1
North Carolina	85	88	3.7
North Dakota	88	91	3.2
Ohio	96	96	(0.3)
Oklahoma	86	88	2.1
Oregon	89	88	(1.0)
Pennsylvania	99	95	(4.6)
Rhode Island	101	96	(5.3)
South Carolina	77	77	(1.0)
South Dakota	82	81	(1.1)
Tennessee	83	85	2.2

## ATTACHMENT I

## ATTACHMENT I

<u>State</u>	<u>Index No., U.S. = 100</u>		<u>Percent Difference</u>
	<u>Per Capita Income</u>	<u>Per Capita Taxable Resources</u>	
Texas	92	98	7.1
Utah	75	79	4.9
Vermont	90	90	0.7
Virginia	105	103	(1.4)
Washington	98	97	(0.8)
West Virginia	75	76	0.3
Wisconsin	96	95	(1.4)
Wyoming	91	117	28.2

Note: Index numbers were rounded to the nearest whole number

COMPARISON OF PER CAPITA INCOME WITH POVERTY RATES

<u>State</u>	<u>Per Capita Income</u>	<u>Poverty Rate</u>
Mississippi	\$10,000	36.7%
Utah	11,059	20.4
West Virginia	11,067	24.7
Arkansas	11,078	32.0
Idaho	11,337	23.8
New Mexico	11,345	29.6
South Carolina	11,347	27.1
Alabama	11,555	29.3
Louisiana	11,620	28.4
Kentucky	11,620	29.2
South Dakota	11,978	26.6
Montana	12,124	22.6
Tennessee	12,234	27.7
North Carolina	12,507	25.3
Oklahoma	12,668	22.5
North Dakota	12,873	22.8
Maine	12,943	25.0
Oregon	13,009	20.1
Arizona	13,142	22.6
Vermont	13,184	21.9
Georgia	13,363	26.9
Indiana	13,392	17.6
Wyoming	13,411	14.4
Texas	13,455	24.7
Iowa	13,616	16.8
Nebraska	13,676	19.1
Ohio	14,055	17.8
Missouri	14,074	22.1
Wisconsin	14,079	15.8
Nevada	14,127	16.1
Florida	14,150	22.8
Washington	14,416	18.0
Kansas	14,513	18.7
Pennsylvania	14,586	18.5
Hawaii	14,592	17.9
Rhode Island	14,892	18.7
Minnesota	14,908	17.0
Michigan	15,055	18.3
Delaware	15,068	20.3
Colorado	15,234	17.8
Virginia	15,367	19.4
Illinois	15,801	18.1
California	16,247	20.4
New Hampshire	16,333	16.8

## ATTACHMENT II

<u>State</u>	<u>Per Capita Income</u>	<u>Poverty Rate</u>
Maryland	16,862	16.7
New York	17,214	22.1
Massachusetts	18,163	17.1
Alaska	18,499	16.7
New Jersey	19,302	16.6
Connecticut	20,157	14.5
U.S.	\$14,674	21.2%

## ATTACHMENT II

COMPARISON OF FEDERAL MEDICAID MATCHING PERCENTAGES UNDER  
THE CURRENT FORMULA AND A FORMULA USING (1) TOTAL TAXABLE  
RESOURCES, (2) POVERTY COUNTS, AND (3) A 40 PERCENT  
MINIMUM FEDERAL SHARE: FY 1989

<u>State</u>	<u>Federal Share</u>	
	<u>Current Formula</u>	<u>Alternative Formula</u>
Alabama	73%	76%
Alaska	50	40
Arizona	N/A	N/A
Arkansas	74	79
California	50	52
Colorado	50	49
Connecticut	50	40
Delaware	53	55
Florida	55	65
Georgia	63	70
Hawaii	54	50
Idaho	73	72
Illinois	50	48
Indiana	64	55
Iowa	63	52
Kansas	55	53
Kentucky	73	75
Louisiana	71	72
Maine	67	70
Maryland	50	44
Massachusetts	50	40
Michigan	55	52
Minnesota	53	47
Mississippi	80	83
Missouri	60	62
Montana	71	67
Nebraska	60	56
Nevada	50	45
New Hampshire	50	45
New Jersey	50	40
New Mexico	72	75
New York	50	53
North Carolina	68	69
North Dakota	67	65
Ohio	59	53
Oklahoma	66	65
Oregon	62	61
Pennsylvania	57	55
Rhode Island	56	55
South Carolina	73	75

## ATTACHMENT III

## ATTACHMENT III

<u>State</u>	<u>Federal Share</u>	
	<u>Current Formula</u>	<u>Alternative Formula</u>
South Dakota	71	73
Tennessee	70	73
Texas	59	65
Utah	74	66
Vermont	64	64
Virginia	51	53
Washington	53	52
West Virginia	76	73
Wisconsin	59	47
Wyoming	63	40

COMPARISON OF FEDERAL MEDICAID ASSISTANCE UNDER THE CURRENT  
FORMULA AND A FORMULA USING (1) TOTAL TAXABLE RESOURCES,  
(2) POVERTY COUNTS, AND (3) A 40 PERCENT MINIMUM FEDERAL  
SHARE: FY 1989 (millions of dollars)

State	Federal Aid		Difference	Percent Difference
	Current Formula	Alternative Formula		
Alabama	\$408.5	\$488.7	\$80.2	19.6%
Alaska	74.1	44.8	(29.3)	(39.6)
Arizona	N/A	N/A	N/A	N/A
Arkansas	395.3	535.7	140.4	35.5
California	3,233.7	3,519.7	286.0	8.8
Colorado	268.5	234.6	(33.9)	(12.6)
Connecticut	532.8	346.1	(186.7)	(35.0)
Delaware	63.1	69.4	6.3	9.9
Florida	1,133.4	1,711.2	577.8	51.0
Georgia	823.4	1,118.4	295.0	35.8
Hawaii	104.8	88.9	(15.9)	(15.2)
Idaho	101.6	99.5	(2.1)	(2.1)
Illinois	1,132.5	1,028.1	(104.4)	(9.2)
Indiana	772.1	531.2	(240.9)	(31.2)
Iowa	353.1	227.0	(126.1)	(35.7)
Kansas	222.6	205.8	(16.8)	(7.5)
Kentucky	621.8	722.8	101.0	16.2
Louisiana	840.1	918.6	78.5	9.4
Maine	254.2	293.7	39.5	15.5
Maryland	534.1	407.3	(126.7)	(23.7)
Massachusetts	1,232.4	795.8	(436.6)	(35.4)
Michigan	1,273.4	1,090.2	(183.3)	(14.4)
Minnesota	706.6	551.1	(155.5)	(22.0)
Mississippi	415.2	535.2	120.0	28.9
Missouri	515.6	542.8	27.1	5.3
Montana	124.5	106.7	(17.8)	(14.3)
Nebraska	177.3	149.9	(27.5)	(15.5)
Nevada	59.9	47.5	(12.4)	(20.7)
New Hampshire	105.5	82.9	(22.6)	(21.5)
New Jersey	1,043.8	678.2	(365.6)	(35.0)
New Mexico	189.0	225.1	36.0	19.1
New York	5,635.7	6,314.5	678.8	12.1
North Carolina	837.4	903.8	66.5	7.9
North Dakota	121.8	115.9	(5.8)	(4.8)
Ohio	1,656.9	1,274.9	(382.0)	(23.1)
Oklahoma	461.8	453.4	(8.3)	(1.8)
Oregon	308.1	305.9	(2.2)	(0.7)
Pennsylvania	1,652.6	1,503.2	(149.4)	(9.0)
Rhode Island	217.0	205.4	(11.5)	(5.3)
South Carolina	442.5	509.8	67.3	15.2



## ATTACHMENT IV

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<u>State</u>	<u>Federal Aid</u>		<u>Difference</u>	<u>Percent Difference</u>
	<u>Current Formula</u>	<u>Alternative Formula</u>		
South Dakota	106.1	115.2	9.0	8.5%
Tennessee	824.7	959.9	135.2	16.4
Texas	1,426.2	1,811.0	384.7	27.0
Utah	171.7	122.6	(49.1)	(28.6)
Vermont	92.9	90.0	(2.9)	(3.1)
Virginia	458.5	488.7	30.2	6.6
Washington	570.3	545.2	(25.0)	(4.4)
West Virginia	271.7	246.1	(25.6)	(9.4)
Wisconsin	781.7	481.6	(300.1)	(38.4)
Wyoming	37.3	14.3	(23.0)	(61.7)
Total Redistributed			\$3,159.5	17.0%