CONFIDENTIAL

The Challenges for Medicaid

AN ECONOMIC ASSESSMENT

McKinsey&Company

Presentation to the Medicaid Commission
July 27, 2005

WHO IS McKINSEY & COMPANY?

- **We are a management consulting firm** – for 75 years our primary mission has been to help our clients achieve distinctive, lasting, and substantial improvements in their performance

- **We are first and foremost a client service organization** – we help leading organizations in the private, public, and nonprofit sectors solve their most difficult management challenges in strategy, organization, and operations

- **We are neither a public policy organization nor an advocacy organization** – as an apolitical entity, we will contribute to public debate only when we believe that we can offer either a distinctive management perspective or a new set of market data that can assist decision makers

- **In health care, we work across the system** – we serve local, state and federal agencies as well as a wide variety of private sector clients, including payors, providers, suppliers of pharmaceutical and medical products, pharmacies and distributors

OUR ANALYSIS ON MEDICAID

National Medicaid Research Effort 2004-05

- An outside-in analysis to look at the future economic sustainability of the Medicaid program as currently constructed and funded
- Further proprietary analysis drawing on publicly available data, but *without* independent verification

State Level Insight

- Detailed assessment of financial viability and options for reform of Medicaid in one state
- Interviews/conversations with Medicaid experts and leaders in more than 10 other states

Health Care Insight

- Our Health Care Practice has nearly 20 years experience with assessing drivers of cost, sources of inefficiency, and opportunities for improved performance in both cost and quality across the system
- We have also worked with various participants in the health care system who operate under Medicaid
- Even while we focus on economics and numbers, we do not lose sight of the important medical needs of program recipients, and the access to and quality of health care they receive

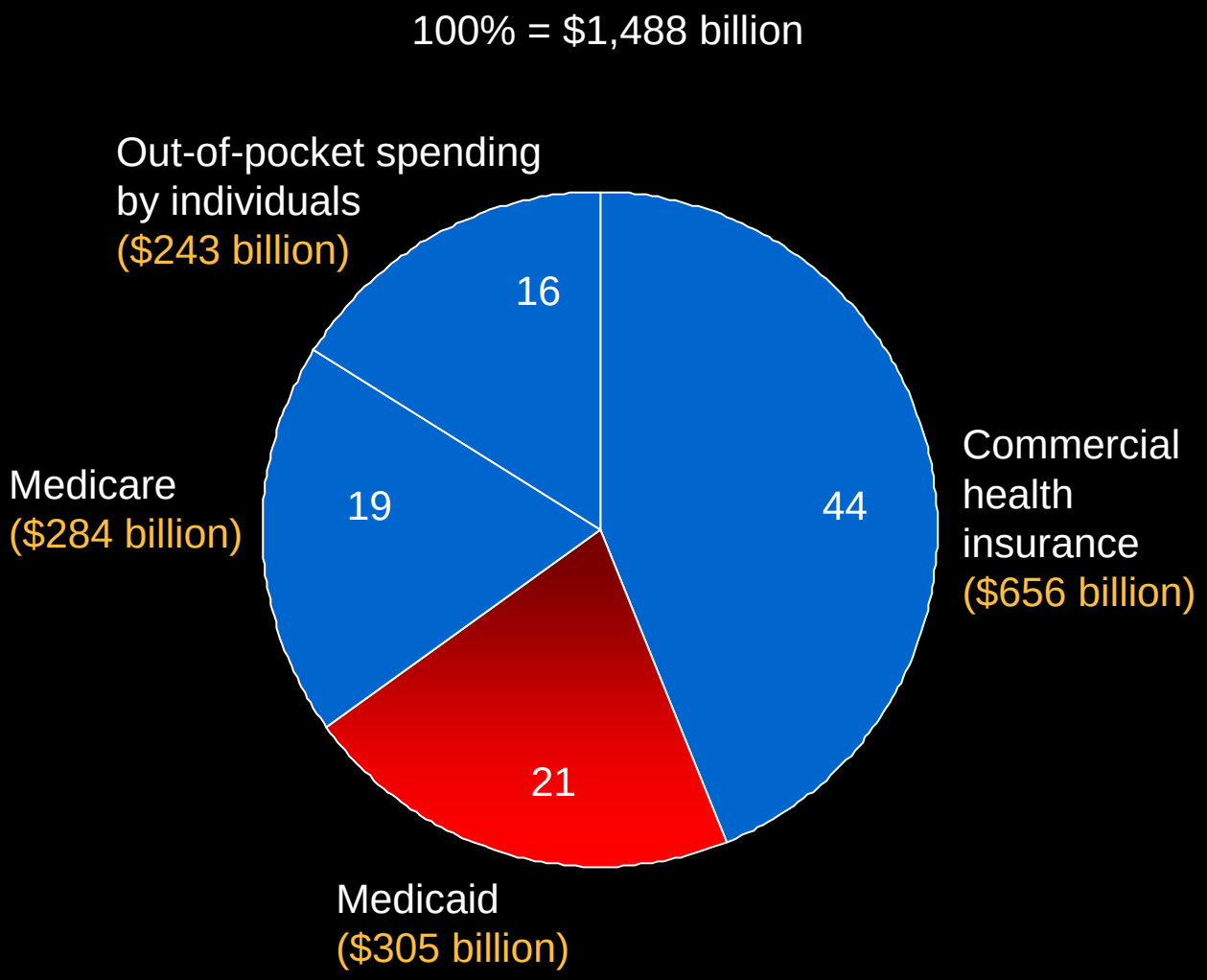
OUR PRESENTATION TODAY ADDRESSES THE COMMISSION'S TASK OF IDENTIFYING OPTIONS FOR LONG-TERM REFORM

- **Medicaid costs are large and growing at a substantial pace. Without change Medicaid will crowd out other priorities at the state level and exert budget pressure at the federal level**

- In addition to looking at health care benefit offerings (which are often discussed), any efforts for long-term reform should also consider
  - The variety of populations covered by Medicaid, which have widely differing health needs, expenditure levels, and persistency of participation in Medicaid
  - The structural factors that have posed challenges to reform efforts to date

MEDICAID IS NOW THE LARGEST PUBLIC PAYOR

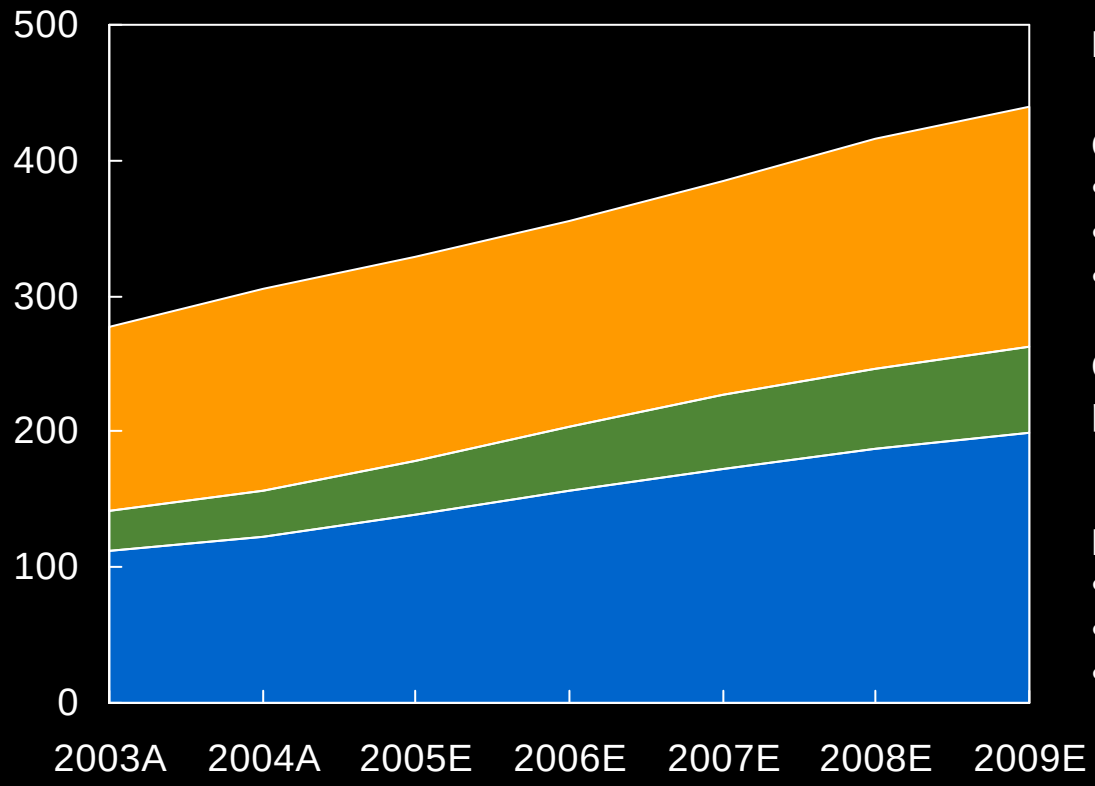
U.S. health care expenditures, 2004
Percent



- A report from the nation's governors and state budget officers noted that in 2004, spending on Medicaid exceeded state expenditures for elementary and secondary education
- Medicaid represents 21% of state budgets, on average, up from just 13% a decade ago

LIKE OVERALL MEDICAL COSTS, THE RATE OF MEDICAID COST GROWTH WILL OUTPACE FEDERAL AND STATE REVENUE GROWTH

Medicaid cost projections (2003-09)
$ Billions



	CAGR 2003-09
Medicaid overall	**6-9%**
Other costs • Professional • Inpatient • Outpatient	**5%**
Outpatient pharmaceuticals	**14%**
Long-term care • Institutional services • Home health care • Community-based services	**10%**

OUR ANALYSIS ESTIMATED THE IMPACT OF MEDICAID'S COST TRAJECTORY ON STATE BUDGETS (2004-09)

This analysis was conducted outside-in

- Used publicly available data, including the census, CMS, BEA, CBO, and NASBO
- Did not independently verify
- Recognizes that states have very different Medicaid program configurations. As a result, reform efforts will impact states differently

These projections are based on several key assumptions

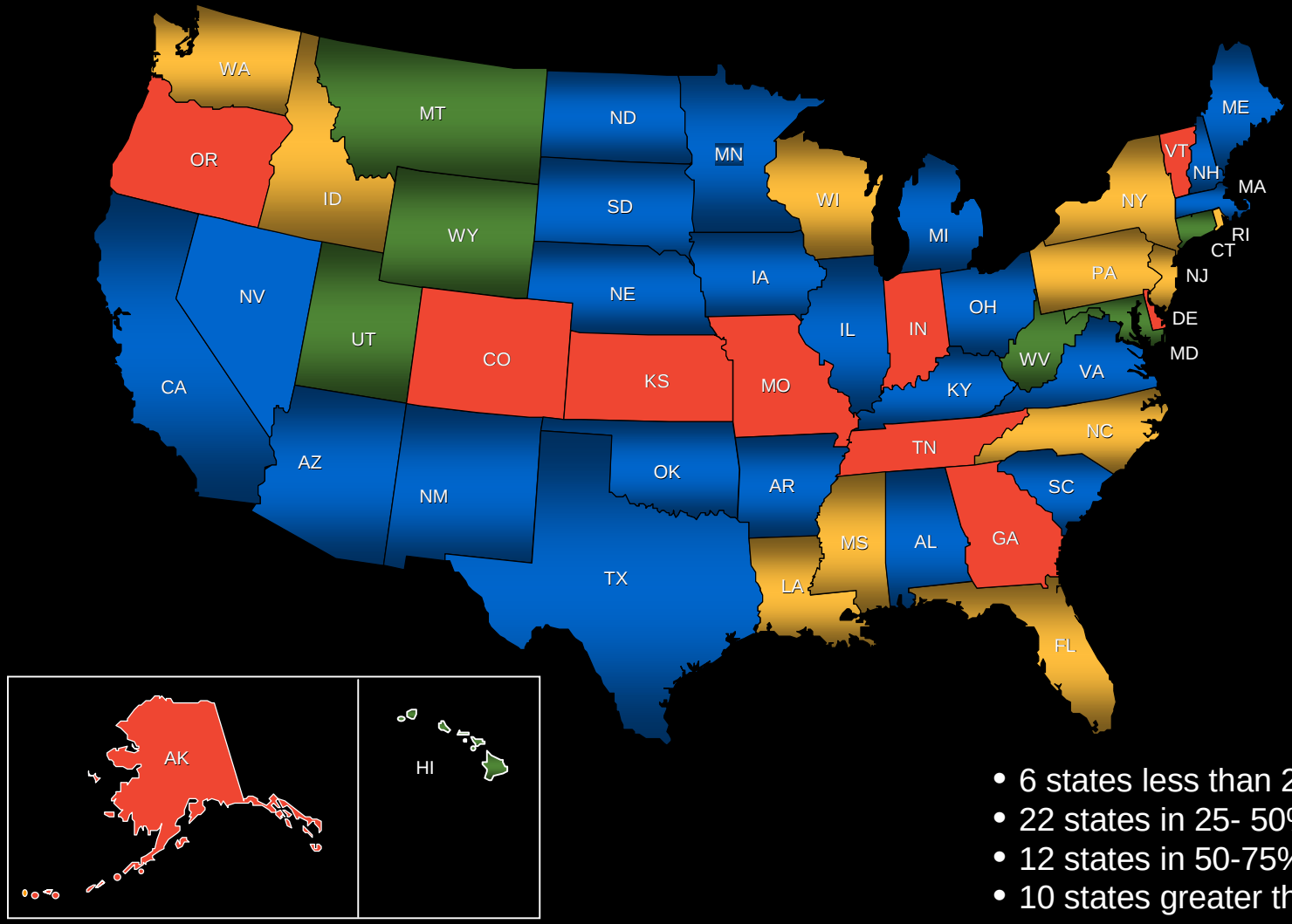
- Moderate recovery in economic growth (base case) in each state. Impacts revenue collection as well as enrollment growth
- Federal match rates remain unchanged from 2004
- Cost of pharmaceuticals for dual eligibles still borne by states therefore included in budget numbers, even though federal government administers benefit under Medicare Reform

22 STATES WILL HAVE MORE THAN HALF OF NEW TAXES CONSUMED BY MEDICAID BY 2009

Percent of incremental new state taxes consumed by growth in Medicaid, 2009E

HIGH-LEVEL ESTIMATES

- <25%
- 25-49%
- 50-74%
- >75%



- 6 states less than 25%
- 22 states in 25- 50% range
- 12 states in 50-75% range
- 10 states greater than 75%

McKinsey&Company

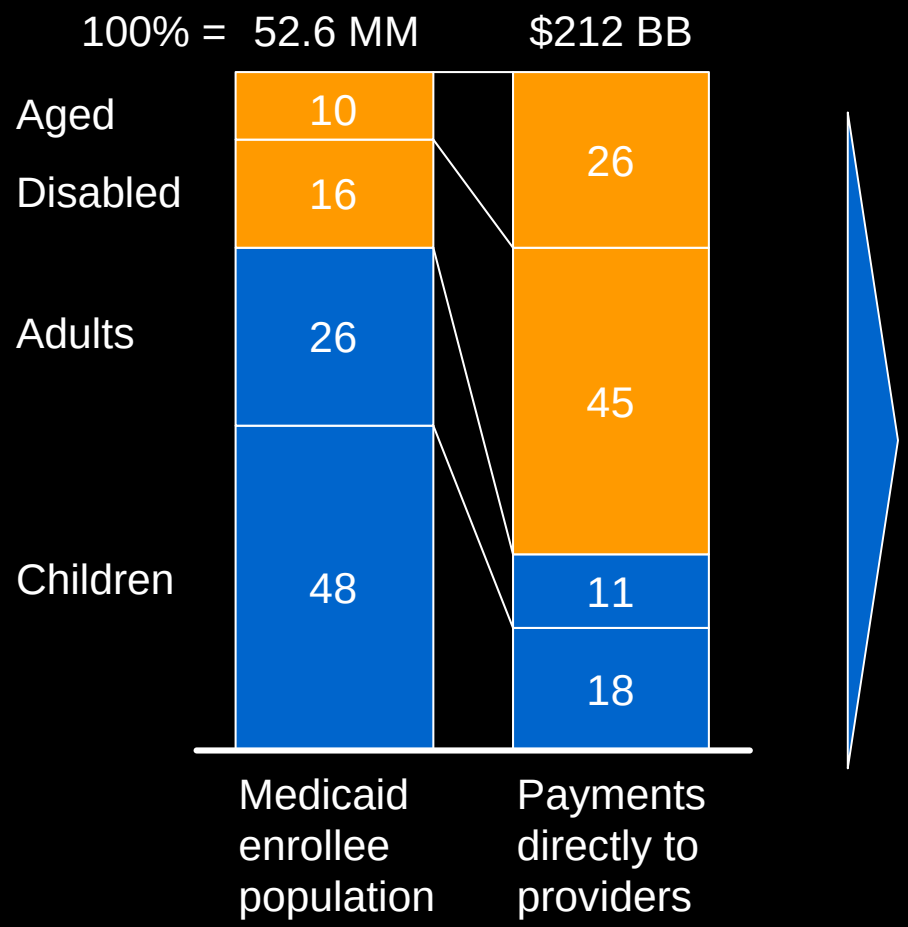
OUR PRESENTATION TODAY ADDRESSES THE COMMISSION'S TASK OF IDENTIFYING OPTIONS FOR LONG-TERM REFORM

- Medicaid costs are large and growing at a substantial pace. Without change Medicaid will crowd out other priorities at the state level and exert budget pressure at the federal level

- **In addition to looking at health care benefit offerings (which are often discussed), any efforts for long-term reform should also consider**
  - **The variety of populations covered by Medicaid, which have widely differing health needs, expenditure levels, and persistency of participation in Medicaid**
  - **The structural factors that have posed challenges to reform efforts to date**

THE AGED, DISABLED AND AGED/DUAL ELIGIBLES DRIVE THE MAJORITY OF COSTS TODAY

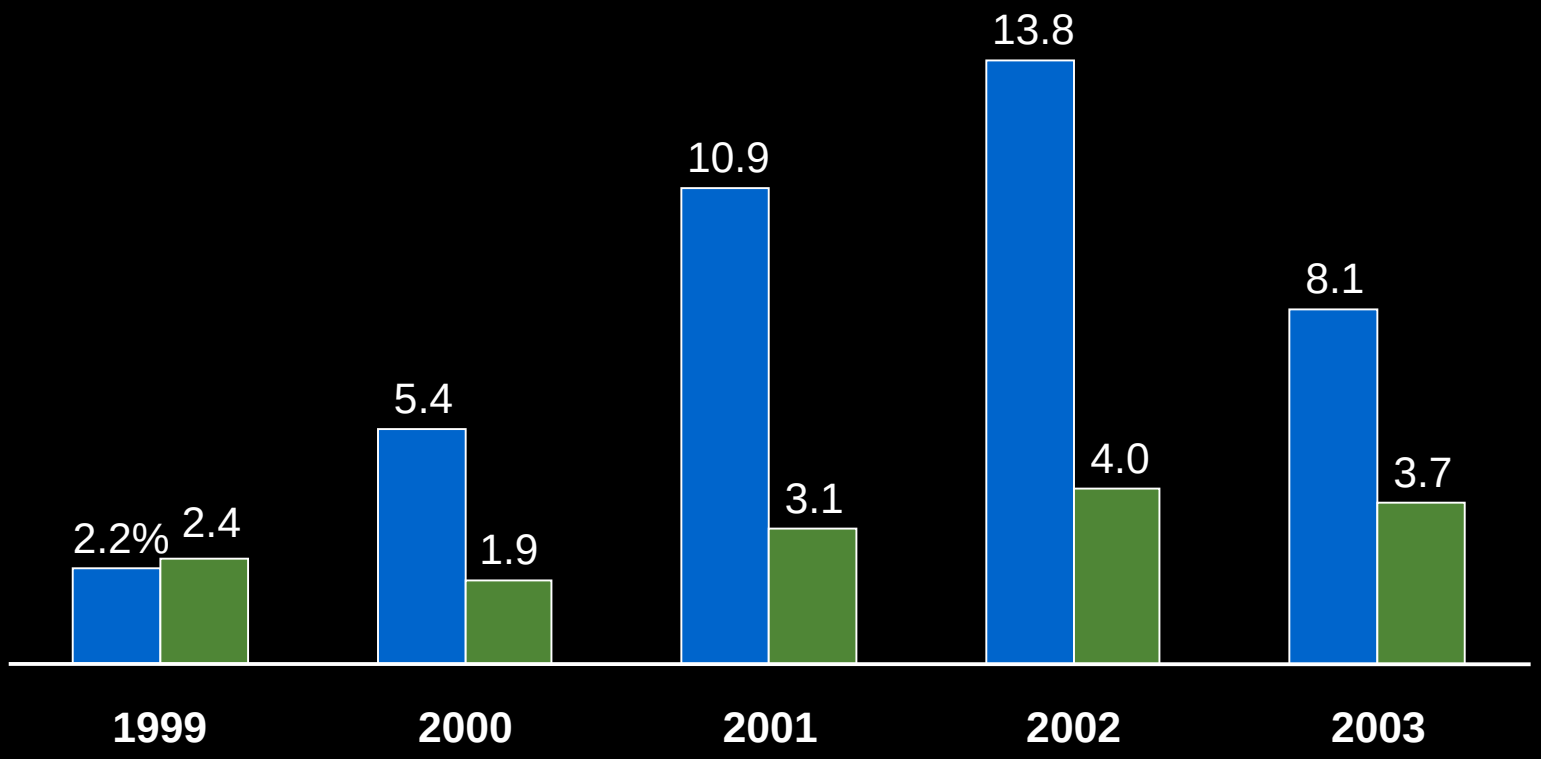
U.S. Medicaid population and spend breakdown – FY 04
Percent



- Less than 30% of the population accounts for over 70% of Medicaid outlays to providers
- Those driving the costs are not typically covered by managed care organizations (e.g., Medicare enrollees/elderly, mentally ill, severely chronically ill, nursing home patients)
- These populations tend to persist longer in Medicaid because of their significant health needs (e.g., ~40% retention rate in Medicaid vs. ~10% for comparable population in commercial health insurance)

WHILE LESS COSTLY, FAMILIES IN POVERTY DRIVE THE INCREASING NUMBER OF MEDICAID ENROLLEES

Changes in Medicaid enrollment by eligibility category
Percent, 1999-2003



McKinsey&Company

STRUCTURAL BARRIERS HAVE MADE FUNDAMENTAL REFORM VERY CHALLENGING TO DATE

Program rules	• Federal benefit and enrollment rules can hamper states' flexibility to offer cost-effective solutions to different populations • Federal-state matching fund mechanism can create perverse incentives to spend
Shrinking provider base	• Historically low Medicaid reimbursement rates have shrunk the number of providers willing to serve Medicaid patients
Gaps in program management	• Improvements in execution and oversight would enable better service to enrollees and providers • Challenges in recruiting and retaining management talent
Lack of patient involvement	• Most enrollees insulated from meaningful information by which to make decisions or responsibility for costs
Insufficient outcome data	• Lack of robust outcomes data prevents Medicaid for rewarding good outcomes rather than activity