

What Works

Stronger Policies for Public Services in Minnesota

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Executive Summary

Fiscal Policy

The Governor and Legislature should balance the 2006-07 state budget with no accounting gimmicks.

The Governor should propose and the Legislature should approve a change in state law that would require all state forecasts to include inflation on the expenditure side as is the case on the revenue side today.

The Governor and Legislature should approve a budget for 2006-07 that produces a balanced budget forecast for 2008-09.

Minnesota should reduce the volatility of its revenue system. Two means of doing so that the Governor and Legislature should consider for the individual income tax are multi-year income averaging and using a “trigger tax” rate that would automatically adjust up or down to yield a target amount of revenue for the state.

If the Governor and Legislature believe that current tax rates and laws would not raise enough revenue, they should consider increasing the sales tax. Also, the cigarette tax is well below average and another good candidate for an increase.

Elementary and Secondary Education

In general only a weak relationship has existed between increases in spending on education and results achieved. In particular, under the salary arrangements currently in place in Minnesota, there is little relationship between teacher pay (the largest component of education expenditure) and student outcomes.

There is increasing but disputed evidence that private school choice can improve the achievement of disadvantaged blacks by over 6 percentile points in three years. On average, given private school choice, disadvantaged children achieve at least as well as in public school, they have a slight advantage in their acquisition of civic virtues, and their parents are highly satisfied with the education their children are receiving. This is accomplished at about half the cost of the public schools.

A few other means of improving academic achievement in public schools exist. They can increase average student performance by 1-11 percentile points or more over a period of several years.

Merely spending more money cannot be the core of a state policy to improve education, and no one policy change by itself will bring about dramatic academic achievement increases, particularly for disadvantaged children. The most cost-effective

way to accomplish education quality appears to be a combination of public and private school choice. Coupling teacher pay to outcomes or to teacher qualities that are associated with improved outcomes could be superior to the present system of payment which is linked almost not at all to whether students benefit. School-based management and high stakes testing are inexpensive and complementary to choice but only marginally beneficial. Full day kindergarten potentially has larger effects than choice though whether those effects persist is not clear, and this policy costs upwards of \$1000 per child. Slight decreases in class size have no effect. A policy of large decreases in class size over several years is much more costly than full day kindergarten for roughly comparable results. Minnesota might wish to implement several of the options discussed here. In any event, it is difficult to justify increases in expenditures unless they are accompanied by reforms that can be expected to give us better student outcomes for our money.

Health Policy

Minnesota has been a national leader in all aspects of health insurance and health care delivery systems. We now need to apply that same level of energy to health expenditures in the state budget.

The State's largest health care budget item is nursing home care for the elderly and disabled. The State regulates both price and quantity in the market for nursing home services. The State requires nursing homes to charge the same to private patients and patients on Medical Assistance. Relaxing that restriction probably would result in higher prices for private patients, but it is doubtful that either allowing the private patient price to float or lifting the state's current moratorium on additional nursing home beds would dramatically reduce public expenditures for nursing home services.

Community-based long-term care services can hold down costs temporarily by delaying nursing home utilization. But achieving these savings has proven to be challenging. Under current delivery models, the substitution of community-based services for nursing home services appears to dissipate after about one year.

Government now pays over two-thirds of nursing home costs in Minnesota – a state with the fifth highest median family income in the U.S. Minnesota needs to have a thorough public debate about the purpose of the Medical Assistance program for seniors. Is the purpose to protect the assets of middle and upper income families for transfer to future generations or is it to provide help only to the destitute elderly?

If protecting assets is deemed to be the purpose, then the state might wish to institute a mandatory long term care insurance premium or “user fee” to pay for this growing responsibility. If, instead, the purpose is deemed to be assistance to the truly destitute, then for eligibility purposes, the state should consider the income and assets of the potential beneficiary's spouse, siblings and children.

There are vast differences across the states – to the detriment of Minnesotans --in the federal government’s subsidies to private health plans serving Medicare beneficiaries. These disparities affect not only Minnesota Medicare beneficiaries, but also the cost of the State’s Medical Assistance program. Remedying this inequity is a task to be taken up more vigorously by the state’s congressional delegation.

For more than a decade, Minnesota state government and the University of Minnesota used the health insurance purchasing system for their employees that has been shown to produce the lowest overall premiums, e.g., setting the State’s contribution to premiums no higher than the cost of the lowest cost plan offered to employees.

The state government’s current system that requires its employees to pay part of the incremental cost of higher cost health care providers is a commendable initiative, as is the University’s addition of a high deductible plan to its low cost offerings. Both initiatives deserve careful evaluation.

Permitting health insurance premiums and other health care expenses to be paid from pre-tax dollars not only dampens the incentive to shop carefully for insurance and health care services, but also constitutes a significant tax break that provides greater benefits to Minnesotans in higher tax brackets. The State minimally should end the state-level tax exemption of out-of-pocket premiums under Section 125 of the IRS code. In addition, the state either should consider eliminating the tax exemption of health insurance premiums entirely, or capping the exemption at its value to a low income, working Minnesotan who purchases a modest health insurance policy.

Opening MinnesotaCare to all and varying premiums by age might enable some currently uncovered Minnesotans to buy insurance.

Both state government and the University of Minnesota should consider using their health benefit plans to demonstrate policies that do not pay for unnecessary and ineffective care and that offer incentives for use of best medical practice.

The State should prepare a report to the public on the level of market concentration for sub-specialist physician services in the state’s metropolitan areas.

Human Services

Poverty adversely affects children’s cognitive, linguistic, emotional and social development and thus damages children’s long run prospects.

Welfare programs – Minnesota Family Investment Program, MFIP support services, General Assistance/Work Readiness, MFIP and Basic Sliding Fee Child Care Subsidies, Working Family Tax Credit, and Dependent Care Tax Credit – now account for 2.3% of the state general fund budget. This represents a decrease of 13 percent from their level in FY1993.

Welfare-to-work employment programs yield modest increases in employment and income but have often been associated with corresponding reductions in welfare receipt, thus accomplishing no measurable gains in family incomes or reductions in poverty.

Intensive training programs are more effective (though basic education activities such as GED preparation or ESL courses have minimal impacts).

Perhaps the most promising policy has been identified in demonstration programs in Minnesota and two Canadian provinces. These increased incomes by requiring work and allowing families to earn amounts well over the poverty level and still retain eligibility for some welfare cash assistance. There is evidence of cognitive, behavioral and health improvements in the children of participating families.

Minnesota could enhance the anti-poverty effectiveness of its current welfare programs by expanding the exit rate under the current MFIP program to its original level in that demonstration program. It also could make a more concerted effort to ensure that eligible families receive benefits, both by expanding outreach, and by re-evaluating policies such as time limits, family caps, and sanctions, that may limit access of the working poor.

Given the substantial deterioration in real benefits for families who are unable to work, Minnesota may also want to consider raising cash benefits for the non-working poor. Currently, the maximum real benefits for a single parent with two children who are not working fall 33 percent below poverty. This could lead to serious financial hardship for families with substantial personal barriers to work, or for families who have lost their jobs due to economic downturns.

There is evidence that very ambitious programs (costing twice as much as current child-care programs) offering preschool and child-care services produce sustained improvements in child outcomes resulting in long-term savings for taxpayers.

Finally, Minnesota may want to conduct careful evaluations to determine which particular mix of child-care, enriched preschool, and financial assistance programs offers the best potential payoff in terms of improving family and child well-being. Minnesota now spends more per family on average for child-care benefits than it does for MFIP cash and food assistance benefits. While these investments have the potential to be particularly cost-effective from a societal perspective, because they may produce long-run improvements in children's well-being, we have little concrete evidence on the impact of our current child-care investments. For example, the state's At-home Infant Care program, which allows families to remain at home to care for their children and still receive child-care subsidies, may offer a promising way of meeting the need of families with infants. This is because costs of child-care for infants are much higher than for older children, while the impacts of low-incomes for young children are particularly acute.

Introduction

John Brandl

This report offers several alternatives to current state policies, alternatives that hold some promise for improving Minnesota's currently serious fiscal problem by helping us get more for our money.

In recent years Minnesota along with almost all other states has confronted large budget deficits. Financial commitments made in the robust economic times of the 1990s are difficult to honor in the current period of a less hardy economy, growing demographically driven demands for state-funded services, and considerable public pressure to hold taxes down. By aggressive belt tightening, along with gimmickry that pushed off some of the deficit into the future, the legislature and governor managed to make it through the 2003 and 2004 legislative sessions without a state tax increase. That feat will be difficult to repeat in 2005.

The report begins with a chapter on the fiscal condition of the state: the size of the budget, changes over time in taxes and spending, the seriousness of the shortfall facing the state, and some suggestions for improvement. Three chapters follow. Each of them consists of a description of current and proposed policies and a report on what academic research tells us about their efficacy.

We assess the effectiveness of policies in the three largest items of the state general fund budget: elementary and secondary education, health care and human services. Together these three alone account for two-thirds of the state's general fund budget, so more efficacious policies there could have significant salutary effect on taxpayers' pocketbooks or on the results achieved from public spending or both. And we expect that the findings reported here have applicability to other areas of state policy. The authors resort little to expert opinion but rather rely mostly on research that statistically holds constant extraneous variables and isolates the extent to which policy (e.g., additional money, smaller class size, sanctions on welfare recipients, subjecting service providers to competition) yields desired outcomes. The most powerful research design randomly assigns some individuals to be subject to a policy and assigns others to a control group. That is sometimes called the "gold standard" of research design because it is the best way to determine whether a particular outcome is due to a policy or, rather, to some other factor. We looked for policy evaluations that use random assignment, and report on those we found.

In general we merely report – not propose – then leave it to the citizens and policymakers of the state to decide which policies they prefer. However, in some cases current policies are so weak or alternatives so promising that we offer recommendations.

This report sweeps away not a few misunderstandings and biases widely held by citizens, for example, the two stances that have dominated the budget debate in Minnesota for the last several years. The budget problem is typically posed as a choice

between cutting spending and raising taxes. It seems that for many people of the first persuasion it is axiomatic that money spent by government yields a lower return than does private sector investment. Cutting nearly any part of government improves the state. It seems that for many people of the second persuasion state government is the manifestation of a decent society. Social progress requires increased spending, particularly at this time when a lower fraction of Minnesotans' income is going to state and local taxes than in times past.

A theme that runs through the largely independently written chapters of the report is that neither of those positions is consistent with the findings of the huge body of relevant academic research. Opportunities exist for government spending that yields greater returns than the average investment in the private sector. Early childhood development is a prominent example. On the other hand, much current government spending does not yield the effects citizens expect of it. For example, paying teachers more, solely on the basis of their academic degrees, courses taken, and years of experience -- which is current policy -- is associated almost not at all with the academic progress of students.

Corollary themes emerge: The budget is a weak instrument of policy. Often, spending more money does not yield better results, so to think of policymaking as budget allocation -- which is common practice -- is to be blind to the possibilities for cost-effective government. Rather, policymaking is more aptly understood as so designing government that when funds are spent, expected results occur. Constructing accountability arrangements is more important, more conducive to effective government, than is budget allocation.

The report is not a partisan manifesto. The politics of the contributors vary widely and none set out to bolster positions of this or that political party. Rather, we have constructed a catalog or menu, showing the relative strengths and weaknesses of a variety of policies. We hope that this will contribute to more productive policymaking at what has been a tense Capitol in recent years. We believe the report is an example of what the citizens of the state expect of their land grant university -- bringing academic research to bear on issues of the day.

Independently the three substantive policy papers identify a crucially important subject. That is the relationship between the families of Minnesota and their state government. Should families be able to choose the school their children attend and have government funds support that choice? Should government expect middle- and upper income families to accept greater responsibility for their frail elderly? And should government bolster family income enough to keep people out of poverty since doing so enhances the cognitive, emotional and social development of children? Minnesota sorely needs a great debate on the general topic and the three questions in particular. Here's an opener to that debate: An affirmative answer to each of those three questions would in the long run give us less costly but more effective government.

Chapter 1

The Financial Condition of Minnesota State Government

Jay Kiedrowski

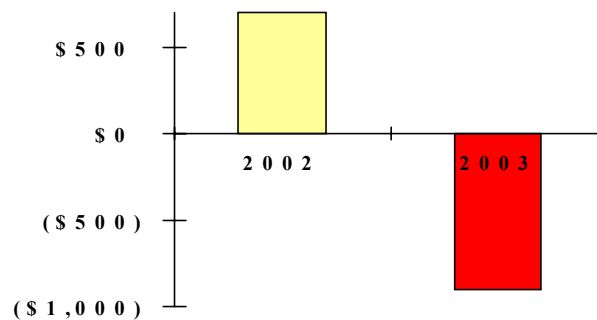
The state of Minnesota has a forecasted budget deficit again for the upcoming 2006-7 biennium. The general fund budget forecasted deficit is \$1.4 billion with inflation included for both revenues and expenditures (\$700 million if expenditure inflation is removed). Minnesota state and local taxes and spending are falling in comparison to other states. The Governor and legislature need to put into place a permanent budget solution in the 2005 legislative session that will: 1) Continue the above par personal income growth Minnesotan's have experienced; and 2) Provide for the traditional investments and services that have made MN a great place to live and prosper.

Introduction

Minnesota's state government finances have been characterized by budget deficits since 2001. Minnesota state government is forecasted to spend \$2 million a day more than it is collecting in actual revenue in the state's general fund. Fiscal year 2005 will be the fourth straight year that state government has had a structural deficit (While state government is required by the state constitution to balance its biennial budget, in 2002-3 and 2004-5 it did so using accounting shifts of expenditures, revenue accelerations, and one-time reserves such that ongoing revenues were not balanced with real expenditures.).

For the first time in 20 years, Minnesota state government actually had a "Generally Accepted Accounting Program (GAAP)" deficit in 2003 as shown in Figure 1.

Figure 1
First GAAP (Accrual) Deficit in 20 Years



Source: Minnesota Department of Finance Presentation, 2004

The cause of this ongoing structural deficit was the inability of the Governor and legislature to enact permanent expenditure reductions or revenue increases. Figure 2 shows a comparison of the sounder Carlson and Ventura administrations' responses to recession induced budget deficits.

Note that while both Governors Carlson and Ventura either accomplished or proposed a combination of revenue increases, spending reductions, and one-time adjustments, the Legislature before the 2002 election rejected Governor Ventura's balanced proposal, and opted for primarily one-time adjustments. For 2004-5, Governor Pawlenty and the legislature rejected a balanced response to the budget deficits they faced, and utilized a combination of one-time adjustments and spending cuts that left a structural deficit. As a result of those actions and the lack of a budget adjustment bill in 2004, Minnesota state government now faces a budget deficit of \$700 million for the coming biennium. This amount includes inflation in revenues, but does not include inflation in expenditures. According to the Commissioner of Finance, inflation in 2006-7 would add another \$700 million for a total deficit of \$1.4 billion.

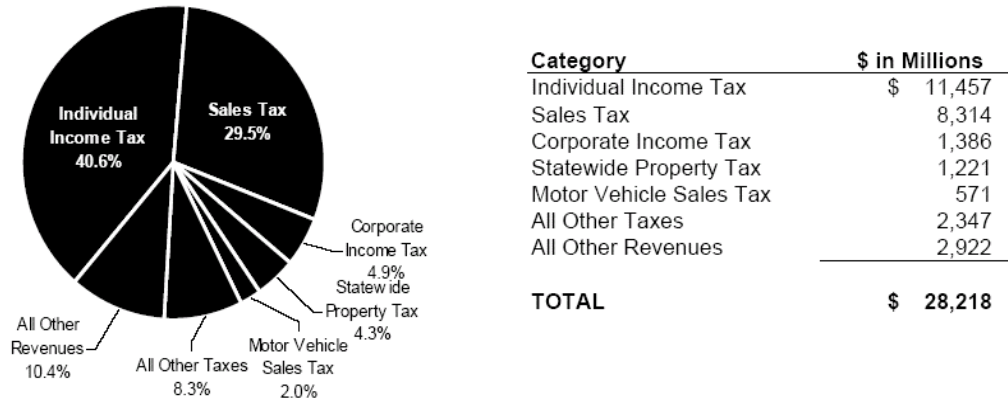
After adoption of the 2004-5 Minnesota state budget, the Department of Finance decided to sell long-term debt and asked the credit rating agencies to rate Minnesota's debt. Moody's downgraded Minnesota from the highest rating Aaa to Aa1 in June 2003 and stated, "The down grade reflects the dramatic deterioration of the state's financial position and the likelihood that the balance sheet will remain weak for at least two more years" (Moody's Investors Service, 2003, p. 1).

Revenues

Should state revenues be increased to eliminate the deficit and balance the 2006-7 biennial budget? The answer to that question depends in part on whether the benefits of doing so outweigh the costs of having money withdrawn from the private sector. Other papers in this report will analyze the benefits vs. the costs for existing and proposed programs.

Before answering that question, it is appropriate to review the current state general fund revenues. Figure 3 shows the 2004-5 state general fund revenues.

Figure 3
Sources of General Fund Revenues
 2004-05 Biennium



Source: Minnesota Department of Finance, 2004

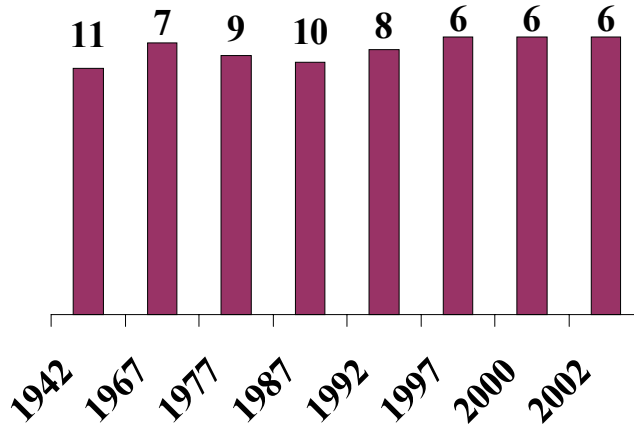
Tax revenues for 2006-7 are forecasted to increase \$2 billion, or 8%, while other revenue is forecasted to fall \$1.2 billion, because of the use of one-time revenue in the prior budget. Combined revenues are forecasted to increase \$.8 billion or 3% to \$29.5 billion for the biennium.

Level of Taxation

How high are state taxes now? According to the national Tax Foundation (2004), Minnesota state taxes per capita were \$2,586 or 4th highest in the US for 2002. It is difficult to use this comparison because different states perform different functions. For example, one of the reasons state taxes per capita rank high nationally now is because Minnesota has traditionally collected revenue at the state level that it then transfers to local school districts and governments through state aid expenditures. Minnesota uses no local income taxes and few local sales taxes.

If one adds Minnesota’s local taxes to its state taxes per capita, the state drops to 6th nationally (in 2002). Figure 4 shows Minnesota’s the historical rankings for state and local taxes per capita.

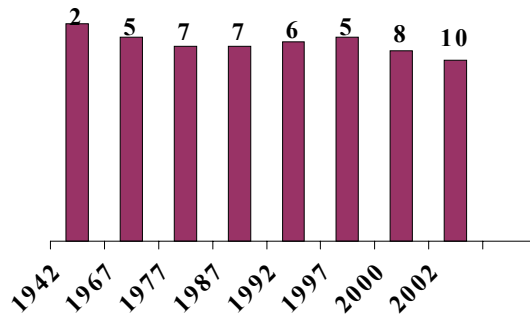
**Figure 4
MN State and Local Taxes Per Capita**



Source: Minnesota Taxpayers Association, 2004

State rankings based on per capita do not take into account local conditions such as local labor costs. For example, Minnesota has significantly higher than average labor costs with personal income per capita ranked 9th nationally in 2002. Using state and local taxes per \$1,000 of personal income changes the ranking to 10th in 2002 (Minnesota Taxpayers Association, 2004). Figure 5 shows that measure over time.

**Figure 5
State & Local Taxes / Personal Income**



Source: Minnesota Taxpayers Association, 2004

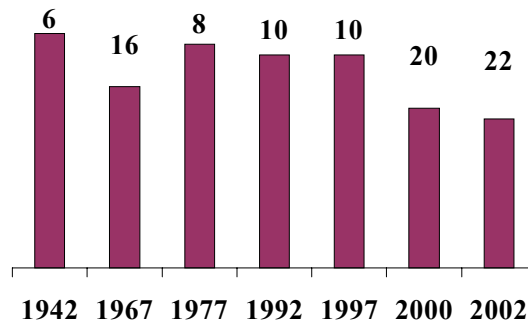
The use of tax rankings is not reflective of the extent to which a state uses fees, assessments, tolls, and other non-tax items to finance its services. Citizens still pay these fees so they should be included in any revenue analysis. Minnesota uses less non-tax support than other states. Minnesota is ranked 16th on its non-tax revenue for 2002 (Minnesota Taxpayers Association, 2004).

Another aspect of Minnesota's spending that should be noted is that this state is 47th in the nation in the amount of federal dollars it receives per taxes paid (Tax

Foundation, 2004). Arguably, if Minnesota could secure more federal dollars, it could reduce its state and local taxes. This also helps to explain why state and local spending rankings, which include federal dollars, are significantly below our state and local tax rankings.

If Minnesota state and local spending per \$1,000 personal income is used, Minnesota drops to 22nd. Figure 6 shows Minnesota state and local spending per \$1,000 of personal income.

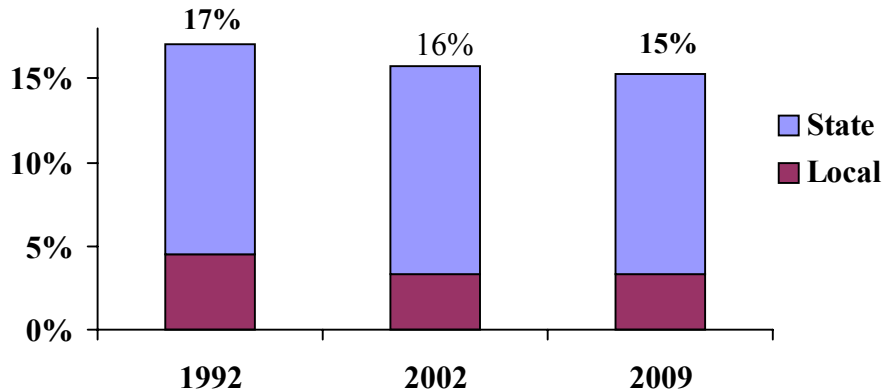
Figure 6
State & Local Spending/Personal Income



Source: Minnesota Taxpayers

Perhaps the best way to consider state and local revenue is to look at the absolute levels rather than rank. Figure 7 shows the “Price of Minnesota Government” (POG = state and local revenue / personal income) at 17% in 1992; then it dropped a percent to 16% by 2002, and it is expected to drop another percent to 15% if state and local revenue occur as forecast by the Minnesota Department of Finance.

Figure 7
Price of Government



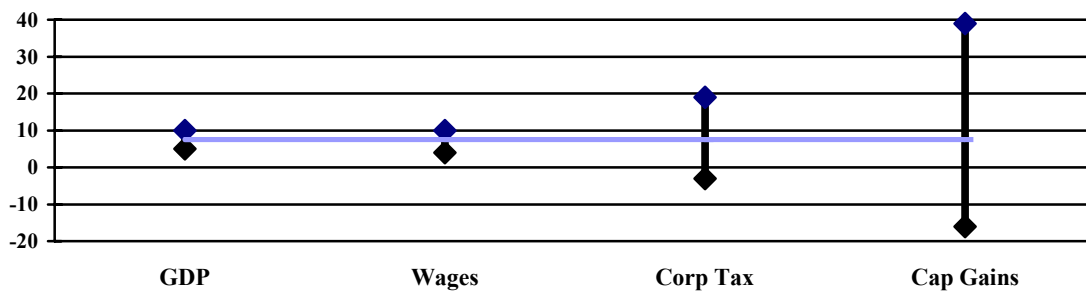
Source: Minnesota Department of Finance, 2004

Minnesota state and local government is costing Minnesotans less of their personal income than has historically been the case. In fact, MN's state taxes compared to income growth grew less than 38 other states from 1992 to 2002 (Tax Foundation, 2004). If Minnesota's Price of Government returned to the 17% level of 1992 for the 2006-7 biennium, MN would have \$4.4 billion more in revenue.

Volatility of Revenues

One of the key causes of budget problems in Minnesota is the volatility of state revenues. State Economist Tom Stinson developed Figure 8 to show how volatile state taxes are.

Figure 8
Percent Change of Key Factors



Source: Stinson, T., & Prahm, J., 2004

While Gross Domestic Product, a measure of the total output of the national economy, varies over time, wages vary more in Minnesota, the Corporate Income Tax more yet, and Capital Gains (a proxy for individual income taxes) varies the most. Minnesota has one of the most volatile tax systems in the US. The volatility is a function of its progressiveness to a large extent.

Distribution of Taxes

One of the reasons that Minnesota has such a volatile tax system is that it uses the most volatile taxes the most. Table 1 shows the national ranking of MN state and local taxes.

Table 1
Distribution of State & Local Taxes
(Per Personal Income 2002)

<u>Taxes</u>	<u>Rank</u>
Property Taxes	26
Ind. Income Taxes	7
Corporate Taxes	13
Sales Taxes	34
Excise Taxes	17

Source: Minnesota Taxpayers Association, 2004

Minnesota uses the most volatile taxes like the individual and corporate income taxes proportionately more than other states, and uses the sales tax (which includes more stable items in other states) less than other states. Interestingly, Minnesota is ranked 35th on its cents per pack of cigarettes as of January 1st, 2004 (Tax Foundation, 2004). Ten other states increased their cigarette taxes in 2005 (State Budget Officers Association, 2004). A \$1-per-pack increase in the cigarette tax would raise \$500 million over the 2006-7 biennium (Minneapolis Star Tribune, 2004).

Minnesota is ranked 34th in its beer tax per gallon and tied for 42nd in the tax on table wine per gallon as of December 31, 2003 (Tax Foundation, 2004). Allowing the excess alcohol tax not to sunset June 30th as required by current law would generate \$85 million for the 2006-7 biennium (Minneapolis Star Tribune, 2004).

Expenditures

Minnesota in 2004-5 will spend approximately \$28 billion from its general fund. This is an increase of 5% over 2002-3. Table 2 shows expenditure increases since 1984.

Table 2
MN State General Fund Expenditures

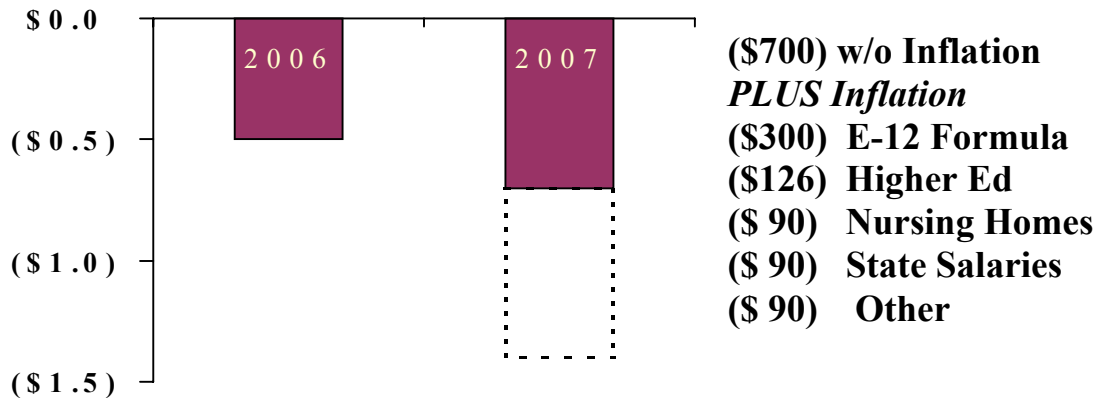
Biennium	Dollars (thousands)	Change	% Change
1984-85	\$9,807,814	\$1,571,426	19.1
1986-87	10,289,740	481,927	4.9
1988-89	11,524,013	1,234,273	12.0
1990-91	13,635,374	2,111,361	18.3
1992-93	14,496,834	861,460	6.3
1994-95	16,739,762	2,242,928	15.5
1996-97	18,629,098	1,889,336	11.3
1998-99	21,193,108	2,564,010	13.8
2000-01	24,179,031	2,985,923	14.1
2002-03	26,648,114	2,469,083	10.2
2004-05	27,954,532	1,306,418	4.9
2006-07F	30,177,000	2,139,000	7.6

(Note that 2004-05 is from the Spring 2004 forecast.)

Source: Minnesota Department of Finance, 2004

The forecast for 2006-7 is without inflation and the 8% increase is driven by the accounting shifts and fund transfers made in the 2004-5 legislative session. What are some of the pressures that the Governor and Legislature will have to face on the expenditure side of the 2006-7 biennial budget? Figure 9 shows some of the potential increases assuming 2% inflation per year.

Figure 9
Possible Increases to 2006-2007 Budget

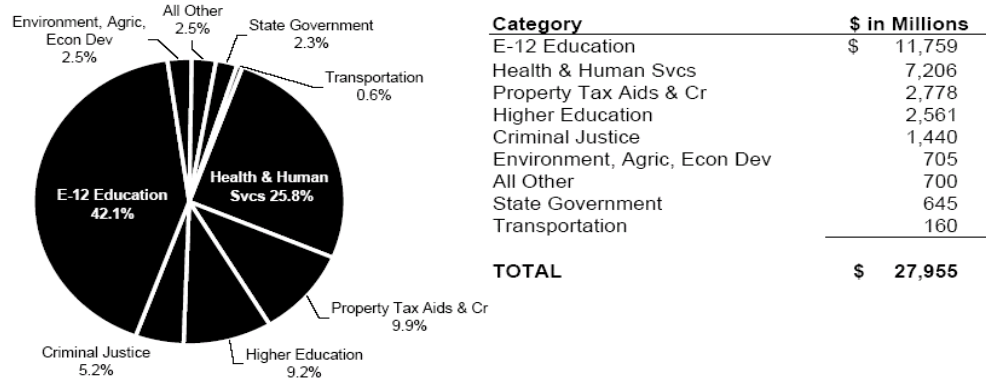


Source: Created from Minnesota Department of Finance Data, 2004

MN expends a small proportion of its general fund budget on state only activities. Much of the state budget is payments to school districts and other local government units. Figure 10 shows MN's spending for 2004-5.

Figure 10

**General Fund Spending
2004-05 Biennium**



Source: Minnesota Department of Finance, 2004

How high is Minnesota spending? As noted previously, MN state and local spending per \$1,000 of personal income has fallen. Table 3 shows the drop from 11th in 1996 to 22nd in 2002 with some of the major spending category rankings.

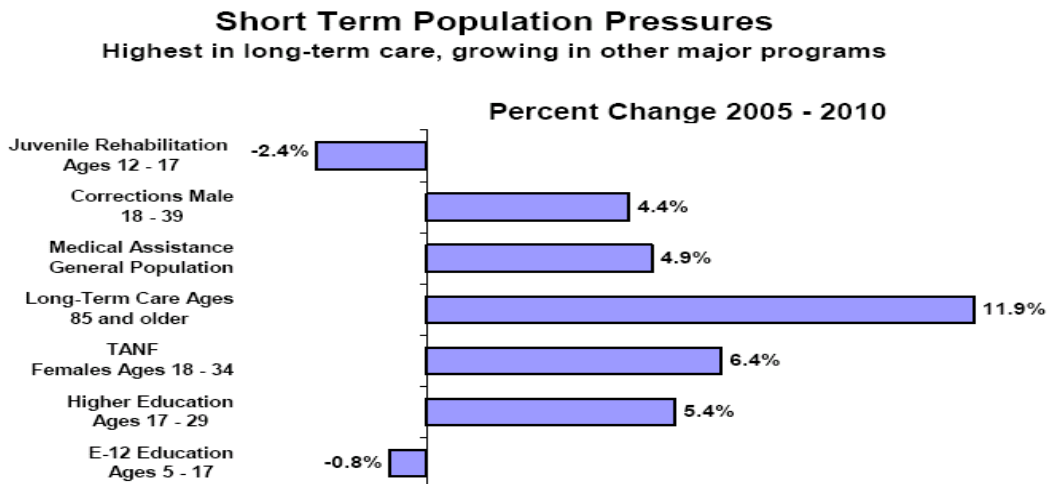
Table 3
National Rank S & L Spending / Personal Income

	<u>1996</u>	<u>2002</u>
• E-12 Education	5	27
• Higher Education	32	35
• Public Welfare	6	10
• Health & Hospitals	13	43
• Highways	18	23
• Police	38	31
• Corrections	38	49
• <u>Debt</u>	<u>16</u>	<u>23</u>
TOTAL	11	22

Source: Minnesota Taxpayers Association, 2004

In Table 2, Minnesota general fund spending was forecasted to increase 8% for the two year budget 2006-7. Besides inflation and other possible increases, there are other pressures on Minnesota state and local expenditures long-term. Demographics are a key determinant of state and local spending. For example, with the population of the state aging, there is more need for elderly services. Figure 11 shows some of these impacts thru 2010.

Figure 11



Source: Minnesota Department of Finance, 2004

Revenue Solutions to Minnesota's Financial Problems

With structural budget deficits for the last 4 years and a forecast deficit of \$1.4 billion for 2006-7, Minnesota needs to consider a number of options to resolve its ongoing financial problems.

Honestly Balance the Budget

The Governor and Legislature need to balance the 2006-7 state budget with no accounting gimmicks. If they don't, the state faces the need to borrow funds to meet state inter-year payments for the first time in 20 years. It also is unfair to future citizens and the next Governor and legislature who will start the 2008-9 budget deliberations facing a budget deficit.

Second, the Governor should propose and the legislature should approve a change in state law that would require all state forecasts to include inflation on the expenditure side as is the case on the revenue side today. If government wants to operate like the private sector, it would approve this change.

Finally, the Governor and Legislature need to ensure that the state budget they approve in 2005 for 2006-7 produces a balanced budget forecast for 2008-9. This is to ensure that none of their actions for 2006-7 negatively impact the future.

Reform the Tax System

Minnesota needs to reduce the volatility of its revenue system. Fundamentally, it's the "roller-coaster" revenue system that exaggerates the economic swings that affect the state. For example, the sales tax is defined narrowly. It does not cover food, clothing, or services that are often covered in other states. An expansion of the items covered would reduce the swings in the sales tax receipts.

Minnesota has a very progressive individual income tax which makes it more volatile. An approach to dampening the volatility while maintaining the progressivism of the individual income tax would be to "income average" over a three or five year period.

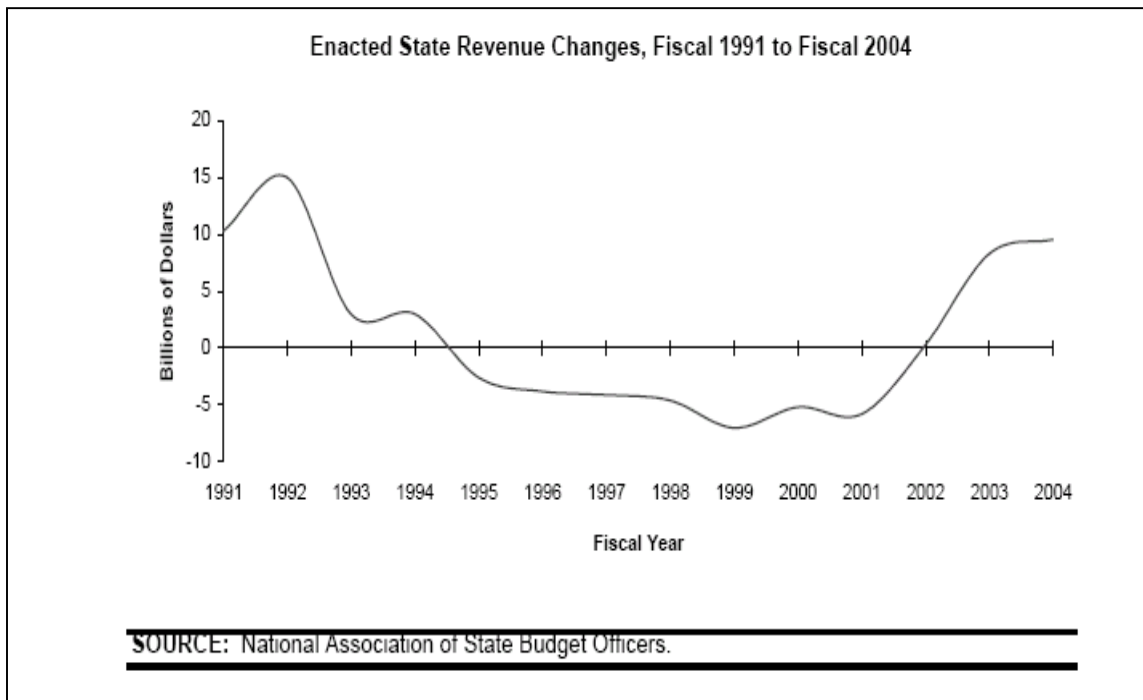
Another approach to reducing the swings in revenue would be to change how the tax rate is set. The individual income tax can serve as an example. Currently the Governor and Legislature enact an individual income tax rate and the revenues float with the changes in the economy. The reverse could be done as was the case in 1986-7. The Governor and legislature could determine the amount of money they wanted to raise from the individual income tax for the biennial budget period. The individual income tax rate would be adjusted through the withholding tables to ensure that within a specified range that amount would be collected in the budget period. This has been referred to as a

“trigger tax”...the tax rate is triggered up or down to ensure the correct amount of revenue is collected.

Increase Revenues

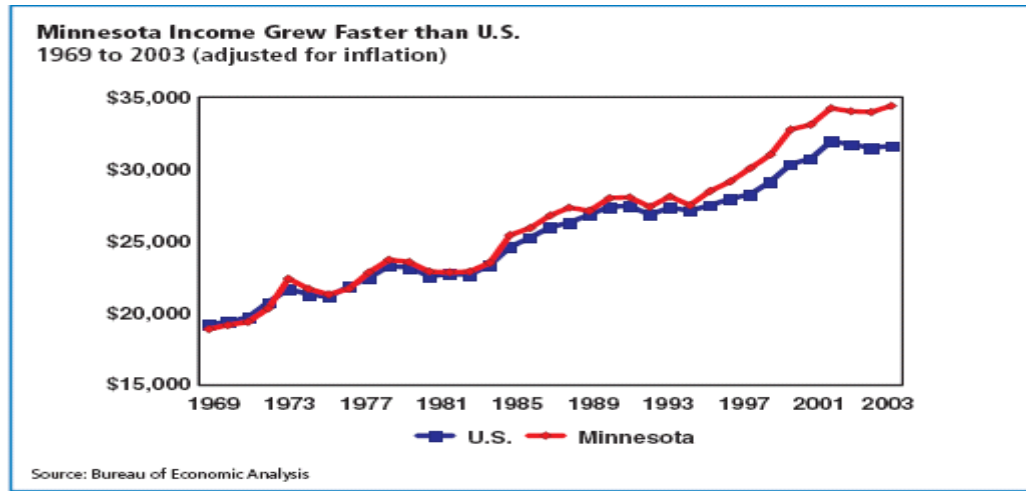
Finally, if the Governor and legislature believe that current tax rates and laws would not raise enough revenue, they should first consider increasing the sales tax. The state and local sales tax collections are the lowest ranked of all Minnesota taxes. Arguably, it has the capacity to be increased. As suggested earlier, a sales tax base expansion would be desirable to reduce volatility, but a rate increase is politically the easier choice. Also, the cigarette tax is well below average and another good candidate for an increase. As Figure 12 shows, other states are increasing their revenues of late.

Figure 12



An argument is sometimes made that Minnesota’s relatively high taxes restrain its economic growth. While admittedly a simple analysis, one can see in Figure 13 that above average increases in personal income occurred while Minnesota has been a “high tax” state since 1969.

Figure 13



Some who believe that higher taxes can produce higher income growth argue that effective public investments in developing a highly educated workforce, taking care of the poor and elderly, and creating an attractive quality of life lead to stronger economic growth.

Summary

Minnesota is at a cross-roads. Should it continue the recent “no tax increase” approach, using gimmicks to balance the budget, and under invest in the future? Or should the state take a more traditional balanced approach using increased taxes, smarter spending, and prudent investments in its future to structurally balance its budget? The remaining three chapters will discuss the three largest components of state general fund expenditures. Policy options will be identified and assessed to determine where additional spending might be expected to yield incremental benefits and where it might not.

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Chapter 2

Policy for Cost-Effective Elementary and Secondary Education

*John Brandl and JT Haines**

Minnesotans have long been proud of their schools, and some comparisons with education elsewhere have bolstered our pride.¹ Several emergent developments should rattle this complacency. It now appears that Minnesota's high position among the states has come about largely because we have had few hard-to-teach children. On the National Assessment of Educational Progress the average achievement of Minnesota students in some years and grades ranks first or second in the country, and scores on our state's own test, the Minnesota Comprehensive Assessment, have been rising for the past five years.² However, when adjusted for the relative advantages and disadvantages of our students (such as their race, poverty levels, health, and the incidence of crime in their neighborhoods) compared with those of students in other states, we rank only 14th. (There is controversy about this ranking because some people argue that the number of hard-to-teach children is rising. But that doesn't explain Minnesota's disappointing position relative to other states.) And on an efficiency measure – the achievement levels that could be expected given the combination of what some researchers call the relatively higher teachability of our students together with the amounts of money we spend on schooling -- Minnesota drops to 34th.³ Not much to brag about.

Things could get worse quickly. For several decades we have known that overcoming the deficiencies of family background by means of schooling is extremely difficult and for most disadvantaged youngsters it does not happen.⁴ Across the country the achievement gap between black and white students narrowed in the 1970s and 1980s but actually grew in the 1990s and may now be narrowing again.⁵ Today the gap is greater in Minnesota than in any of the other 27 states in which the same achievement tests are administered.⁶ That bare fact is somewhat misleading, however, because, except

* The authors thank Edward Dirkswager, Ted Kolderie, Joe Nathan and Stacy Becker for their helpful advice.

¹ See, for example, http://www.alec.org/meSWFiles/pdf/Education_Report_card.pdf

² U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics, National Assessment of Education Statistics, 2000 and 2003 Mathematics Assessments, Tables 1 and 3; and 1998 and 2003 Reading Assessments, Tables 1 and 4. These tables show achievement test scores for grades four and eight. See also, M.L. Davison, et.al., *2003 Minnesota Education Yearbook: The Status of Pre-K-12 Education in Minnesota*, Office of Educational Accountability, College of Education and Human Development, University of Minnesota, Minneapolis, 2004, page 45.

³ Jay P. Greene and Greg Forster, "The Teachability Index: Can Disadvantaged Students Learn," Education Working Paper No. 6, September 2004, Manhattan Institute, New York, pages 4, 28-33; and an e-mail message, September 8, 2004, from Greene and Forster to the authors.

⁴ See William G. Howell and Paul E. Peterson, *The Education Gap: Vouchers and Urban Schools* (Washington, DC: Brookings Institution Press, 2002), chapter 1.

⁵ Bryan S. Gordon and David J. Armor, "The Effects of Accountability Systems on the Achievement Gap, 2000-2003," presented at the 26th Annual Association for Public Policy Analysis and Management Research Conference, Atlanta, GA, October 31, 2004.

⁶ Ann Flanagan and David Grissmer, "The Role of Federal Resources in Closing the Achievement Gap, chapter 10 in John E. Chubb and Tom Loveless (editors), *Bridging the Achievement Gap* (Brookings Institution Press, 2002), page 212.

for Asians, in some subjects the achievement of all ethnic groups in Minnesota (whites, blacks, Hispanics, American Indians) exceeds that of their ethnic peers elsewhere in the country. It's just that Minnesota has disproportionately more whites than the country as a whole, and whites here are doing well compared with their ethnic peers elsewhere.⁷ But now the number of students of the other, disproportionately disadvantaged, ethnic groups is growing faster in Minnesota than is the number of more privileged children.⁸ So, Minnesota is not adequately confronting its education challenge, and in the near future that challenge will become much more serious.

In this chapter – in the context of a tight state budget -- we lay out the most prominent proposals that have been put forward for dealing with Minnesota's academic achievement problem. We approach each with a cold eye and present what current research has to say about its potential efficacy. Does the proposal emerge from wishful thinking or is there a powerful policy underlying it? A powerful policy is one that contains a lever, an engine, a driver, a reason why if the policy is undertaken the desired results can be expected to occur. At the end we sum up by identifying which proposals yield the most student achievement for the money.

The Options

1. Increased spending

One rejoinder to the worrisome picture just painted is that surely we would do better if only we funded education more generously. But just that has been happening for decades. *After adjusting for inflation*, the amount of money devoted to today's average student is *double* what was allotted to the schooling of that child's parents thirty-five years ago.⁹ So much more is being spent now and so slight has been the change in academic achievement over time that for much of the past quarter century perhaps the dominant impression among careful researchers was that in elementary and secondary education no statistical relationship exists between spending and results.¹⁰ However, in recent years a more nuanced and somewhat more encouraging understanding of the situation has emerged. Larry V. Hedges and Rob Greenwald have made a counter argument that has come to be accepted by many who evaluate academic effectiveness: more money, spent carefully, can and does have a positive effect. For example, the

⁷ Davison, et.al., pages 48-53.

⁸ See "Minnesota School Enrollments Projected to Peak in 1999-2000," [PopBites](#), MN Planning, State Demographic Center, St. Paul, MN April 1999; and Tom Gillaspay, "Metamorphosis in Minnesota," MN Department of Administration, October 2004, page 8.

⁹ Hanna Skandera and Richard Sousa, [School Figures: The Data Behind the Debate](#) (Stanford, CA: Hoover Institution Press, 2003), page 198.

¹⁰ See, for example, Eric A. Hanushek, "The Economics of Schooling: Production and Efficiency in Public Schools," *Journal of Economic Literature*, September 1986; and Gary Burtless (editor), [Does Money Matter? The Effect of School Resources on Student Achievement and Adult Success](#) (Washington, DC: Brookings Institution Press, 1996). See also, "How Well Are American Students Learning?" The 2004 Brown Center Report on American Education, The Brookings Institution, Washington, DC. There we learn that the recent apparently dramatic rise in mathematical proficiency of American fourth graders and eighth graders may be illusory. "Students know more math than in 1990, but the increase is probably far short of the two years worth of knowledge suggested by the NAEP [National Assessment of Educational Progress] scales." What can explain this? "It appears that even if [fourth and eighth grade] American students are making progress in mathematics, the arithmetic on which the gains are being registered is not very challenging, certainly no more demanding than that taught in third grade." Page 15.

Effective Schools movement of the 1970s and 1980s identified a number of characteristics of more successful schools and found in them strong leadership, an orderly environment, the teaching of basic skills, high expectations of students, homework regularly assigned and accomplished, a substantial part of the students' day spent on academic work, systematic monitoring of students' progress, and a sense on the part of students, teachers, and parents that their school is a community. Unfortunately, although the efficacy of those practices is now well known, they do not characterize our schools; much expenditure on schooling goes rather to items lacking a link to better education for children. So yes, in some cases additional spending leads to improved student outcomes. Remarkably, however, in (a smaller number of) other cases it actually is associated with a decline in achievement.¹¹ Spending by itself cannot be counted on to improve results.

How can this be? Consider how additional funds for education are usually spent: most of the time the money goes to raise teacher salaries or to lower class sizes.

Nearly everywhere in Minnesota and the rest of the country teacher pay is a function only of college credits, degrees earned, and longevity of service. However, “[a]dvanced credentials in education, while certainly a worthy pursuit, do not translate into improved student learning... [and] teaching experience appears only loosely related to teaching quality, especially beyond the first few years of teaching.”¹² One researcher quantified this disquieting situation as follows: “3 percent of the contributions teachers make toward explaining student achievement is associated with teacher experience, degree level and other readily observable characteristics [T]he remaining 97 percent is made up of teacher qualities and behaviors that could not be separately isolated and identified.”¹³ Of course, some teachers can and do make a wonderful difference in children's lives. Not surprisingly, teachers who are knowledgeable in their subject matter and mathematically and verbally skilled have been found to be more effective. Unfortunately, as indicated above, by and large, teacher pay is not dependent on or related to those qualities. On average across the country teaching is attracting people who scored low on the SAT or ACT, and over the last half-century there has been a decline in the verbal and mathematical skills of people entering this field.¹⁴ Improving the teaching corps is desirable but difficult and it would take a long time. As we will see below, the teachers we have can do better, but simply paying them more money would not improve the education of our children.

¹¹ See Hedges and Greenwald, “Have Times Changed?” in Burtless; Gary Burtless, “Introduction and Summary,” in Burtless, page 22; and John E. Brandl, Money and Good Intentions Are Not Enough (Brookings Institution Press, 1998), page 32 and references there.

¹² Bryan C. Hassel, “Better Pay for Better Teaching: Making Teacher compensation Pay Off in the Age of Accountability,” Progressive Policy Institute, Washington, May 2002, page 2; and Harold Weglinsky, “How Teaching Matters: Bringing the Classroom Back Into Discussions of Teacher Quality,” Education Testing Service, Princeton, NJ, 2000.

¹³ Dan Goldhaber, et.al., cited in Bryan C. Hassel, “Better Pay for Better Teaching,” Progressive Policy Institute, Washington, DC, May 2002, page 6.

¹⁴ “Good Teaching Matters: How Well-Qualified Teachers Can Close the Gap,” Thinking K-16, a publication of The Education Trust, summer 1998, page 6 and references there; “Teaching at Risk: A Call to Action,” The Teaching Commission, New York, 2004, page 17 and references there; and Sean P. Corcoran, et.al., “Women, the Labor Market, and the Declining Relative Quality of Teachers,” Journal of Policy Analysis and Management, Vol. 23, No. 3, 2004.

On the average, class size is a stronger contributor to student achievement than is teacher pay, if not radically so. (Before consulting the research it is possible to draw some inferences about the power of small classes to generate student achievement. Average class size today in the United States is less than half what it was a century ago and a third lower than fifty years ago.¹⁵ If small classes were a powerful generator of achievement, test scores might not be languishing.) One of the best-designed pieces of education research ever conducted took place in Tennessee in the 1980s and 1990s. Determined to find whether class size does make a difference, policy makers approved random assignment of large numbers of children to different-sized classes, and then measured their progress in the ensuing years. Some students were placed in classes of 15 for the four years K-3, others in classes of 22. By the time the children reached eighth grade those who had been in the smaller classes in their early years were performing better than those who had been in the larger classes. Blacks had gained 5 percentile points and whites 1.5. The black-white gap had been reduced by 15%.¹⁶

This possibility of positively affecting achievement by dramatically reducing class size comes with a caveat. An ambitious attempt to replicate Tennessee's positive results came too little. In the 1990s, citing the Tennessee experiment, California undertook a statewide policy of reducing maximum class size in the early grades from 28 to 20. Eighteen thousand new teachers were hired in the program's first year, 1997; implementation costs have been 1.5 billion additional dollars per year. Some evaluations found small benefits for the children; some found none.¹⁷ Perhaps the sudden hiring of the large number of new teachers brought in people ill prepared or ill suited to the profession and unable to make productive use of the reduced class size. Of course, long-term follow-up needs to be conducted.

Education spending in Minnesota has risen much more rapidly than has the number of children, but with slight consequence. Unless we find a more effective way to use it, a small increase in spending likely would do little or nothing to boost student achievement.¹⁸ If the funding increase were great enough (upwards of \$1000 per affected child each year) to cut class sizes for four years in the early grades by as much as a third, then considerable improvement in achievement, as well as a modest reduction in the black-white achievement gap, might occur, or – think of California – might not. We continue by assessing other education policies in search of more productive ways to spend the education dollar.

¹⁵ Tommy M. Tomlinson, "Class Size and Public Policy: Politics and Panaceas," Educational Policy, September 1989, page 263; and Scandera and Sousa, page 97.

¹⁶ Alan B. Krueger and Diane M. Whitmore, "Would Smaller Classes Help?" in John E. Chubb and Tom Loveless (editors), Bridging the Achievement Gap (Washington, DC: Brookings, 2002), pp. 23,27.

¹⁷ Op.cit., page 22; and Scandera and Sousa, pages 283-285.

¹⁸ "There is no experimental research suggesting that any benefits are realized by subtracting only a few children from a larger class – for example, transitioning from 28 to 25 students," from "Class Size: Counting Students Can Count", Research Points, American Educational Research Association, Fall 2003, page 2.

2. High stakes testing

High-stakes testing means administering achievement tests to students then subjecting them or their teachers or schools to substantial consequences dependent on the results of the tests.¹⁹

In fits and starts the country appears to be moving toward accepting a policy of “accountability” involving testing student achievement then publishing the results. Quotation marks appear in the previous sentence to acknowledge that in many places what has been called an accountability program has contained no significant consequences for the results of the testing. For example, since 1988 the federal government has claimed to require that Title I appropriations (this refers to funding specifically intended to enhance the education of disadvantaged children) are contingent on the states’ producing and implementing achievement standards. After the states failed to do that the first President Bush convened a summit at which governors agreed to do so. Further legislation produced funding to help the states in this regard. After another decade nearly half the states had not developed achievement standards.

Three years ago passage of the federal legislation called No Child Left Behind started to shake things up. NCLB has three components: student achievement goals, measurement of progress toward those goals, and consequences (both positive and negative) for the degree of attainment of the goals. For a variety of reasons many educators greatly disapprove of NCLB and find the funds inadequate for the task. The legislation does have some puzzling features: By 2014 all children are to be proficient in basic subjects. That stipulation is either impossible to meet or contentless depending on what proficiency means. In 1990 the federal government’s National Assessment of Educational Progress found only about one child in eight to be proficient in mathematics. Quickly bringing all youngsters up to a standard recently met only by that few students will not happen. On the other hand if the states determine what proficiency means – as some are doing in a dumbing down way -- accomplishing “proficiency” might be easy. (Colorado has determined that 78% of its children are proficient as they begin implementing NCLB.) Educators also object that the legislation contains sticks and a few carrots for them (children can transfer out of schools that are not meeting their goals, and those schools can lose Title I funds as well as becoming subject to reorganization and takeover) but students do not face consequences.

So, what do we know about whether high stakes testing – i.e., testing with sizeable consequences – can improve student achievement?

Hamline University professor Tracy Williams and several colleagues recently conducted a survey of all the research that has been conducted on whether statewide school accountability programs influence student achievement.²⁰ They found over 1800 articles that at first blush dealt with the subject but only a dozen met their several

¹⁹ We take it as given that high stakes testing should include a measure of progress (such as “value added testing”) as opposed to achievement only, and that results should be readily accessible by the public.

²⁰ Gary W. Ritter, et.al., “Keeping Score: What Do We Know About the Impact of Statewide School Accountability Programs on Student Achievement?” Paper presented at the 2004 Annual Meeting of the Association for Public Policy Analysis and Management, Atlanta, GA, October 30, 2004; see especially , pages 14-16..

reasonable criteria including that a study be statewide and quantitative. Though some of the studies appeared to find no link between accountability programs and student achievement the most careful research did discover such a connection. In states with high stakes testing student achievement increased by a small amount (a 1.6% greater increase in mathematics scores from grade 4 to grade 8 than the increase attained in non-high stakes states).²¹ Minnesota, at the time lacking positive or negative consequences, was not deemed a high-stakes state.

As with reducing class size, a large caveat hangs over this research. It may be that high stakes testing nudges average achievement higher but widens the gaps between some racial groups. One pair of researchers found that the gains of both blacks and Hispanics were greater than those of whites, so that high stakes testing could both be beneficial overall and narrow the racial gaps.²² However other researchers, using a larger body of data, found that gains of Hispanics and whites were greater than those of blacks, so implementation of high stakes testing could have the effect of widening the achievement gap between blacks and whites and between blacks and Hispanics.²³ The conflicting results of the two studies have not been reconciled, though since the second study used a larger data set its findings may be more persuasive.

Some interested observers also have expressed concerns about a phenomenon known as “teaching to the test,” suggesting that a modest increase in test scores may actually be due to a change in teaching methods at the expense of other more comprehensively beneficial methods. It is not clear whether teaching to the test indeed results in either improved scores or a longer-term detrimental change in classroom methods.

Two conclusions emerge: Research has not reached definitive conclusions concerning the effect of high stakes testing on the achievement gap but in any event the achievement gains for all groups are small. If we want our students to do better, and in particular if we want to narrow the achievement gap, other policies in addition to or in place of high stakes testing will have to be implemented.

3. School-based management

"School-based management," "site-based" management," or "school-based budgeting" (collectively referred to here as SBM) has been emerging across the U.S. for two decades in a number of forms. This policy trend is particularly difficult to assess, as SBM has no standard meaning. Indeed, it has taken different forms in every district that has tried it. There is agreement in the literature about at least the following with regard to SBM: it refers to some degree of decentralization of budget control or decision-making from districts to individual schools, teachers, and parents. Such decentralization is extremely rare in this country; most decision-making now occurs in school boards, superintendents' offices and collective bargaining agreements.

²¹ Margaret E. Raymond and Eric A Hanushek, "High Stakes Research," Education Next, Summer 2003, page 53.

²² Martin and Carnoy and Susanna Loeb, "Does External Accountability Affect Student Outcomes? A Cross-State Analysis," Educational Evaluation and Policy Analysis, Winter, 2002.

²³ Eric A Hanushek and Margaret E. Raymond, "The Effect of School Accountability Systems on the Level and Distribution of Student Achievement," Journal of the European Economic Association (forthcoming).

The hypothesis behind SBM is that, if decision-making authority in education is placed with principals, teachers, parents and students, reforms will take place that improve education. The basic premise behind these hopes is that people in schools are better able to discern their own operational needs than is a centralized bureaucracy.

Because SBM is uncommon and varies greatly from application to application, there is little solid knowledge of its efficacy. A survey of 83 empirical studies of SBM found no reliable evidence of its having any effect on students.²⁴

Nevertheless, decentralizing budgetary control might hold promise. It appears that SBM can facilitate a change in school culture and classroom practice – two factors that have been found to be antecedent to improved student achievement.²⁵

Perhaps, also, in order for SBM to have significant effects it must be combined with other reforms. Researchers at the RAND Corporation concluded from their cross-city study of decentralization and deregulation in six urban districts that, for decentralization to work, reforms must include autonomy for schools, assistance with implementation, some form of accountability, and family choice of school.²⁶ They assert that schools should have control over the checkbook, hiring, and firing, parents should have choice of schools, states and districts should not attempt to deliver "one-size-fits-all" training and assistance, and that these efforts should be combined with high-stakes testing.²⁷

We suggest that a potentially powerful aspect of SBM is an enhanced ability by the state to allocate funds more directly to designated populations, and for the state and other interested observers to track where and how funds are spent. In the past in Minnesota, the money trail has been obfuscated by an arrangement under which districts received state funds based on enrollment statistics (which stem, of course, from individual schools), but were then free to spend most of these funds anywhere in the district. This system has resulted in such anomalies as an inverse relationship between a school's poverty level and the amount of money spent at or on behalf of that school (as higher salaried more experienced teachers chose teaching positions in schools with lower poverty levels).²⁸ A well-intended state policy, therefore, can be frustrated at the district level. Notably, in the 2004 Minnesota legislative session a law passed stipulating that henceforth districts must report expenditures on a school-by-school basis.²⁹

²⁴ Kenneth Leithwood and Teresa Menzies, "Forms and Effects of School-Based Management Strategy," *Educational Policy*, May 1998.

²⁵ Briggs and Wohlstetter, "Key Elements of a Successful School-Based Management Strategy," Working Paper, University of Texas at Austin, October 21, 1999." Working Paper, University of Texas at Austin, October 21, 1999.

²⁶ Ziebarth, Todd, "The Changing Landscape of Education Governance," *Education Commission of the States*, January 1999, p. 7.

²⁷ Ibid.

²⁸ Under the current practice in Minnesota, schools with the same number of teaching positions can have vastly different instruction budgets due to teacher education and seniority levels.

²⁹ See House File 1793, and the resulting legislation in Chapter 294 of the 2004 Omnibus K-12 Education Policy Act, Sections 3 and 10 (or summaries available at the Minnesota Department of Education website). In response to this legislation, the Minnesota Department of Education plans to begin posting side-by-side comparisons of revenue

One method, frequently discussed in conjunction with SBM, of delivering control over the checkbook to individual schools, is known as the "weighted student formula" (WSF). The Edmonton, Alberta Public School District uses such a system.³⁰ WSF weighs individual students according to at-risk categories and funds them accordingly. Minnesota considers at-risk categories too, but unlike our system of a haphazard link to actual students, the WSF system has almost all funds following students directly to individual schools. For example, a low-income student with a learning disability would bring more money to an individual school than would a student without these "at-risk" characteristics.

The rationale behind the WSF approach is two-fold: 1) it encourages schools to provide programming for, and indeed compete for, students in at-risk categories, and 2) it funds programming for such students appropriately. Under a combined WSF-SBM system, individual schools make their own decisions regarding staffing levels and experience desired. WSF also affords a degree of enhanced accountability as it provides the state the ability to follow state dollars more directly.

Potential drawbacks of SBM have been identified in Edmonton. Judith Evans warns, based on her interviews with principals and teachers at three schools in that relatively decentralized district, that the SBM reforms may actually be increasing the achievement and opportunity gap (by, for example, encouraging top schools to recruit high achieving students), while also raising the levels of teacher and principal stress.³¹

Any discussion of SBM should also acknowledge challenges associated with a genuine shift in budgetary control to the schools. First, SBM requires a significant commitment from all stakeholders of time, energy, and patience, particularly in the implementation phases. As principals and teachers take on additional responsibilities with SBM, enhanced support and training may be needed. SBM is often discussed in the context of doing more with less, so it is important to note that schools might not become accustomed to new roles immediately. The adjustment could very well require additional funds. Second, under genuine SBM, schools may show very different results (and unequal opportunities) as management styles and demographic factors differ among schools. Equity concerns are therefore likely to arise in SBM districts. Third, some observers have expressed concerns about a role shift for principals from education facilitator and educator to manager and marketer.³² Finally, SBM does not mean that schools should operate entirely as islands. Obstacles exist at the state and district levels

generation and expenditures on a school-by-school basis by July 2005. Salary expenditures reported by building must reflect actual salaries for staff at the building and must not be based on district wide averages.

³⁰ Houston, Seattle, Edmonton, Cincinnati, San Francisco currently use WSF to some degree. See "School-Based Budgeting," Cross City Campaign for urban School Reform," at http://www.crosscity.org/advocacy_action/advocacy_budget_weight.html.

³¹ Evans, Judith, "Organizational and Individual Responses to Educational Reforms in Alberta," Paper presented at the Graduate Students Research Conference in Edmonton, Alberta, on March 14, 1997.

³² See, e.g., Robenstine, Clark, "School Choice and Administrators: Will Principals Become Marketers?" The Clearing House, November/December 2000. (Robenstine fears that, with SBM schools competing to increase enrollment and resources, the focus of schools could shift from comprehensive values such as innovation, community, and creativity towards market-based values, with principals becoming increasingly concerned about "self-preservation, surface appearance, and image.")

that affect the ability of schools to make decisions, even if schools have control over the operating budget. State laws (such as the hiring and firing requirement of “last in-first out”) and contract terms that grant assignment preferences to more senior teachers reduce a school’s ability to manage itself. Without the removal of such barriers, schools in Minnesota cannot be said to be conducting genuine SBM, nor can they be held solely responsible for results.

At this time it cannot be said that SBM by itself has been shown to have significant effects on student achievement. Yet, recent evidence from Edmonton and from a study comparing student achievement across 41 countries – to the embarrassment of the United States – indicates potential not for the timid form of SBM practiced here and there in Minnesota now, but for an authentic version that delegates almost all decision making to the school level.³³ SBM has promise but only if it is real and, as well, probably only if it is combined with student choice, transparency of funding, alleviation of outside obstacles, and some form of accountability such as high stakes testing.

4. Full-Day Kindergarten*

Minnesota is one of a shrinking minority of states that does not fund full-day every day kindergarten (FDK). Nineteen states including Minnesota allocate less money for kindergarten than for first grade and provide no additional state aid for full-day kindergarten beyond what is already offered for half-day programs.³⁴ At least 27 states³⁵ fund kindergarten at a dollar amount equal to or greater than first grade, and seven of those provide more aid for full day than for half-day kindergarten.³⁶

Despite Minnesota’s lack of statewide FDK funding, about one-fourth of Minnesota’s kindergartners are currently enrolled in FDK programs. Some of the funding for these kindergartners comes from the state through the First Grade Preparedness Program, which consists of an annual appropriation of \$7.5 million.³⁷ Districts wishing to offer FDK beyond the small amount funded by FGPP typically finance the effort using compensatory aid or their own district funds.

In 1997, a meta-analysis (a mathematical aggregation of the results of many individual studies) performed on 23 separate FDK studies found that, overall, students who attended full-day kindergarten manifested significantly greater achievement than did students who attended half-day kindergarten.³⁸ The study found a very large FDK effect

³³See William G. Ouchi, Making Schools Work: A Revolutionary Plan to Get Your Children the Education They Need (New York: Simon and Schuster, 2003), chapter 2; and Learning for Tomorrow’s World: PISA 2003, Organization for European Cooperation and Development, Paris, 2004, pages 233-240. [PISA is the OECD’s Program for International Students Assessment.]

* Pre-kindergarten child development is considered in chapter 4 of this volume.

³⁴“How States Fund Full-Day kindergarten,” Education Commission of the States, August 2004, at <http://www.ecs.org/clearinghouse/52/30/5230.htm>.

³⁵ It is likely more than 27, as some states do not use a comparable pupil weighting formula.

³⁶ How States Fund Full-Day Kindergarten,” Education Commission of the States, August 2004, at <http://www.ecs.org/clearinghouse/52/30/5230.htm>.

³⁷ Full funding of FDK in Minnesota has been anticipated to increase the cost to the state of educating kindergartners by about \$160 million. See Senate File 2035, introduced at the 2004 Legislative Session.

³⁸ Fusaro, Joseph A., “The Effects of Full-Day Kindergarten on Student Achievement: A Meta-Analysis”, University of Scranton. Child Study Journal, Volume 27, No. 4, 1997.

– about 25 percentile points.³⁹ This corroborates the general agreement among experts that students in full-day programs show significantly stronger academic gains over the course of the school year than their half-day counterparts.⁴⁰ A few interesting specific findings of other studies are detailed below.

A 2004 study found a positive effect for FDK programs over half-day: a difference in the reading gain scores of about 11 percentile points.⁴¹ It also found that black children in FDK classes with a reading aide make greater reading gains than do black children in FDK without an aide.⁴² However, white children's gains were greater than those of blacks so FDK had the effect of widening the achievement gap.⁴³ The study also found similar FDK benefits in mathematics. Children in full-day programs gained about 7 percentile points in mathematics more than children in half-day programs. Again black children's gains were smaller than those of whites.⁴⁴

If FDK has academic benefits in the short term, does it have valuable staying power? The literature on this question is, of course, less clear and more difficult to come by. The research generally shows academic benefits extending at least through first grade. The evidence beyond first grade is murkier. Some studies have shown evidence that academic achievement benefits in both reading and math extend to the third and even eighth grades for FDK participants.⁴⁵ One 8-year longitudinal study found higher reading and math achievement still evident at the ends of grades four and eight as compared with control groups.⁴⁶

Some studies (with mixed results) have also suggested that FDK is associated with reduced grade retention (holding students back) and special education referrals.⁴⁷ Both lower special education referrals and lower grade retention levels for students appear to be associated with FDK programs.⁴⁸ In eighth grade, 5% of students who had been in full-day programs had been referred to special education and 9% had been subject to grade retention.⁴⁹ The corresponding figures for half-day participants were 11% and

³⁹ Ibid.

⁴⁰ "Full-day Kindergarten Programs Improve Chances of Academic Success," Education Commission of the States, *The Progress of Education Reform 2004*, Vol. 5, No. 4, September 2004. See also Plucker, Jonathan, et al., "The Effects of Full Day Versus Half Day Kindergarten: Review and Analysis of National and Indiana Data," Center for Evaluation and Public Policy, January 9, 2004, page i.

⁴¹ J.T. Watson and J. West, "Full-day and Half-day Kindergarten in the United States: Findings from the Early Childhood Longitudinal Study, Kindergarten Class of 1998-99," NCEES 2004-078, National Center for Educational Statistics, U.S. Department of Education, Washington, DC, 2004, page 47.

⁴² Loc.cit.

⁴³ Op.cit., page 48.

⁴⁴ Op.cit., page 49. The authors note, "given the non-experimental, pretest-posttest design of the study, there is no way to determine if the samples were equivalent in all important ways at the beginning of the kindergarten year. This is a research design limitation which makes it impossible to draw causal conclusions from the data," page 46.

⁴⁵ Jonathan Plucker, et.al., "The Effects of Full Day Versus Half Day Kindergarten: Review and Analysis of National Indiana Data," Center for Evaluation and Public Policy, January 9, 2004, and citations there.

⁴⁶ Ibid.

⁴⁷ Op.cit., page 5.

⁴⁸ Ibid.

⁴⁹ Ibid.

12% respectively.⁵⁰ FDK may also have its greatest impact for students in “at-risk” categories. An earlier assessment of the US Department of Education’s Early Childhood Longitudinal Study (discussed above), found greater academic gains for at-risk students in FDK.⁵¹

Should Minnesota fund full-day kindergarten on a statewide basis? The research suggests that FDK has benefits over half-day programs, which include: enhanced academic achievement, reduced grade retention and special education referrals, and positive social and behavioral effects.⁵² Most (but not all) of the research shows statistically significant benefits of FDK over half-day kindergarten in these areas. To our knowledge, no studies have shown negative effects of FDK, though FDK for all could well widen the achievement gap. Of course, both the benefits and the costs of FDK need to be compared with those of other potential enhancements to education.

5. Choice

In the past the most controversial policy proposal has been choice – permitting families to choose the schools their children attend. We will first discuss choice from among public schools then turn to what research tells us about the effects of opening government funded choice to private schools.

Public School Choice

Caroline Hoxby has conducted the most sophisticated studies of public school choice. An economist, she expects competition to improve efficiency and that is what she believes happens in schools. Comparing U.S. metropolitan areas, and statistically adjusting for differences in income, race and other potentially confounding variables, she found student test scores higher in those areas that permit the most choice than in those that do not permit any. For example, eighth grade reading scores were 3.8 percentile points higher, tenth grade mathematics scores 3.1 points higher, and twelfth grade reading scores 5.8 points higher. Interestingly, she calculated that on average the competitive, higher performing districts spent 7.6% less per child.⁵³ These results underline the importance of genuine SBM. Were schools to have more authority, presumably more variation in curriculum, pedagogy, and school culture would come about. This could enhance the power of choice.

Not everybody is convinced. Hoxby’s most spirited critic is the equally distinguished economist Helen Ladd, who believes that turning education over to the market is potentially damaging to children. She makes two arguments: 1) Since education is compulsory, and successful schools do not have the incentives to expand that successful firms have, those students left behind in poor schools would do worse when their luckier peers get into better schools. 2) Many parents would want to move their children to schools in which the socioeconomic status of the families is higher than in

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² Ibid.

⁵³ Hoxby, “Rising Tide,” *Education Next*, Winter 2001. See also, Hoxby, “School Choice and School Competition: Evidence from the United States,” *Swedish Economic Policy Review*, 2002.

their current schools. This would result in a “hierarchy of schools” that, again, would be detrimental to those left behind.⁵⁴ Hoxby’s rejoinder is two-fold: 1) The current education system has long since effectively abandoned the most disadvantaged children, trapping them in schools that are not enabling them to catch up with their privileged contemporaries. 2) In any event, says Hoxby, competition is so powerful that it particularly benefits those schools from which some children move. She gives examples of several cities where those disadvantaged children who stayed in schools newly subject to competition achieved at higher levels than previously.⁵⁵ In the end, Ladd seems to concede that at the current levels of competition Hoxby’s argument might have some merit but may nevertheless be of slight value since it describes only the effects of the quite limited competition now existing in American public education: “[W]hile Hoxby’s description of the basic patterns to date may well be valid, they tell us little about the extent of sorting or of cream-skimming [that is, movement by poor schools’ best students into other schools] that is likely to arise in a larger or less restrictive choice program.”⁵⁶ Hoxby would reply that broadening competition would enhance its effectiveness, and she would again refer the reader to her points 1) and 2) above.

Minnesota was the leader among the states in bringing choice to education. Open enrollment, post-secondary options, and charter schools were all invented here. It appears that encouraging use of these programs would be advantageous for the young people of the state.

Private School Choice

As recently as three years ago it appeared that a consensus was quickly developing among researchers that students would benefit from extending choice to private, including religious, schools. Indeed, in 2001, political scientist Jay Greene wrote an article entitled “The Surprising Consensus on School Choice.” There he described the ten most recent studies of the subject as “consistently reveal[ing] positive benefits from school choice.”⁵⁷ Two factors bolstered his conclusion: one methodological, the other a (to some people) surprising finding of the research. The methodological development was the use of random assignment of students to a program. The program granted privately funded vouchers to low-income applicants in several cities. Previously many had attributed findings that students in private schools often perform better than those in public schools to what statisticians call “selection bias” -- the notion that not the treatment, that is the school attended, but some other systematic difference between two groups, might explain differences in results. In the case of schooling the supposed selection bias was that private – in particular, religious -- school students and their parents might be more highly motivated, or in other relevant ways, privileged, than their public school counterparts. This, then, not the private school experience, was thought to explain the difference in achievement often found. Greene, and before him, Paul Peterson, the national leader in this type of research, reported on instances where such

⁵⁴ Ladd, “Comment on Caroline M. Hoxby, ‘School Choice and School Competition: Evidence for the United States,’” Swedish Economic Policy Review, 2002, pages 68-70.

⁵⁵ Hoxby, “Rising Tide.”

⁵⁶ Ladd, *op.cit.*, page 72.

⁵⁷ Greene, The Public Interest, Summer 2001, page 20.

large numbers of children had applied for privately funded vouchers that recipients could be chosen by lot.⁵⁸ This meant that there would be no appreciable differences between the two groups except the schools they attended. Those chosen and those not were tested by Peterson and his colleagues for several years. The research seemed to show not only that families were much more satisfied with schools they chose but also that some groups in the chosen schools performed better than their counterparts who remained in public schools. The latter finding presumably could not be attributed to selection bias.

The surprising research result responded to another persistent concern many people have had about vouchers, namely that they might facilitate segregation and concomitant erosion of such civic values as tolerance and public-spiritedness. Some recent research is showing the contrary. Not only are private schools (almost all of which are religious) better integrated by race than are public schools, but also children attending private schools are more apt to tolerate anti-religious activities, more willing to favor members of their “least-liked group” being permitted to participate in public life, more engaged in volunteer work, and more inclined to speak and write on public issues. Some have found them to be more likely to have friends of another race but Peterson found no significant difference between public and private school students in this regard. Greene concludes as follows: “[W]hile promoting democratic principles is a central mission of public schools, there is virtually no evidence to support the claim that government control of schools is necessary to achieve this goal.”⁵⁹

So an impressive recent series of research projects has largely resolved some of the major issues surrounding private school choice: disadvantaged students who choose private alternatives achieve at least as well in academic subjects; children appear to acquire stronger civic virtues; parents are overwhelmingly pleased; and the cost -- not tuition but full cost -- of the religious schools that are usually chosen is on the order of half the cost of public schools.⁶⁰

Still, the consensus that Jay Greene thought he saw is not complete. Several reservations exist and must be considered. The first is an arcane but important statistical argument having to do with the methodology of the researchers who studied the privately funded vouchers. One pair of critics has noted that using different definitions of what constitutes a black child, and including in their calculations some children to whom baseline tests had not been administered, can cause the disappearance of the calculated

⁵⁸ See Howell and Peterson.

⁵⁹ Greene, page 30; See also, Greene, “Civic Values in Public and Private Schools,” in Paul E. Peterson and Bryan C. Hassel (editors), *Learning from School Choice* (Washington, DC: Brookings Institution Press, 1998), pages 93-98; and Howell and Peterson, chapter 5.

⁶⁰ See Michael Garet, et.al., “The Determinants of Per-Pupil Expenditures in Private Elementary and Secondary Schools: An Exploratory Analysis,” NCES Working Paper 97-07, U.S. Department of Education, National Center for Education Statistics, March 1997, table 3, where public school costs in the United States are estimated to be slightly less than double private school costs. See also Howell and Peterson, pages 91-99. Their estimates compare public and Catholic schools in New York City. (The vast majority of private schools are Catholic.) They removed from the public schools’ costs all funds for transportation, special education and school lunches, and much of the expenditure for central administration. With those costs (which sum to 40% of the public school total) excluded from consideration, the remaining public school costs were just over twice those of the Catholic schools.

positive effect that school choice has on black children.⁶¹ This is defensible if questionable research procedure; another set of calculations, published in the country's leading statistics journal, found results similar to the original ones.⁶² This argument matters because the original research found an achievement increase of 6.6 percentile points for low-income black children after three years in religious schools, compared with students who sought but did not get that choice.⁶³ That is a greater increase than is associated with any of the other policy options reported here with the exception of full day kindergarten and, perhaps, large class size reductions.

Another reservation is that though some research over the years has claimed to find lasting beneficial achievement effects of religious schools, the well-designed research has taken place only in the past few years. Effects on students will have to be measured over time.

A third lingering question concerns the puzzling fact that the original research on school choice using randomized assignment found benefits from choice only among black children; no other groups achieved at higher levels in the choice schools. This could seem so odd as to put in question the whole study. A possible explanation is the following: perhaps the main reason for the efficacy of religious schools lies not in their being engaged in competition but with their constituting nurturing communities. All of the children in the voucher studies reported on in this section were disadvantaged, but maybe poor inner city blacks on average are more disadvantaged than others in the sense of frequently lacking sufficient family and neighborhood support to thrive academically. The enclave formed by a religious community in the midst of an impoverished and dangerous neighborhood might provide sustenance that, though possible, is rare in public schools. James Coleman and Thomas Hoffer surmised this twenty years ago and believed they had measured such an effect, but the hypothesis requires further study.⁶⁴

The research on school choice is turning what had appeared to be an intractable ideological and partisan dispute into a discussion over research methods and results. Under what conditions do disadvantaged children learn best? Can non-governmental schools accomplish some public purposes (fostering academic achievement, promoting civic values) better than public schools? Can beneficial effects of choice (nurturance of disadvantaged youngsters, responsiveness of public institutions) be achieved while preventing deleterious effects (creaming, resegregation)? Contemporary research is offering encouraging answers to those questions.

⁶¹ Alan Krueger and Pei Zhu, "Another Look at the New York City Voucher Experiment," IZA Discussion Paper No. 663, Institute for the Study of Labor, Bonn, Germany, December 2002.

⁶² John Barnard, et al., "Principal Stratification Approach to Broken Randomized Experiments: A Case Study of School Choice Vouchers in New York City," "Comment," and "Rejoinder," Journal of the American Statistical Association, June 2003. The Comment and Rejoinder are part of an exchange with Alan Krueger and Pei Zhu, the main critics of the research showing substantial benefits for black students in chosen private schools. See also, Paul E. Peterson and William G. Howell, "Voucher Research Controversy," Education Next, Spring 2004.

⁶³ Howell and Peterson, page 146.

⁶⁴ Public and Private High Schools: The Impact of Communities (New York: Basic books, 1987); see also John E. Brandl, Money and Good Intentions Are Not Enough (Washington, DC: Brookings Institution Press, 1998), chapter 6.

Conclusion

Here is what we know about education policy:

*Family and home factors are far and away the most important determinants of academic achievement.

*It is very difficult for schooling to overcome disadvantages of background.

*In general only a weak relationship has existed between increases in spending on education and results achieved. In particular, under the salary arrangements currently in place in Minnesota, there is little relationship between teacher pay (the largest component of education expenditure) and student outcomes.

**Quality* of education, as measured by levels of literacy and numeracy, influences long-term economic prospects much more strongly than does *quantity* of education as measured by years of schooling.⁶⁵

*Some promising policies are costly, others not.

*There is increasing but disputed evidence that private school choice can improve the achievement of disadvantaged blacks by over 6 percentile points in three years. In any event, on average, given private school choice, disadvantaged children's achievement is no worse than in public school, they have a slight advantage in their acquisition of civic virtues, and their parents are highly satisfied with the education their children are receiving. This is accomplished at about half the cost of the public schools.

*A few other means of improving academic achievement in public schools exist. They can increase average student performance by 1-11 percentile points or more over a period of several years.⁶⁶ The less effective, such as high-stakes testing, are not very costly. The more effective, such as much smaller class size and full day kindergarten, cost upwards of \$1000 per child per year. (Alan Krueger, the toughest critic of the research showing gains for low income voucher recipients states: "When comparable samples are considered, black students who attended a small class for two years in the [Tennessee] experiment improved their test performance by around 50 percent more than

⁶⁵ Serge Coulombe, et.al., "Literacy Scores, Human Capital and Growth Across fourteen OECD Countries," Statistics Canada, Human Resources and Skills Development Canada, Ottawa, 2004.

⁶⁶ There is a drawback to expressing achievement increases in percentile points as has been done throughout this paper. (In some cases for purposes of comparison we have transformed other measures, such as changes in percentages of standard deviations, into percentiles.) By definition, the student with the average score, the median student, is at the 50th percentile. If every student in the state were to make great gains the average percentile score would rise not at all. The percentile scores presented here should be understood not as measures of absolute gain but as rough relative gauges of the differences in the efficacy of the several policies. The policies discussed in this chapter are not insignificant in their effects, but also none of them can be expected to yield huge gains in achievement. What the percentile figures show is that the policies differ considerably in their relative efficacy. They also differ considerably in their cost.

the gain experienced by black students who attended a private school as a result of receiving a voucher ...” He did not report the costs of the two policies.⁶⁷)

*Several promising policy options are now being tested. These include charter schools, smaller schools, and teacher ownership of their professional practice (as against teachers being employees as at present). Some of these options are backed by strong theory. Early evaluation research is heartening, but not yet conclusive. These policies are all the more promising because they are complementary to each other and to another low cost policy, choice.

* Merely spending more money cannot be the core of a state policy to improve education, and no one policy change by itself will bring about dramatic academic achievement increases, particularly for disadvantaged children. The most cost-effective way to accomplish education quality appears to be a combination of public and private school choice; this approach offers some benefits and lower costs compared with the status quo. Coupling teacher pay to outcomes or to teacher qualities that are associated with improved outcomes could be superior to the present system of payment linked almost not at all to whether students benefit. School-based management and high stakes testing are inexpensive and complementary to choice but only marginally beneficial. Full day kindergarten potentially has larger effects than choice though whether those effects persist is not clear, and this policy costs upwards of \$1000 per child. Slight decreases in class size have no effect. A policy of large decreases in class size over several years is much more costly than full day kindergarten for roughly comparable results. Minnesota might wish to implement several of the options discussed here. In any event, it is difficult to justify increases in expenditures unless they are accompanied by reforms that can be expected to give us better student outcomes for our money.

⁶⁷ Krueger and Diane M. Whitmore, “Would Smaller Classes Help?” in Chubb and Loveless, page 37

Chapter 3

Health Care Expenditures in the State Budget¹

Bryan Dowd

I. Introduction

Minnesota is known as a leader in the health care industry – the home of Walter McClure and Paul Elwood, early leaders in development of health maintenance organizations; innovative public health insurance programs that have resulted in one of the lowest rates of uninsured persons in the country; and national leadership in public health and the managed care and biotechnology industries. Minnesota also routinely is rated as one of the healthiest states in the nation (United Health Foundation, 2004), and analyses of Medicare costs show it to be among the lowest cost areas of the country (CMS, 2004a).²

Despite these accomplishments, however, growth in the health care portion of the state budget is beginning to force difficult decisions regarding not only state expenditures on health, but also on other public programs. Minnesota is no different from other states in this regard, though our policies may make us more vulnerable to rising costs than other states. Hopefully, however, Minnesota can demonstrate the same innovative leadership in dealing with these public budgeting problems that it has shown in other areas of health care.

This chapter will consider first, in Part II, the goals of health care policy. Part III takes up the several areas of the state's budget in which expenditures on health care arise. Part IV goes beyond the state's programs to discuss health system-wide factors that drive up costs. Part V is a conclusion with a summary of main findings and recommendations.

II. The goal: Increased efficiency and fairness

Frequently, discussion of health policy is couched in the language of “cost containment,” but people who use that term rarely mean what they say. For example, it would be unusual to hear anyone say that they wanted to reduce spending on health care services if doing so reduced the general level of health of the American public. The term “cost containment,” often means “reduce cost, but hold virtually everything else constant.” That goal is unattainable. Properly stated, the first goal of health care reform is not cost-containment, per se, but increased economy efficiency.

What does efficiency mean with respect to the health care sector? There are several different kinds of efficiency. Producing more health in patients for each visit they

¹ The views expressed in this section are solely those of the author and do not represent official views of the Division of Health Services Research, School of Public Health, University of Minnesota or Minnesota State Government.

² The same was true of insurance costs for the under-65 population in the past, although more recent data suggest that Minnesota's advantage for that age group is deteriorating.

make to a doctor's office or hospital is an example of technical efficiency. Producing any given level of health at lower cost or producing more health for the same cost is an example of economic efficiency. Increasing an individual's level of happiness by substituting a different package of health insurance benefits versus other types of compensation would be an example of improved efficiency in consumption.

Efficiency (of all types) is a characteristic of perfectly competitive markets, and thus economists often attribute inefficient outcomes to one type of market failure or another.³ The economist's prescription for efficiency generally involves identifying and eliminating a source of market failure.

Efficiency, as a concept, can be applied fairly easily to private insurance programs, but public policy decisions, especially those regarding public insurance programs for the poor, must address a second criterion – fairness, sometimes referred to as equity.⁴ Equal payment of taxes by people with the same taxable income would be an example of *horizontal* equity, while a progressive income tax schedule would be an example of *vertical* equity. This distinction between efficiency and fairness constitutes one of the most important contributions of economics to the analysis of public policy.

Although there might appear to be a conflict between efficiency and fairness, particularly in public health insurance programs, that is not how economists view the problem. Economists require that efficiency improvements meet a criterion known as Pareto efficiency. Improvements in efficiency, according to the economist's definition, make at least one person better off, while making no one worse off. All of the efficiency improvements discussed above meet that criteria. Increased efficiency, as economists use the term, thus has no opponents.

Other changes make some people better off while making other people worse off. Those are changes in the *distribution* of resources, not efficiency improvements, per se, and are an important way in which we pursue the goal of fairness. Thus, tightening the eligibility criteria for Medical Assistance (Medicaid), for example, would not necessarily represent an improvement in efficiency, even if it saved taxpayers money, if people who lose eligibility for Medicaid are made worse off. However, if taxpayers could compensate people who lost their Medicaid eligibility and still have something left over, then we would have an example of improved efficiency.

³ Market failure can be due to causes that are intrinsic to the commodity and intractable, such as a pure public good or monopolies resulting from decreasing marginal cost industries. Economists define pure public goods as commodities with two characteristics: (1) one person's consumption does not affect the consumption possibilities of other consumers, and (2) once the commodity is provided, no one can be excluded from consuming it. National defense against incoming ballistic missiles is the textbook example. A decreasing marginal cost industry is one in which the cost of producing each additional unit of output decreases as the volume of output increases. The production of electrical power is a frequently cited example. Market failure also can arise from market conditions that can be corrected, such as poor information, distorted prices and restricted market entry or spillover costs or benefits. The reduction in the exposure to contagious disease that one consumer enjoys by virtue of another consumer's immunization is an example of a spillover benefit.

⁴ Fairness matters in private insurance programs, as well, and in ways that affects expenditures under public insurance programs.

III. Health care costs in the State budget

Health care costs in the state budget can be divided into two broad categories: *direct* expenditures on health insurance and health care services and *indirect* expenditures on activities such as enforcement of regulations and health-related activities and health promotion activities.

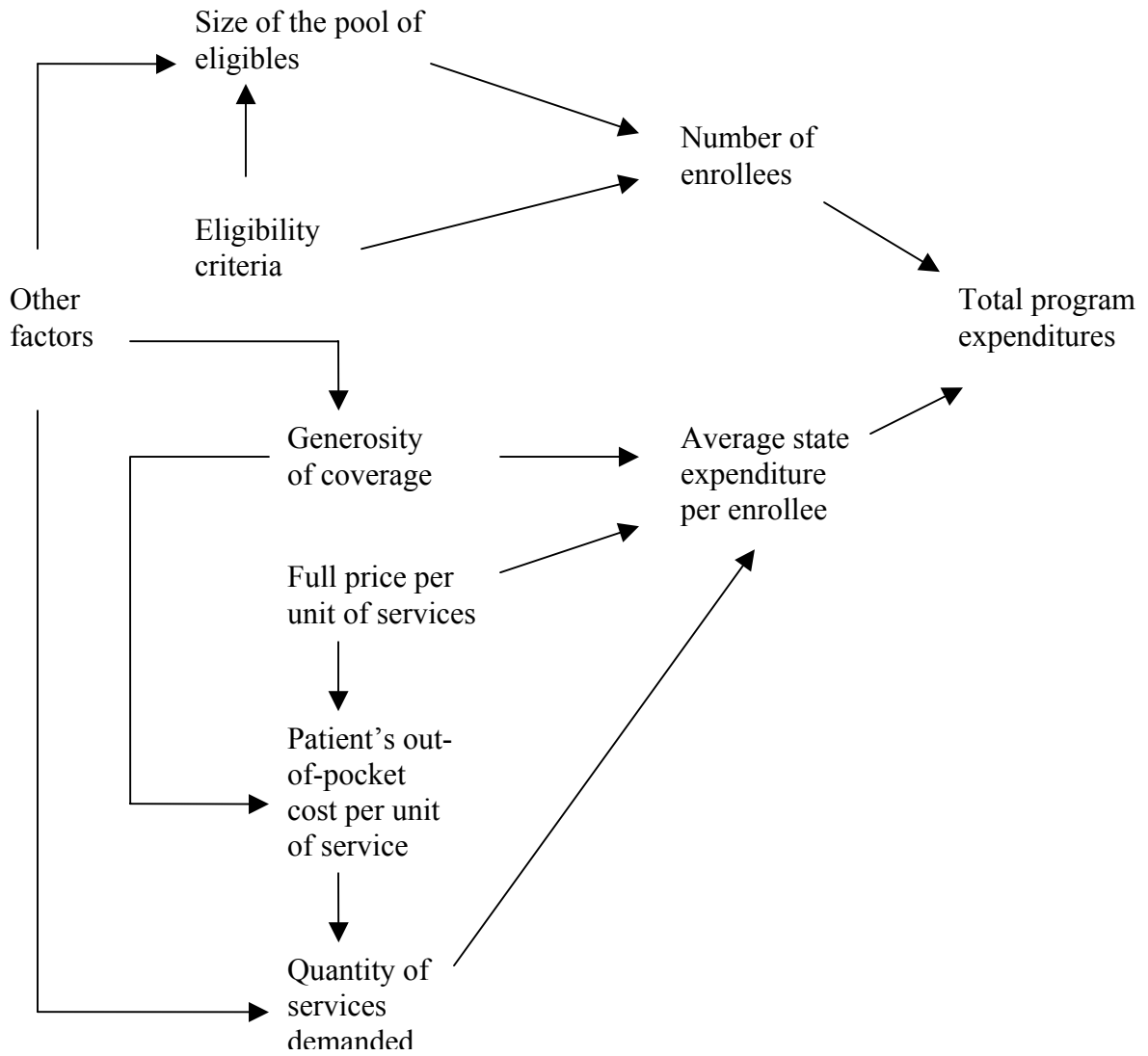
The largest and most transparent *direct* effects of health care costs on State expenditures are the budgets for the Department of Health and the Department of Human Services. A second significant direct effect is the cost of State employee's health insurance. A third is MinnesotaCare, a subsidized health insurance program for low income people who do not qualify for Medicaid. These three subjects are discussed in sections A, B, and C respectively below. In each case indirect costs are also considered.

The simplest way to think about these direct expenditure programs of the state is as health insurance programs. In other words, the State enrolls people in health insurance programs (e.g., Medical Assistance, MinnesotaCare, private health plans) and then pays all or part of the premium. In some cases such as MinnesotaCare and private health plans, the premium is explicit and visible. In other cases, such as Medical Assistance, the premium is implicit and amounts to the average cost of the program per beneficiary.

The determinants of program costs in each of the three program areas discussed in this part are summarized in Figure 1. A program's eligibility criteria determine what types of people can enroll in the program. The size of the eligible population can fluctuate independently of the eligibility criteria. Taken together, these two factors determine the number of people that actually enroll in the program. The generosity of benefits affects both demand for health care services and the proportion of health care costs that will be paid by the insurance policy or program versus paid out-of-pocket by enrollees. Economists refer to the former effect of insurance as "moral hazard." Expenditures for covered services, in turn, are made up of two components: the price per unit of service, and the number of services consumed. These variables affect the efficiency and fairness of the State's health insurance programs.

The variables labeled "other factors" are an important part of Figure 1. The factors vary, depending on the program. They are not necessarily the same for State employee's health insurance as for long-term care under the Medical Assistance Program. These factors often are beyond the traditional control mechanisms available to state government, but nonetheless play an important role in determining the cost of state-run health insurance programs. Governor Pawlenty's Health Care Cabinet has recognized the importance of these factors and the associated implication that solutions to some of the State's health care budget problems may require system-wide reforms. (Governor's Office, 2004).

Figure 1: Determinants of Expenditures under State Health Insurance Programs



The Department of Health and Department of Human Services

Health care expenditures by the Department of Health and the Department of Human Services account for approximately 24 percent of the state’s total budget, and about 87 percent of the budget of health and human services (Figure 2). The majority of the Department of Human Services budget (77 percent) is the Medical Assistance program and General Assistance Medical Care. The majority of the Medical Assistance program budget goes to the elderly and disabled (77 percent), and the majority of the expenditures on the elderly and disabled goes to long-term care (62 percent).

In 2000, 46 percent of all Medical Assistance expenditures went to skilled nursing facilities. In fact, almost one out of every ten health care dollars spent by all public and private sources in Minnesota in 2000 was a Medical Assistance dollar spent on care in skilled nursing facilities (Minnesota Department of Health, 2003). That number is largely unchanged over the past ten years.

Figure 1 illustrates the difficulty of altering the state's financial obligation for health care services in the Medical Assistance program. Minnesota was a forerunner in the use of managed care for its Medical Assistance population, and thus far appears to have avoided some of the problems that have beset other states such as Tennessee. As in any insurance program, there undoubtedly are unexploited opportunities for greater efficiency in unit prices and the number of services consumed per beneficiary, but many Medical Assistance beneficiaries are enrolled in plans that have a financial incentive to make such substitutions.

The most expensive services in the Medical Assistance program are long-term care services. A subset of long-term care services, nursing home services, are regulated to some degree by the state. Two policy aspects of long-term care services are particularly important: rate equalization between Medical Assistance and private payers and efforts to substitute community-based long-term care services for nursing home services.

1. Regulating nursing home prices and the supply of beds

Minnesota is one of a handful of states that requires nursing homes to charge the same rates to Medical Assistance and private pay patients. This requirement is motivated by a concern that allowing nursing homes to charge higher rates for private patients will result in discrimination against, and limited access for, Medical Assistance patients. Harrington Meyer (2001) found that in states with a larger differential between Medicaid and private rates, nursing home patients were less likely to be Medicaid patients.⁵ A proposal to eliminate rate equalization in the 2003 Minnesota legislative session was opposed by AARP (AARP Minnesota, 2003).

The Medical Assistance program adds a large number of consumers to the nursing home market whose demand is not affected by the price of care (once they qualify for Medical Assistance), though it may be affected by other factors, such as the desire not to be in a nursing home. The result is to shift the market-wide demand curve outward and, assuming that the market-wide marginal cost of providing care increases with volume, the market equilibrium price of care will rise.

⁵ Harrington Meyer's result must be interpreted cautiously. Despite her claim that nursing homes were less likely to admit Medicaid patients when private payment rates were high relative to Medicaid rates, what she actually showed was that nursing home patients were less likely to *be* Medicaid patients in states with high payment differentials. She acknowledges her inability to control for income and assets in her study. Her results could be due, in part, to omitted variables that are correlated with the rate differential and the proportion of nursing home residents that are on Medicaid in a state.

It is difficult to predict what would happen if the price of private care were allowed to “float” independently of the price paid for Medical Assistance patients. One difficulty is knowing what would need to happen to the Medical Assistance price under that scenario. Because the demand for Medical Assistance care is not sensitive to price, that price must be regulated to a degree. Currently, rate equalization provides one form of regulation, but if the private price could float, another more formal type of regulation would need to be substituted. Under normal circumstances, one would expect a floating private rate to result in an expansion in the number of nursing home services provided to private patients, whether the private rate went up or down relative to the Medical Assistance rate. A higher private price also might result in greater demand for Medical Assistance care if it caused nursing home residents to spend down their assets at a faster rate. The odd situation under spend-down is that demand for Medical Assistance days in nursing homes, though insensitive to the Medical Assistance price, *is* sensitive to the private price.

However, “normal circumstances” may not apply to the Minnesota nursing home market because in addition to the pricing constraints imposed on the Minnesota nursing home market, there also is a moratorium on additional licensed beds. If nursing homes were operating at full capacity, then allowing the private price to float could reduce the nursing home’s ability to admit as many Medical Assistance patients as they would like. This result must be stated carefully. It could be the case that nursing homes were both willing and able to admit more Medical Assistance patients, but were prevented from doing so under the bed moratorium.

If the moratorium on beds was lifted at the same time that private prices were allowed to float, then there could be a significant expansion of services to private patients. There could be no change in public expenditures or an increase, if a higher private price resulted in quicker spend-down. Thus, it is not clear that either allowing the private price to float or lifting the moratorium on beds would significantly reduce public expenditures for nursing home services.

Substituting Community-Based Long-Term Care Services For Nursing Home Services

A second approach to reducing public expenditures on nursing home services would be to encourage the use of substitutes for nursing home services, e.g., community-based long-term care services. A large number of programs and demonstration projects have attempted to encourage such substitution. The model with the strongest incentives for cost-effective substitution is the Program of All-inclusive Care for the Elderly, or PACE program (Rudolph and Lubitz, 1999). Payments under the PACE program cover all primary, acute, and long-term care services, including adult daycare and home care. In November, 1998, there were fifteen PACE sites in ten states, not including Minnesota, with a total of 4,226 beneficiaries.

Early evaluation results from the PACE program were somewhat encouraging (Chatterji, et al., 1998). Relative to a comparison group, PACE enrollees were more

likely to use adult daycare services and less likely to have a nurse visit in their home. PACE enrollees also had fewer hospitalizations and inpatient days than the comparison group. PACE enrollees spent only 6.5 nights in a nursing home during the first six months of the evaluation period, relative to 22.7 for the comparison group. The same numbers for the second six months were 15 and 38 nights, respectively. These differences were statistically significant at the one percent level. In months 13 through 24, however, the differences in nursing home utilization began to converge, and no longer were statistically significant.

The difficulties of substituting community-based long-term care services for nursing home services were summarized by Weissert (1985). An important problem is that the substitute services and health assessments also are expensive, and need to be targeted only to the individuals who truly are “on the margin” for requiring nursing home admissions. When we look for people on the margin, we inevitably find additional people who qualify for the intervention or who need services – not a bad thing, but not cost reducing either. The problem of calculating a capitation rate that accurately reflects the beneficiary’s expected expenditures also has proved challenging (Temkin-Greener, Meiners and Gruenberg, 2001).

Research continues on these aspects of long-term care, and undoubtedly will produce better systems and some savings to the Medical Assistance program. However, they may not address the most important factor influencing Medical Assistance expenditures on long-term care services.

2. The nature of demand for Medical Assistance among the elderly

Public expenditures on skilled nursing facilities in Minnesota are more than double the level of private expenditures, and 87 percent of the public expenditures are Medical Assistance expenditures (Minnesota Department of Health, 2003). The high proportion of expenditures on nursing home services accounted for by Medical Assistance in Minnesota is noteworthy in view of the fact that Minnesota has the fifth highest median family income in the U.S. (U.S. Census Bureau, 2004a). Serious discussions of increased efficiency in the Medical Assistance program cannot avoid the question, “Why do the elderly in one of the richest states in the nation have such a significant need for public assistance with nursing home expenditures, and what could be done to reduce that need?”

One approach to reducing the need for public assistance is to encourage the purchase of private long-term care insurance. The task is formidable because long-term care insurance has proven to be a challenge for the private market. In December 2003, *Consumer Reports* (2003) largely panned the long-term care insurance industry as a whole, but noted that it was the only option for a financial liability that otherwise was unaffordable for the average person. Nationally, in 2002, Medicaid was the largest payer for long-term care services at \$84.7 billion (47 percent of all expenditures). Out-of-pocket payments were second at \$37.2 billion (21 percent). Medicare paid \$30.7 or 17 percent, and private insurance paid for ten percent or \$18.2 billion (Georgetown

University, 2004).⁶ Long-term care insurance is expensive, the premiums can increase unexpectedly and because the claims often occur in the distant future, the long-term reliability of the policies becomes an issue. Pauly (1990) also has suggested that many people may not buy long-term care insurance because it facilitates their placement in a nursing home and they have no wish to be placed in a nursing home. These difficulties suggest a degree of market failure that might justify some type of government activity, and state and federal governments already have offered tax-advantages for long-term care insurance premiums. These incentives are both costly and are likely to go to some consumers who would have bought the coverage anyway.

The most important factor regarding long-term care insurance may not be any lack of government action, but a belief on the part of the populace that the government itself is selling long-term care insurance. In other words, Minnesotans may believe that having paid their taxes over the years, they are entitled to government assistance with their long-term care expenses, even if that involves some complex transfers of income and assets to meet the eligibility guidelines.

Although it promises no quick fix to the problem, a useful step might be to convene a citizen's panel, perhaps as part of the Governor's Health Care Cabinet, to take up in a very public and visible way the question, "What is the purpose of the State's Medical Assistance program in the area of long-term care? Is the purpose:

- a) to protect and preserve the assets of middle and upper income families for transfer to the next generation; or is it
- b) to provide help to the destitute elderly who, as a result of unforeseeable circumstances, have absolutely no other financial recourse?"

Option (a) is not put forward as a "straw man." It might be very good public policy to allow middle and upper income families to transfer assets to the next generation. But it also might be a very expensive policy, and one that currently is under-financed. Endorsement of the first option has implications for both efficiency and fairness. It would be equivalent to determining that privately purchased long-term care insurance or out-of-pocket payments for long-term care services are realistic only for the very wealthy, and the rest of Minnesotans will rely on the state as their long-term care insurer.

If that determination is made explicit, then the State will need to reconsider the revenue side of its long-term care liability on behalf of the citizens of Minnesota. For example, the State could compute an actuarially fair premium for its long-term care insurance policy and define a dedicated source of revenue to cover the State's share of the Medical Assistance costs of long-term care. This approach would not violate the "no new taxes" pledge as long as the process producing it was equivalent to the citizens of Minnesota acknowledging that the State was their long-term care insurer and the new "tax" was, in fact, the premium for that insurance, e.g., a "user charge."

⁶ Includes nursing home and home care services.

Although the federal government might be skeptical of such an explicit expression of the purpose of the Medicaid program, Minnesotans would be making use only of existing, legal ways of exempting income and assets from eligibility tests. The tax revenue for the premium could be progressive and thus “means-tested” to a degree, and assessed through the current tax system’s administrative structure. However, if the assessment was viewed as an insurance premium, then the advisability of applying the usual tax exemptions and deductions to that revenue stream should be examined. It could be paid simply as an add-on to any taxes owed or a reduction in any refund due.

If, on the other hand, Minnesotans reached agreement that the State’s Medical Assistance program should be interpreted as a program to assist only the destitute elderly, then it might be necessary to revisit the rules regarding the means-test for eligibility. For example, it might be necessary to incorporate the income and assets of the beneficiary’s spouse, siblings and children into the means-test.

Means-testing the assets of relatives may sound harsh, but consider the fact that siblings and children currently enjoy favored status in the State’s policies regarding liens on beneficiary’s home (Minnesota Department of Health, 2004). When a Medical Assistance beneficiary enter a nursing home for more than six months, the State places a lien on the beneficiary’s home to cover the State’s costs, but the lien is waived or delayed if the beneficiary’s home is occupied by a spouse, a child under 21, a disabled child, a sibling who still lives in the home, or a child or grandchild who provided care to the beneficiary during the two year period prior to admission to the nursing home and still lives in the home. The policy question centers on finding the right mix of financial benefit and financial responsibility that individuals can derive from their relationship to a Medical Assistance beneficiary.

Other areas to examine under the second characterization of the Medical Assistance program include the financial instruments used by the elderly to protect assets. By converting assets to annuities, it is possible to protect the assets, while still qualifying for Medicaid. These annuities are not available to the truly destitute elderly, thus calling their fairness into question. The treatment of annuities is the focus of a current research project in the Division of Health Services Research at the University of Minnesota.

3. The effect of federal MA payments on Medical Assistance costs

One factor beyond the State’s control that influences the State’s Medical Assistance costs is the federal government’s payment to Medicare Advantage (MA)⁷ plans (largely Medicare HMOs) that enroll Medicare beneficiaries. For 2005, MA plans in Hennepin and Ramsey County will receive \$654.22 per month for a “standard” beneficiary, while MA plans in Dade County, Florida will receive \$986.14 and plans in Richmond County, New York will receive \$988.58. These rates are based on the cost of caring for beneficiaries in the traditional Medicare fee-for-service (FFS) system. The wide variation in FFS costs has been studied for years by John Wennberg and his

⁷ Not to be confused with the Medical Assistance version of “MA.” MA plans in the Medicare program recently were known as “Medicare+Choice” plans.

colleagues at Dartmouth University and they have been unable to find any systematic relationship between costs in FFS Medicare and the health status or health outcomes of beneficiaries.⁸

One effect of lower payments to Minnesota's MA plans on Medicare beneficiaries is widely known. Minnesota enrollees in MA plans pay \$45 to nearly \$100 per month out-of-pocket for outpatient prescription drug coverage, while residents of Dade County pay nothing for much more generous prescription drug coverage.⁹

What is not as well understood is the effect of lower MA payments on the probability that low income beneficiaries choose to become dually enrolled in both Medicare and Medicaid (Medical Assistance). Although Medicaid covers services not covered by traditional FFS Medicare, enrollment in Medicaid has some disadvantages, as well. Medicaid beneficiaries may experience difficulty finding providers who accept Medicaid patients, and when they do, they may find themselves treated as "second class citizens." In areas where MA payments are high, those same beneficiaries can enroll in an MA plan for the cost of the Part B premium and receive free outpatient prescription drug coverage, and access to care on the same terms as any other MA enrollee.¹⁰ Atherly and Dowd (2004) found that a \$10 increase in the monthly MA payment rate reduced the probability that a low-income beneficiary would be dually enrolled in both Medicare and Medicaid by about four percentage points and the probability of enrollment in FFS Medicare only by about 11 percentage points.

The effect of low MA payments in states like Minnesota thus is not limited to the reduction in federally-financed benefits enjoyed by MA enrollees in low payment states. Low MA payments also result in taxpayers in Minnesota providing a *further* subsidy of Medicaid costs in Florida and New York, in addition to the normal subsidy inherent in the combination of a progressive federal income tax and Minnesota's relatively high income level.

This is a national problem requiring a national solution. The Medicare Modernization Act of 2003 contained a mandate for 2010 national demonstration of competitive pricing for Medicare that includes some smoothing of federal government payments in FFS Medicare. Due to the potential impact of this legislation on high cost but politically powerful regions of the country (e.g., Florida, California, and New York), this part of that legislation will become endangered as the date of implementation draws closer. Minnesota's Congressional representatives should work with their "low MA payment" colleagues (most of whom represent "red" political states) to use that opportunity to address some of the current inequities in the system. The Bush administration's recent interest in altering the federal government's role in the Medicaid program deserve the same careful attention (Hernandez and Baker, 2005).

⁸ See the October 7, 2004 issue of *Health Affairs Web Exclusives* for some of the most recent research (<http://www.healthaffairs.org/>).

⁹ Other than the Part B premium paid by all beneficiaries

¹⁰ Some states even cover the MA premium and other out-of-pocket expenses under Qualified Medicare Beneficiary (QMB) and Specified Low-Income Medicare Beneficiary (SLMB) programs. Although this assistance increases the state's costs, they still are lower than the cost of dually-enrolled beneficiary.

Health Insurance For State Employees

Another major expense for the state budget is the cost of health insurance for its own employees. For the purposes of health insurance, state employees are divided into two groups: University of Minnesota employees and all other state employees. The State's share of the health insurance premium for University employees was approximately \$106 million for 2004, and \$366 million for other state employees. In addition to the impact on the State's budget, the state employee's health benefit plans offer an important opportunity to demonstrate efficient management of employment-based health insurance benefits. To a great extent, the State has availed itself of that opportunity.

Figure 1 again provides a useful guide to the determinants of expenditures for state employees' health insurance costs. An obvious way to reduce those costs is to reduce the number of state employees (e.g., the number of "eligibles") and efficient administration of state government always should be a top priority.¹¹

The remaining factors affecting the cost of health insurance for state employees are the generosity of coverage and the unit prices of services. Although the health insurance packages offered to state employees never have been meager, there is an important feature of those offerings that affect the State's costs. From the late 1980s, until the split of the University employees from other State employees, the State of Minnesota was one of handful of model employers nationally that followed Alain Enthoven's formula for a "competitive pricing" structure for health insurance benefits. The components of the competitive pricing formula include:

1. offering multiple health plan choices to employees;
2. providing good information about plan benefits and costs to employees; and
3. setting the employer's contribution to premiums no higher than the cost of the lowest cost plan.

This formula results in employees paying the marginal cost of more expensive health plans out of their own pocket. That, in turn, puts price pressure on the participating health plans that helps keep premiums low. It also means that taxpayers pay only the cost of cheapest health plan for each state employee.

An alternative to the competitive pricing model is one that depends on competition among insurers to be the plan offered by the employer the firm, rather than competition for employees by multiple health plans. Analyzing data from the 1996 Medical Expenditure Panel Survey – Insurance Component (MEPS-IC), Vistnes, Cooper, and Vistnes (2001), showed that employers who adopted the competitive pricing model had lower costs than those who had health plans bid for entry into the firm. In an earlier

¹¹ Nationally, health insurance costs nationally constitute 7.6 percent of total compensation costs (Bureau of Labor Statistics, 2003) so one would have to fire hundreds of state employees to achieve the same savings as reducing the percent of total compensation going to health insurance by one percentage point.

study, Dowd and Feldman (1998) found that in a national sample of large public employers¹² offering multiple health plans to their employees, total enrollment-weighted average premiums in 1994 were approximately seven percent lower in firms that paid a fixed contribution to premiums than in firms using other contribution methods. Dowd and Feldman found that about one third of the multiple plan employers set a fixed contribution to premiums.

The University employees' health plans still follow the competitive pricing model. The plan for other state employees also follows a competitive model, but in a different form that is drawing national interest (MedPAC, 2004). That system, known as the Minnesota Advantage Health Plan, uses claims data to place primary care clinics into cost tiers, based on their average expenditures per enrollee. Employees may use any clinic they like, but their out-of-pocket costs at the point-of-purchase depend on the cost tier of the clinic they choose. That pricing strategy puts pressure on health care providers to keep their fees low and to avoid unnecessary utilization of services. Employee out-of-pocket premiums in the Advantage system are the same for all health plans.

So both the University and the State deserve high marks for being "early adopters" of an efficient health plan purchasing strategy (competitive pricing) that has saved the taxpayers millions of dollars over the years. The Advantage plan has not yet been subjected to rigorous evaluation, but the State also deserves credit for experimenting with a promising alternative. That's how progress is made.

There is another important difference between the health plan offerings of the University and State. The University offers the Definity health plan. Definity is one of new "consumer directed health plans" that features a high deductible. Two levels of deductibles are available, and the higher deductible plan is tied with HealthPartners as the lowest cost plan available to University employees in 2005. So the taxpayers' cost of health insurance for University employees now is based on the cost of tightly managed health plan and a plan with a very large deductible. Thus, at least for University employees, it is difficult to argue that the State's costs are high due to generous coverage.

There is another step that both the University could take that would result in even more competitive pressure on plans and providers. Under the current system, University employees, like many other employees, can pay their out-of-pocket health care costs (premiums and out-of-pocket point-of-purchase costs) with pre-tax dollars using the "health care expense accounts" allowed under Section 125 of the Internal Revenue Code. The effect of this tax exemption is to reduce the effective price of more expensive health plans and providers to employees, thereby reducing the competitive pressure on plans and providers (Dowd, et al., 2001). Eliminating health care expense accounts would be intensely unpopular with state employees unless the State could share some of the savings from increased competition with state employees and have some savings left over for the taxpayers. That would be an example of an improvement in efficiency. We'll return to the topic of tax exemptions in the discussion of the uninsured.

¹² "Large public employers" were city and county governments representing areas more than 100,000 population.

The remaining factors influencing health insurance costs for state employees are system-wide factors that increase the cost of health insurance for all Minnesotans and make it less affordable for low-income workers in Minnesota, thus increasing the need for subsidized programs like MinnesotaCare and Medical Assistance. These factors are discussed in Section IV.

Subsidized Health Insurance For Low Income Minnesotans

Some low-income Minnesotans who cannot afford private health insurance enroll in the Medical Assistance programs. Others, including those whose income makes them ineligible for Medical Assistance, enroll in the MinnesotaCare program. MinnesotaCare provides subsidized insurance for low income individuals and families. The rates vary by family size. There are asset tests for eligibility. The policy covers a maximum of \$5,000 of outpatient expenditures and \$10,000 for inpatient expenditures. Both types of services have co-payments. Pregnant women and children under the age of 21 are exempt from the asset test and some co-payments.

MinnesotaCare is an innovative and successful program. It is an important reason why Minnesota has one of the lowest percentages of uninsured persons in the U.S. (U.S. Census Bureau, 2004b). Furthermore, given the generous tax expenditures on higher income Minnesotans' purchase of health insurance embedded in the tax exemption of premiums and spending (discussed in greater detail later in this section), subsidy of low income Minnesotans' health insurance purchases are easily justified on fairness grounds.

Nonetheless, MinnesotaCare is an expensive program. Projected expenditures for MinnesotaCare are approximately \$586 million for Fiscal Year 2005. About 62 percent of the program's revenue comes from a two percent tax on health care providers, and about 23 percent from carryover funds from previous years. One way to provide additional help the uninsured population without adding to the cost of the MinnesotaCare program would be to open the program to anyone who wants to pay their actuarially fair premium to join.

Again, using Figure 1 as a guide, we can see that the cost of the MinnesotaCare program could be reduced by reducing the demand for subsidized insurance. Holding the eligibility criteria constant, demand can be reduced by improving the economic conditions of individuals and families who currently qualify for the program, or reducing the cost of private health insurance to make it more affordable for low income Minnesotans. Unfortunately, improvements in the economy rarely are the product of state legislation.

How could private insurance be made more affordable for low-income workers? Again, the concept of the marginal person is helpful here. If we are to reduce the number of uninsured, our efforts should focus on the people who are "on the margin" for being uninsured and needing state assistance. Who are those people?

To understand the failure of people to purchase health insurance, it is helpful first to ask why anyone would *want* to purchase health insurance. The simplest answer is because people face financial risk associated with medical care that is required to repair the effects of injury or illness and they want to transfer that risk from themselves to a third party who can pool the risk (we might say “kill” the risk) by combining the risk across many such people.¹³ In fact, we can make the following assertion:

“If people could purchase insurance at actuarially fair premiums that covered the cost of health care services that they would purchase on their own (without insurance) if they became sick or injured, then any risk-averse person would purchase that insurance.”

So when we observe people not buying health insurance, we can assume that the problem can be found somewhere in that sentence. What sort of health insurance purchasing environment do people on the margin for being uninsured actually face?

If they are working, they almost always face premiums that are the same for all employees in their firm, regardless of the employee’s age or health status. In one sense, this type of within-firm community rating is desirable, because it means that if the employee becomes chronically ill, their premiums won’t go up. Having all employees pay the same premium regardless of age, however, usually results in younger, lower income employees subsidizing the premiums of older, higher income employees,¹⁴ and some of the lower income employees may be unwilling or unable to provide that subsidy.¹⁵

A second problem faced by younger healthier employees, is that they may not be able to purchase the health insurance policy they would prefer. The cost of health insurance reflects the distribution of health expenditures, which in turn, is concentrated in a relatively small proportion of high spenders. The high expenditure item for which young, healthy people are at greatest risk is a normal or complicated birth of a child. Yet the premiums of the policies they are offered often reflect the cost of heart attacks, strokes and cancers for which they have very low risk. State mandated benefits also raise the cost of health insurance, and may reflect the cost of benefits that young, healthy people would not choose to purchase if they were given the choice.

¹³ Another possibility is that health insurance provides a way to finance the purchase of expensive medical care for which people would be unable to save or borrow (Nyman, 1999, 2003).

¹⁴ This may seem counterintuitive, particularly in cases where the employee’s out-of-pocket premium is low. However, any increase in the employer’s “share” of the health insurance premium comes out of the employee’s total compensation and thus the employee pays the cost of health insurance whether the premium is “paid” by the employer or by the employee out-of-pocket. So even when the employee’s out-of-pocket premium is zero, the young employees still are subsidizing older employees unless they are paid higher wages purely because they are healthier.

¹⁵ A recurring theme throughout this analysis is that getting older is a predictable event for which one can plan and save, while the onset of illness or injury is not. That is why illness and injury are insurable events and getting older is not.

A third barrier for young, healthy employees is the problem of inefficient moral hazard, discussed previously. Insurance has the effect of reducing the out-of-pocket price of health care and increasing consumption of services. High deductibles (e.g., catastrophic-only coverage) can help address that problem. These “consumer directed” policies currently are enjoying some political popularity, but high deductible policies, *per se*, do nothing to address the problems of poor information and restricted entry in to health care labor markets that drive up the cost of care for everyone.¹⁶

Unfortunately, the relative importance of these factors is unknown. What is known from analyses of the Medical Expenditure Panel Survey (MEPS) by Cooper and Schone (1997) is that the percentage of employees offered insurance by employers increased from 81.8 percent to 82.2 percent during the period 1987 to 1996, but the percent of workers *covered* by insurance fell from 76.2 percent to 73.2 percent. Increases in offer rates were higher among high wage employees, and decreases in take-up rates were greater among low wage employees.

Blumberg and Nichols (2001) find the same patterns among takers and decliners of employment-based health insurance in 1999 National Health Interview Survey data. Compared to takers, decliners tended to be younger, single, minority males with less education, lower wages and employees of smaller firms. The authors also reported a greater prevalence of mental health problems among those who declined insurance versus those who take up the employer’s offer.

University employees are able to decline coverage as a new employee or during open enrollment, but participation in health insurance is mandatory for other State employees. However, that doesn’t prevent the premium structure from being an onerous financial burden on young, low-income employees, and the State could set an example for other employers who *do* allow employees to drop insurance by establishing a different premium structure. An obvious alternative would be to vary employee out-of-pocket premiums by income. The difficulty with that approach is that the State does not have data on the total family income of its employees, and there are some low wage State employees with large family incomes. In the absence of total income data, age-rating employee out-of-pocket premiums might be a second-best alternative.

In addition to these factors that affect primarily young, healthy workers, there are additional problems that raise the cost of health insurance for everyone. The burden of higher health insurance premiums falls disproportionately on low income Minnesotans, and current tax policies exacerbate the problem. These system-wide factors are discussed in the next section.

¹⁶ Depending on how those policies are set up, a healthy individual might not even face a high deductible after an initial year of low health care spending, because the health care account is allowed to roll over from one year to the next.

System-Wide Factors That Drive Up Health Insurance Costs

A. Ineffective medical care

Ineffective medical care is a national problem and it would be naïve to assume that Minnesota is immune.¹⁷ A graphic example of ineffective medical care comes from a study by Moseley, et al. (2002). The authors assigned 180 patients with osteoarthritis of the knee randomly to arthroscopic débridement, arthroscopic lavage or placebo surgery. Neither of the intervention groups reported less pain or better function than the placebo group. At the time of their study, physicians were performing 650,000 arthroscopic knee surgeries each year at a cost of \$5,000 each (\$3.25 billion). Thus, the money spent on *each* knee surgery that Moseley, et al. found to be medically useless could have purchased a generous single coverage group health insurance policy in the Twin Cities in 2004. In other words, 650,000 uninsured people each year could have had their health insurance premium paid in full for them, and those are the savings from just one ineffective procedure. Ineffective medical care is not an endless source of new money, but it is an important source.

HealthPartners recently made headlines by announcing that they no longer would pay for egregious medical mistakes (e.g., amputation of the wrong limb). This is an encouraging development, laying aside the disturbing implication that they *had* been paying for those procedures in the past. However, this initiative needs to be taken a step further, to include non-payment for health care services that are medically ineffective, but place the patient at risk for potential harm.

B. Inefficient medical care

The opposite hand of providing ineffective medical care is *not* providing effective medical care. Currently, there are a number of initiatives underway to encourage physicians to follow best-practice guidelines in the treatment of routine illnesses, particularly chronic conditions. One such initiative is disease-management, which covers a broad range of interventions ranging from the development of practice parameters to electronic health information systems that remind physicians of recommended protocols. Welch, et al. (2002) found that among 65 health plans surveyed nationwide, all reported using evidenced-based guidelines, patient population identification processes, and patient self-management education. Disease management programs had been implemented for diabetes, asthma and congestive heart failure (CHF) by over three-quarters of the plans. Although disease management programs are popular, their ability to increase the efficiency of the market for health care services ultimately will depend on their effectiveness. Currently there is a lack of convincing evidence that they improve patient health or save money (Congressional Budget Office, 2002), but future studies may produce more positive results.

¹⁷ It is important to distinguish between two different concepts. In some discussions, analysts talk about the “cost effectiveness” of a medical procedure. A cost-effective medical procedure is one that achieves the same outcome as another procedure, but at a lower cost. This section addresses a different concept, the concept of care that has no medical benefit at all to the patient.

A related set of efforts ties physician payment to the physician's adherence to best-practice guidelines. These initiatives are known as "pay for performance" initiatives. Pay-for-performance demonstration projects currently are underway in both public and private health insurance programs, but it is too early to know what effect they will have on the efficiency of the health care system.

A good place to test these concepts would be the University and State employees' health benefit plan. Plans with aggressive payment and disease management strategies could be designed and offered to employees along with conventional options.

C. Provider pricing cartels

Another system-wide factor that influences the cost of insurance is the unit price of services, that is, the fees charged by health care providers. In a perfectly competitive market, the level of prices (fees) is determined by the intersection of market-wide supply and demand. The market for health care services, however, is not perfectly competitive. As shown in Figure 1, insurance creates a discrepancy between the price charged by health care providers and the price paid by the patient at the point of purchase (e.g., a price *distortion*). Entry into the labor market for health care providers purposely is restricted in an attempt to control quality. Consumers who might try to find information on the price and quality of providers face substantial problems of poor information. These forms of market failure can result in higher fees, but there is another factor that deserves attention in Minnesota, as well as other health care markets nationwide.

For a number of years, there have been complaints, usually by health plans, about the concentration of health care providers, particularly in the Twin Cities, and particularly in some specialties such as oncology. Pricing cartels, if they exist, can increase the level of fees in the market. Economists generally are skeptical of price-fixing cartels for two reasons. The first is pragmatic. Price-fixing clearly is illegal, but it is very difficult to assemble the type of evidence needed to obtain a conviction. Second, economists point out that the same greed that creates the desire for cartels also works against their long-term stability. As long as one or two suppliers in the cartel actually have an efficiency advantage over other members of the cartel, it is in their best interest to break from the cartel and offer their services at lower prices. Despite these cautions, worries about cartel pricing in local markets for health care services have been persistent enough that it would be helpful to have a careful, public investigation that results either in warnings or prosecutions, or a determination that the problem does not exist.

D. Incentives for health maintenance

A final system-wide factor influencing health care costs for all Minnesotans, is the degree to which people take measures to maintain their health. These measures include the consumption of recommended preventive care and steps taken to reduce their risk factors for injury and disease. Although the primary beneficiary of maintained health is the individual person, the personal benefits of good health appear to be inadequate for large numbers of people who continue to engage in risky behaviors. One explanation could be poor information, but it is difficult to believe that very many people

are unaware of effects of factors such as poor diet, lack of exercise, excessive smoking and alcohol consumption, driving without a seatbelt, or risky sexual behavior.

Economists are fond of pointing out that the obesity “epidemic” that has received so much recent attention could be due to simple economics. They note that the price of exercise has risen over time. In the past, most workers were paid to “exercise” because most labor was manual labor. Today, workers often pay for the opportunity to exercise at a health club. At the same time the price of food, particularly food high in calories, has fallen, due to increased productivity in food production, distribution and preparation.

Although people may be aware that their lifestyle choices invite disaster, they may discount inappropriately the benefits of avoiding those undesirable health outcomes in the future, or they may realize that the costs of their remedial care will be spread over a large pool of insured persons. That combination of poor information and distorted prices could be corrected through some more immediate and personal mechanism that confronts individuals with the economic consequences of their choices. “Sin” taxes on cigarettes and alcohol provide one example, but there appear to be serious political obstacles to appropriate pricing of sin taxes. Manning, et al. (1989) found that the tax on cigarettes actually *exceeds* the value of the external costs that smokers impose on society,¹⁸ while alcohol is under taxed.

Some health plans offer lower premiums for non-smokers, but health plans and employers might be allowed to play an even greater role. State government, including both the legislature and the courts, could play an important role in permitting and even encouraging significant tests of greater experience rating in health insurance premiums based on modifiable risk factors. Current rewards in health promotion and disease prevention activities tend to focus on adherence to processes, rather than achievement of specific health outcomes such as weight loss or smoking cessation. An important step would be to vary premiums on the basis of attaining achievable, individual-specific health outcomes. Separating the modifiable versus genetic components of risk factors will remain a difficult task, as will navigation through the Americans with Disabilities Act, but the difficulty of the task is not a compelling reason to abandon the effort. Again, the University and State employees’ health plans would be a good place to start.

E. Tax exemptions: How to make the problem worse for low income workers

In an effort to encourage the purchase of health insurance, governments (both federal and state) have provided incentives that mask the true cost of both insurance and the health care services they cover. First and foremost is the exemption of health insurance premiums from personal income, Medicare and Social Security taxes. These exemptions have two effects. First, they encourage the consumption of health insurance and health care services that are worth less to consumers than the actual cost of providing them. That consumption is inefficient. In addition, Sheils and Haught (2004) estimate that these exemptions will cost federal and state governments about \$210 billion in foregone tax revenue in 2004. Families with incomes less than \$50,000, who make up

¹⁸ External costs are those costs over and above the personal costs that smokers impose on themselves.

57.5 percent of the population, account for only 28 percent of this foregone revenue. That distribution arguably is unfair.

As noted earlier, Section 125 of the Internal Revenue Code allows employees to set up health care expense accounts from which out-of-pocket premiums and out-of-pocket expenses for health care services can be paid with tax-exempt dollars.¹⁹ Sheils and Haught (2004) found that 52 percent of workers in medium and large firms and 23 percent of workers in small firms had access to these accounts. Minnesota state employees have had these accounts for years.

In theory, allowing employees to pay out-of-pocket premiums with tax-exempt dollars should make them less sensitive to out-of-pocket premium differentials between competing plans. That theory was tested by Dowd, et al. (2001) by comparing the price-sensitivity of health plan choice among employees with and without access to tax-exempt out-of-pocket premiums. They found that tax-exempt out-of-pocket premiums did in fact reduce the price-sensitivity of health plan choice by over fifty percent.

The difficulty with these policies is that the tax advantages they confer are worth much more to the wealthier in higher tax brackets than to the low income workers who are on the margin for being uninsured. Heavy public subsidies for the purchase of generous health insurance policies result in lower out-of-pocket costs that lead to ever greater consumption of ever less medically effective health care services and ever weaker incentives to maintain our health. The result is higher priced insurance that gradually prices more and more low income Minnesotans out of the market for private health insurance, thus increasing the burden on the State budget.

F. Ways to help the uninsured

What can the State do about these barriers to the purchase of private insurance by people on the margin for being uninsured? Here are four possibilities to explore:

1. Use the University and State employees health benefit plans to demonstrate age-rated out-of-pocket premiums that reduce the subsidy of older workers by younger workers.
2. Allow policies that exempt at least young people from state mandated benefits.
3. Use the University and State employees health benefit plans to demonstrate health insurance policies that do not pay for ineffective medical care that places the patient at risk of harm.
4. Allow uninsured Minnesotans to join MinnesotaCare by paying the full premium out-of-pocket. Those premiums could vary with age, but not health status.

Some of these purchasing initiatives would be more effective if the purchasing power of all state health insurance programs were coordinated. Governor Pawlenty's

¹⁹ All individuals can deduct expenditures greater than 7.5 percent of their adjusted gross income.

Health Care Cabinet has made that suggestion as part of “Maximum Strength Health Care” reform plans (Governor’s Office, 2004).

These steps obviously would be controversial and would need to be preceded by an intensive educational effort. They are not as controversial, however, as a step that would have an even greater effect on the efficiency of the health care system – ending the tax exemption of premiums at the state level, including spending under Section 125 health care reimbursement accounts. With its relatively high tax rates on personal income, the effect of repealing the tax exemption would be larger in Minnesota than in states with lower tax rates.

If the tax exemption is not repealed, then at least it should be capped. A defensible cap would be the value of the exemption for a relatively modest health insurance policy purchased by Minnesotans in the lowest tax bracket.²⁰

Conclusion

Discussions about lowering the cost of health care while holding everything else constant are a waste of time. Efforts to improve the efficiency of the health care delivery system need to focus not on how much we are spending, but on efficiency, that is, what we are getting for our money. There are many new initiatives underway in the health care field such as disease management and pay-for-performance programs. These initiatives may provide some efficiency improvements in the future, but they are unlikely to produce significant savings in the short term.

Health insurance programs constitute a large portion of the State’s budget. Although no public or private program is perfect, several of the State’s health insurance programs have been models for national initiatives. However, there still is room for improvement in all these programs, and the State should lead by example.

The Governor and legislature are right to be concerned about the growth in the cost of health insurance programs. Much of the increase is due to factors outside the direct control of the State government. The failure of Minnesotans to maintain their health and the introduction of new medical technology are two examples. Even in those areas, the State could use its own insurance programs to demonstrate new initiatives like aggressive incentives for health maintenance, and non-payment for ineffective medical care that places the patient at risk of harm. It is important that these initiatives not focus solely on Medical Assistance or MinnesotaCare enrollees. They should begin with University and other State employees. They could be tested as health plan options rather than mandatory changes in all plans. In the case of Medical Assistance, what is needed is a frank discussion about the purpose of the program.

²⁰ Alternatively, in the interest of fairness, the exemption could be eliminated and every Minnesotan could be given a refundable tax credit equal to the value of the exemption for Minnesotans in the highest tax bracket, but that would be enormously expensive.

The shortest path to improved efficiency in Minnesota’s health care delivery system is given by the simple rule: “When you find yourself in a hole, stop digging.” At every point in the health care system where money might play an important role in the consumers’ decisions, we have gone out of our way to make sure it doesn’t. Health insurance plans with large deductibles can help restore consumer interest in their health expenditures, but large deductibles, per se, do nothing to address the problems of poor information, restricted market entry and other forms of market failure that consumers face in the market for health care services.

Minnesota has been a model for other states in the various forms of health insurance it offers to the working poor (MinnesotaCare) and individuals who have difficulty purchasing private insurance (MCHA²¹), but demand for public subsidies is exacerbated by our heavy public subsidies for *private* health insurance which provide the greatest benefit to those in the highest income brackets. If we think the cost of health insurance and health care insurance is too high, the first step is to stop fueling the demand side of the problem by providing huge public subsidies to people who don’t need them.

Findings And Recommendations

*Minnesota has been a national leader in all aspects of health insurance and health care delivery systems. We now need to apply that same level of energy to health expenditures in the state budget.

*The State’s largest health care budget item is nursing home care for the elderly and disabled. The State regulates both price and quantity in the market for nursing home services. The State requires nursing homes to charge the same to private patients and patients on Medical Assistance. Relaxing that restriction probably would result in higher prices for private patients, but it is doubtful that either allowing the private patient price to float or lifting the state’s current moratorium on additional nursing home beds would dramatically reduce public expenditures for nursing home services.

*Community-based long-term care services can hold down costs temporarily by delaying nursing home utilization. But achieving these savings has proven to be challenging. Under current delivery models, the substitution of community-based services for nursing home services appears to dissipate after about one year.

*Government now pays over two-thirds of nursing home costs in Minnesota – a state with the fifth highest median family income in the U.S. Minnesota needs to have a thorough public debate about the purpose of the Medical Assistance program for seniors. Is the purpose to protect the assets of middle and upper income families for transfer to future generations or is it to provide help only to the destitute elderly?

*If protecting assets is deemed to be the purpose, then the state might wish to institute a mandatory long term care insurance premium or “user fee” to pay for this

²¹ The Minnesota Comprehensive Health Association.

growing responsibility. If, instead, the purpose is deemed to be assistance to the truly destitute, then for eligibility purposes, the state should consider the income and assets of the potential beneficiary's spouse, siblings and children.

*There are vast differences across the states – to the detriment of Minnesotans -- in the federal government's subsidies to private health plans serving Medicare beneficiaries. These disparities affect not only Minnesota Medicare beneficiaries, but also the cost of the State's Medical Assistance program. Remedying this inequity is a task to be taken up more vigorously by the state's congressional delegation.

*For more than a decade, Minnesota state government and the University of Minnesota used the health insurance purchasing system for their employees that has been shown to produce the lowest overall premiums, e.g., setting the State's contribution to premiums no higher than the cost of the lowest cost plan offered to employees.

*The state government's current system that requires its employees to pay part of the incremental cost of higher cost health care providers is a commendable initiative, as is the University's addition of a high deductible plan to its low cost offerings. Both initiatives deserve careful evaluation.

*Permitting health insurance premiums and other health care expenses to be paid from pre-tax dollars not only dampens the incentive to shop carefully for insurance and health care services, but also constitutes a significant tax break that provides greater benefits to Minnesotans in higher tax brackets. The State minimally should end the state-level tax exemption of out-of-pocket premiums under Section 125 of the IRS code. In addition, the state either should consider eliminating the tax exemption of health insurance premiums entirely, or capping the exemption at its value to a low income, working Minnesotan who purchases a modest health insurance policy.

*Opening MinnesotaCare to all and varying premiums by age might enable some currently uncovered Minnesotans to buy insurance.

*Both state government and the University of Minnesota should consider using their health benefit plans to demonstrate policies that do not pay for unnecessary and ineffective care and that offer incentives for use of best medical practice.

*The State should prepare a report to the public on the level of market concentration for sub-specialist physician services in the state's metropolitan areas.

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Chapter 4

Reaching Above the Line: Why Minnesota Welfare Reform Should Focus on Reducing Poverty as Well as Promoting Work

Maria Hanratty and Marcie Jefferys

Introduction

The Department of Finance is projecting a \$700 million budget shortfall for the 2006-07 biennium, driven largely by increases in “Human Services” spending (State of Minnesota, Department of Finance, November 2004). However, most of this reflects spending on health care, primarily long-term care for the elderly and disabled, a subject that is discussed in chapter 3 of this report.

Spending on the other components of welfare and low-income assistance programs—such as MFIP, child-care subsidies, the Working Family Tax Credit, and General Assistance—represents only 2.2% of the state’s general fund spending in FY 2004-5.

Spending on MFIP and General Assistance cash-assistance programs has decreased substantially since 1992, due to reductions in both caseloads and average grant levels. This reduction in spending has been offset somewhat by increases in state spending on programs to help the working poor, such as the Working Family Tax Credit and child-care subsidies.

Expenditures on these programs are important because they can have a substantial impact on child well-being. A growing body of research has documented the link between poverty and child outcomes, such as cognitive abilities, emotional development, and other factors that are predictive of adult success.

In addition, experimental evidence from two welfare demonstration programs that increased family incomes substantially above the poverty line found these programs increased children’s cognitive abilities and reduced children’s behavior problems. These gains did not occur in other experimental evaluations of welfare-to-work programs that did not increase earnings supports, suggesting that it is essential to move family incomes above the poverty level to achieve gains in children’s well-being.

Since 1990, Minnesota has expanded income and in-kind supports available to working families, through expansions to MFIP earnings supplements, the Working Family Tax Credit, and child-care subsidy programs. These programs have the advantage that they promote work and reduce poverty. Taken together, they make it possible for families with a member working full-time, full year to achieve incomes that are 10 to 30% above the poverty threshold.

However, these programs are only effective in reducing poverty for families who can access all of the MFIP, Working Tax Credit and child-care benefits for which they are eligible. To the extent that access to income supports is limited, due to MFIP time limits or MFIP sanctions, or due to insufficient funding of child-care subsidies, there is no guarantee that families will achieve above poverty level incomes. In addition, these programs are much less effective in reducing poverty for families who do not have stable employment. Maximum benefits for non-working families have decreased since 1988, and now represent 66 percent of the federal poverty level for a single parent with two children.

To further reduce poverty and improve child well-being, Minnesota must either increase family earnings or enhance the financial supports available to low-income families. We provide a brief discussion of several options to achieve these goals, and of the empirical literature on the likely impacts of these policies.

Trends in Welfare Spending

Since the passage of the 1996 federal welfare reform law, the State of Minnesota has implemented the required shift in welfare assistance programs towards employment-based assistance. However, as an analysis of state spending trends reveals, the federal law change merely accelerated the shift to work-based assistance that had begun several years before. There have been few comprehensive attempts to examine the impact of this shift in philosophy, as primary legislative and administrative responsibility for many programs previously run by the welfare agency are now split among various agencies with different perspectives. Furthermore, there is little understanding of how these programs jointly affect individual families.

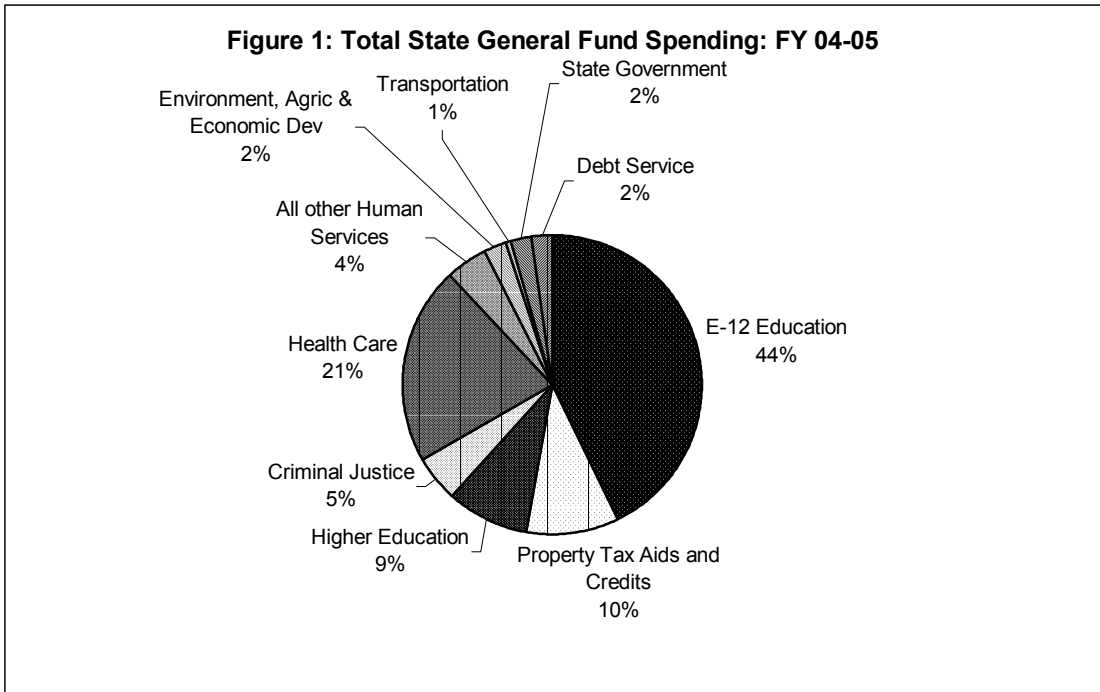
This analysis is intended to show how this policy shift is reflected in state spending and to suggest where policy makers interested in long-term cost effectiveness might most profitably direct their attention.

Welfare Spending in Context

A common public misperception is that most of the health and human services budget is spent on welfare. The pie chart below puts health and human services spending in the context of the total state budget. Most presentations of the state general fund budget combine health and human services into one 'slice' representing about 26% of total spending¹. In fact, health care represents 81% of the health and human services segment and, within health care, 78% of expenditures goes toward purchasing care for people who are elderly or disabled².

¹ This analysis focuses on general fund expenditures. The general fund is the major fund over which state policymakers have the most direct control. Revenue comes primarily from income and sales taxes and, unlike federal or dedicated taxes which must be spent on specific programs, lawmakers have a great deal of discretion over how and at what level the general fund is spent.

² While people who are elderly and/or disabled make up 32% of the Medical Assistance program's enrollment, they account for 78% of its expenditures (Minnesota Department of Finance, *An overview of state government spending*, October 2004)



Source: Minnesota Department of Finance, *Fund Balance Analysis*, November 2004.

Spending for welfare programs as they are traditionally defined (Aid to Families with Dependent Children/Minnesota Family Investment Program, and General Assistance/Work Readiness) are within the human services segment and account for less than 1% of the state’s general fund budget. This analysis is also misleading in that it leaves out several important sources of assistance, such as the Working Family Tax Credit, and the Dependent Care Tax Credit.

The following table shows combined “financial assistance” expenditures on MFIP and General Assistance cash grants, MFIP support services, MFIP and Basic Sliding Fee Child Care Subsidies, the Working Family Tax Credit and the Dependent Care Tax Credit. As shown, these programs represent only 2.2 percent of general fund spending in FY2004-5.

**Table 1:
Minnesota General Fund Spending on Financial Assistance Programs**

	FY2004-05 GF Expenditures (\$'s in Millions)	As a Percent of Total State General Fund Expenditures
Welfare Cash Assistance		
MFIP/DWP Grants	\$97.8	0.4%
General Assistance Grants	\$53.2	0.3%
Work Supports Tied to Welfare Receipt		
MFIP Child Care Assistance	\$136.6	0.5%
Support Services Grants	\$17.3	0.1%
Work Support Programs not Tied to Welfare Receipt		
Basic Sliding Fee Child Care	\$46.4	0.2%
Working Family Credit	\$222.0	0.8%
Dependent Care Tax Credit	\$32.0	0.1%
Other Economic Assistance Grants	\$17.9	0.2%
Total	\$625.20	2.2%

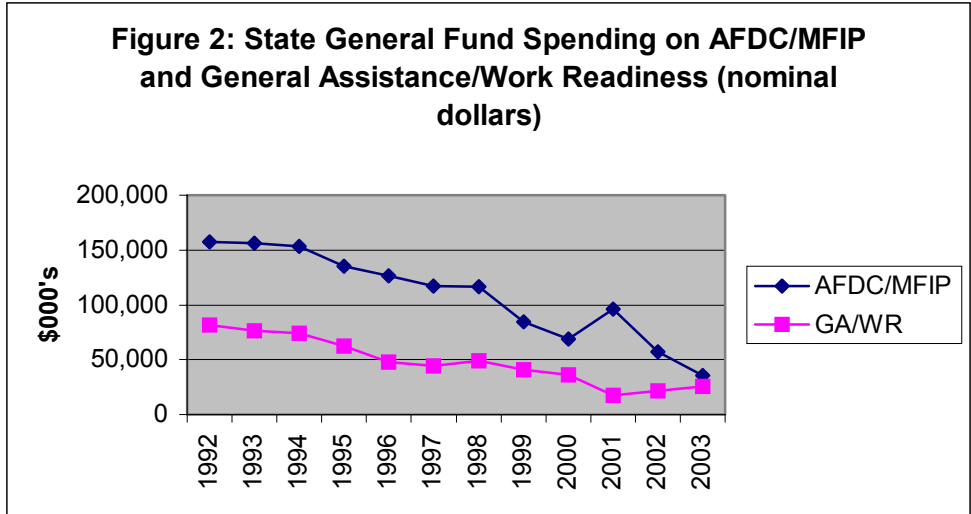
Sources: Minnesota Department of Finance, *Fund Balance Analysis*, Nov. 2004; Minnesota Department of Revenue, *Tax Expenditure Budget*, May 2004.

Spending Trends

Unlike many other areas of the state budget, spending on traditional cash-based welfare programs has generally decreased throughout the past decade. This is due to several factors including MFIP policy changes, a healthy employment climate, and the availability of federal TANF funds since 1996. Before the 1996 law change, the federal government matched state spending at approximately a 50:50 match rate. The 1996 law gave states a block grant to fund welfare related services. Minnesota has been able to offset a good deal of its own expenditures by substituting federal funds³, although it must continue to meet certain federal "maintenance of effort" requirements.

The chart below shows the state general fund expenditures on AFDC/MFIP from 1992 (the peak year of AFDC general fund expenditures) to 2003. The lower line shows general fund spending for single adults in the Work Readiness and General Assistance Programs. (The Work Readiness program was ended in 1995.)

³ States could have chosen to maintain their current state funding effort in welfare and used the federal funds to substantially expand services, increase the grant level or otherwise enhance their welfare programs. Minnesota, which already spent more than many states on a per recipient basis, used much of the federal money to reduce the draw on its own expenditures, thereby contributing to the large tax cuts of the late 1990's.

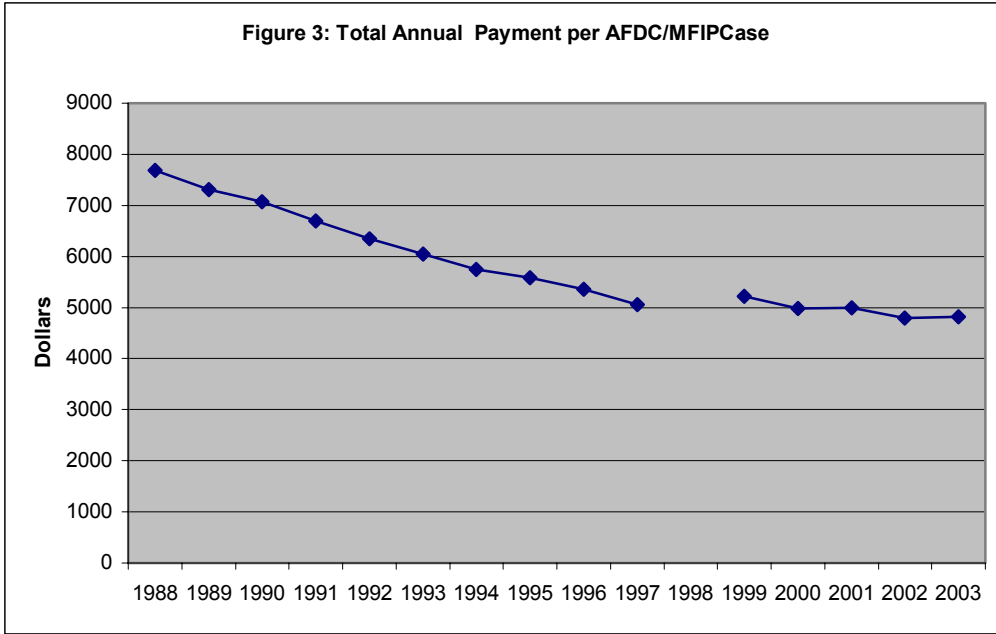


Source: Minnesota Department of Finance General Fund History, June 2004.

These decreases in welfare expenditures are even more dramatic when viewed in the context of the state's economic resources, as measured by total state personal income. In 1982, the state spent approximately \$1.73 of every \$1,000 of personal income on AFDC/MFIP assistance. By 2003, state general fund spending on these programs dropped to \$0.23 for every \$1000 of personal income.

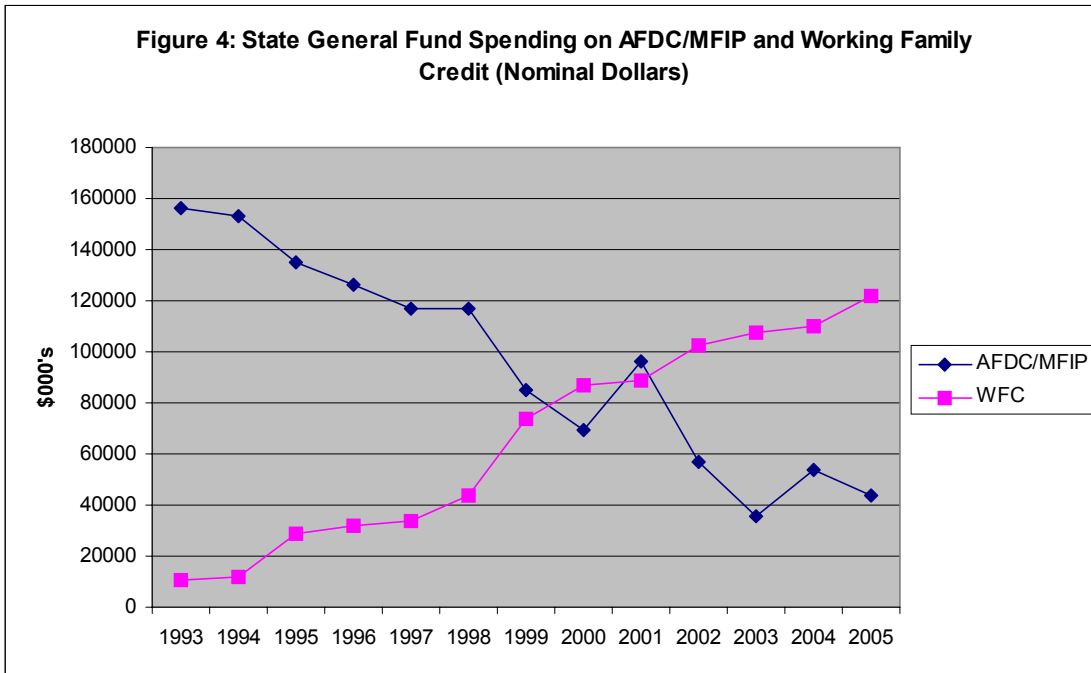
This trend towards reduced expenditures on cash-based welfare assistance is also evident in other states. A recent study found that while states with high fiscal capacity tend to spend more on health care and non-health social services than states with low fiscal capacity, the effect on cash assistance programs is 'inconsistent.' Instead, "ideology and demographic characteristics" played a greater role than fiscal capacity in decisions affecting cash assistance expenditures (DHHS, 2004).

As shown in Figure 3, this decrease in state effort has translated into lower real benefits for families. This chart shows the decrease in inflation-adjusted annual AFDC/MFIP benefit per case from 1988 to 2003, measured in 2000 dollars. As shown, average annual spending per case decreased by nearly 40 percent over this time period.



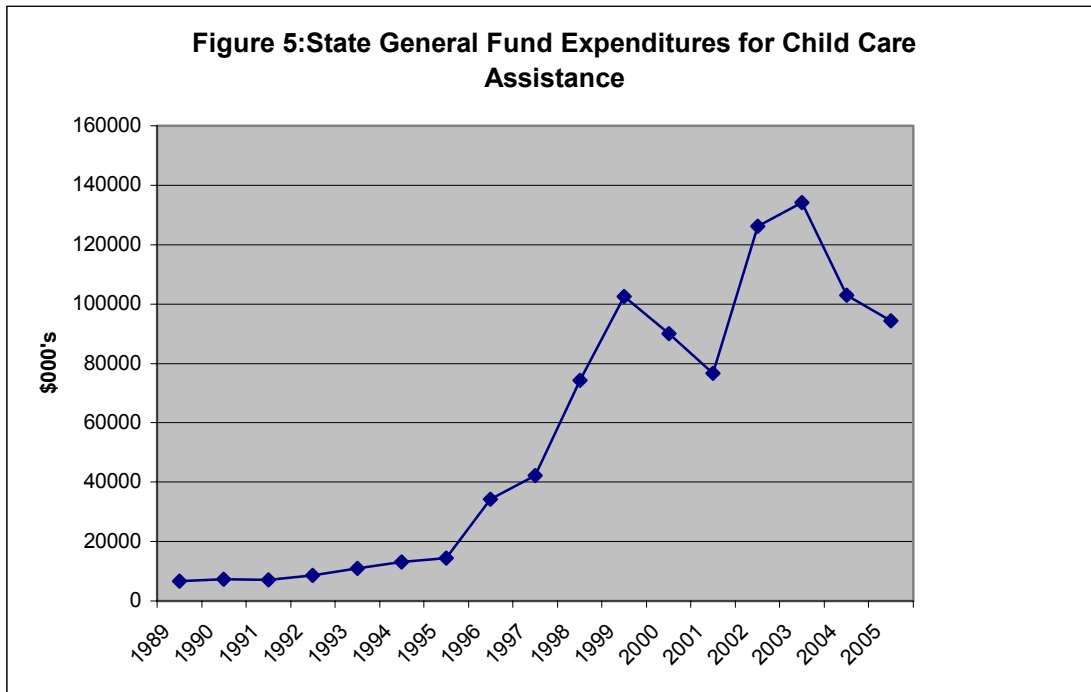
Source: Minnesota Office of the Legislative Auditor, 2002; Minnesota Department of Human Services, Family Self-Sufficiency and Health Care Benefits, August 2004.

Figure 4 shows that while Minnesota has decreased spending on AFDC/MFIP and General Assistance, it has also expanded expenditures on the Working Family Tax Credit. Starting in 2000, the state began spending more on the Working Family Credit than it did on AFDC/MFIP. Expenditures on the much smaller Dependent Care Tax Credit (not shown) have remained relatively constant over this period.



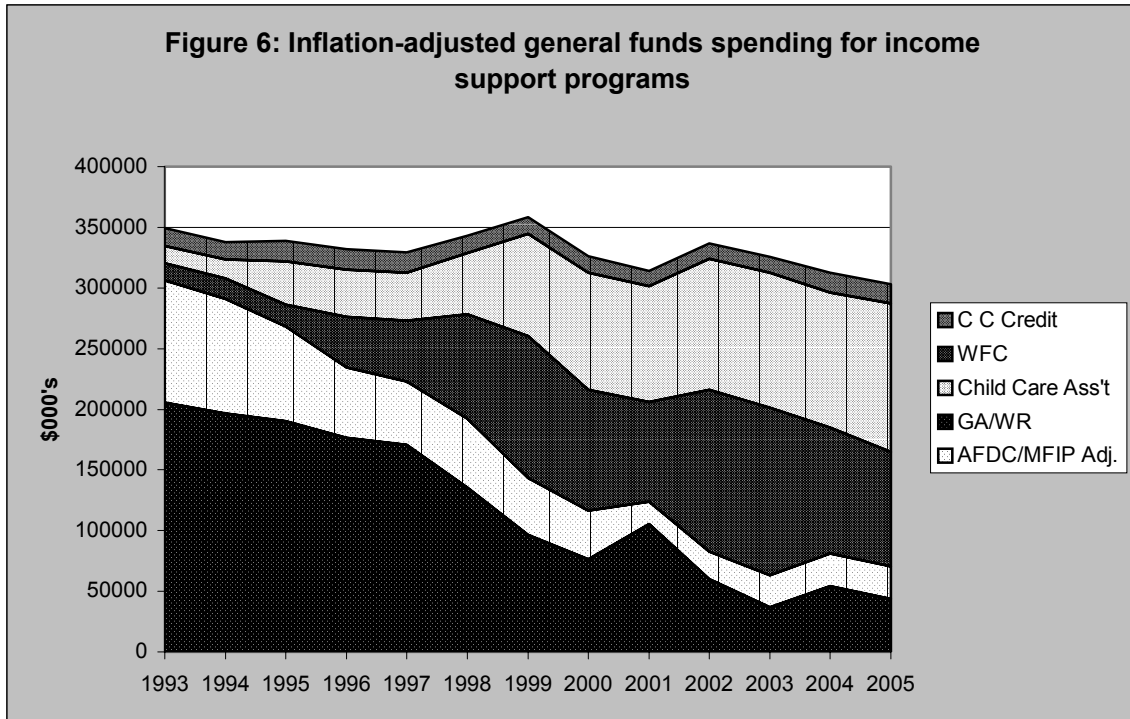
Source: Minnesota Department of Finance General Fund History, June 2004; Minnesota Department of Revenue, *Tax Expenditure Reports*.

Figure 5 shows the substantial increase in child-care assistance that occurred throughout the 1990s (in nominal terms). It also shows the impact of reductions in child-care assistance projected for FY2004-5.



Source: Department of Finance General Fund History (June, 2004)

Figure 6 shows combined AFDC/MFIP, GA/WR, child-care, and Working Family Credit expenditures since 1992, after adjusting for inflation. Despite the increased investment in the Working Family Credit and Child Care Assistance, when the major programs for low-income families are added together, projected inflation-adjusted state spending (in 2005 dollars) on these programs has decreased by 13% since 1993.



Source: Department of Finance General Fund History (June 2004)

Therefore, it is clear that that programs supporting low-income families' income are not responsible for the escalation of state government spending. This chart also shows the major shift from welfare to other types of income support, such as the Working Family Credit, child-care assistance, and the dependent care credit. Expenditures on these programs have increased as a share of spending in this area from 12% in 1993 to 77% in 2005.

Why Reducing Poverty is Important

While most public policy debates have focused on the goals of reducing welfare dependency and promoting work, we argue that decreasing poverty and increasing family incomes are also vitally important goals for welfare programs because of their importance to children's development.

There is a large body of research showing that children who grow up in poverty have worse outcomes than other children do. Children living in poverty enter school behind children from better off families, and lag behind them all the way through their education. They are more likely to be in special education classes, and they have lower scores on cognitive achievement tests. In addition, they are at greater risk of poor health, including higher incidence of asthma and other chronic problems. Children in the child protection and juvenile corrections systems are more likely to have grown up in poor families. Some statistics:

- The infant mortality rate for poor children is 1.4 per 100 live births, compared to 0.8 per live birth for non-poor children.⁴
- Poor children are 1.3 times more likely to have a developmental delay than non-poor children; and 1.4 times more likely to have a learning disability.⁵
- Poor children are twice as likely to repeat a grade or be expelled than non-poor children and 2.2 times more likely to drop out of high school.⁶
- Poor children are 6.8 times more likely to be reported for child abuse and/or neglect.⁷

Several large-scale longitudinal surveys provide information on the mediators through which low income affects children's outcomes. These surveys also make it possible to more carefully control for family characteristics when measuring the impact of income on poverty. Some of the key findings from this literature are presented below.

Family income appears to have the most direct relationship on children's cognitive and linguistic performance. (Duncan, et al, 2000;Gennetian et al, 2002; Mistry et al, 2004; Yeung, 2002). Some of the differences in the cognitive development of higher versus lower income children is attributable to their physical environment, including more cognitively stimulating materials, and higher child care expenditures (Yeung, et al., 2002)

Poverty has the greatest impact on young (ages 0-4) children's cognitive development (Duncan, 2000). Children in the deepest poverty (50% of the federal poverty level) fare the worst (Duncan, 2000; Mistry 2004). Persistent poverty also has a greater impact (Duncan et al); although some researchers determined that income instability also has a negative impact on children's cognitive development (Yeung, 2002).

Income also has an effect on children's social and emotional development, although more indirectly through its impact on parents. Parents who are depressed or feel hopeless as a result of their economic situation tend not to be as sensitive to their children's needs. This affects children's capacity to regulate their emotions and interact with others (Duncan et al, 2000; Conger et al 2002, Mistry et al 2004; Yeung, 2002).

⁴ Data from the National Maternal and Infant Health Survey as reported in Federman, M., Garner, T., Short, K., et al. What does it mean to be poor in America? *Monthly Labor Review* (May 1996) 119, 5:10.

⁵ Data from the NHIS-CHS 1988 as reported in Coriolo, M.H., Zill, N. & Bloom, B. Health of our nation's children. Vital Health and Statistics, Series 10, no. 191. US department of Health and Human Services, Public Health Service, December 1994. Poor children are those who lived in families with income less than %130 of the poverty threshold.

⁶ Data from the NHIS-CHS 1988 as reported in Coriolo, M.H., Zill, N. & Bloom, B. Health of our nation's children. Vital Health and Statistics, Series 10, no. 191. US department of Health and Human Services, Public Health Service, December 1994. Poor children are those who lived in families with income less than %130 of the poverty threshold.

⁷ Data from the Survey of Income and Program Participation. As reported in Federman, M., Garner, T., Short, K., et al. What does it mean to be poor in America? *Monthly Labor Review* (May1996) 199, 5:9

Experimental evidence from demonstration programs in Minnesota and two provinces in Canada indicates that programs that bring family incomes well above the poverty line can achieve improvements in children's school performance. These programs increased family incomes by allowing families to earn incomes well above the poverty level --- up to 38% above the poverty line in the Minnesota MFIP and more than double the poverty line in the Canadian SSP program⁸--and still retain eligibility for some welfare cash assistance. They also required participants to fulfill minimum employment activity or hours of work requirements.

The research suggests that both the MFIP program and the SSP programs produced significant improvements in children's cognitive and behavioral outcomes. The MFIP program also generated increases in other outcomes likely to affect children, such as marital stability, and the incidence of spousal abuse:

- *Improved Cognitive and Behavioral Outcomes:* The MFIP program increased parental assessments of children's cognitive achievement and behavioral outcomes for young children living in single-parent families who had been on welfare for two years or more (Gennetian and Miller, 2002).⁹ The Canadian SSP program increased math test scores for children age three or four at the time the program began. It also increased parental assessments of their children's academic performance, evaluated at 36 months and 54 months after the program began. (Michalopoulos et al, 2002).
- *Reductions in Spousal Abuse:* The MFIP program reduced the probability that a single parent experienced domestic abuse in the past three years from a base level of 60% for the control group to 49% for the MFIP group a cumulative decrease of 11 percentage points (Gennetian and Miller, 2002).
- *Increases in Marital Stability:* The MFIP program increased the proportion of single parents married and living with their spouse after three years, from 6% for the control group to 11% for the MFIP group. Among two parent families, the gains were more substantial: after three years, 67% of MFIP couples were still married and living together, compared to 48% for the control group (Gennetian, Knox, Miller, 2000). These gains in marital stability were still present seven years after the program began (Gennetian, 2003).

These positive outcomes for the MFIP and SSP programs have attracted widespread attention, because they were not present in other experimental studies of welfare-to-work programs. Six experimental evaluations of programs that consisted only of work activity mandates, and two studies that offered less extensive increases in financial subsidies did not find measurable improvements in child outcomes

⁸ The Canadian program matched 50% of the difference between family earnings and a target income of \$30,000 in British Columbia and \$37,000 in New Brunswick in 1993. This corresponds to \$32,000 to \$40,000 in 2004 U.S. dollars.

⁹ The MFIP evaluation did not include an assessment of how the program affected children's cognitive outcomes or behavioral problems for two-parent families, so it is not possible to know if these benefits accrued to children in other families as well.

(Michalopoulos et al, 2002; Grogger, 2002). This may suggest that family income must increase above a threshold level, before it improves child outcomes.

How The Minnesota System Combats Poverty

Over the past sixteen years, Minnesota has substantially reoriented its welfare system to increase financial resources available for working poor families. Key initiatives include introduction of the Minnesota Working Family Tax Credit, expansions to earnings disregards under the MFIP program, and a nearly three-fold increase in the number of families receiving child-care subsidies. These initiatives make it possible for working poor families to move out of poverty, while at the same time reinforcing the incentive for them to work.

At the same time, the MFIP program now requires participants to spend a minimum number of hours in job search, or other work activities; and it can impose 100% sanctions on families who fail to comply with these work requirements. The state has also introduced behavioral requirements, intended to reduce long-term welfare dependency, such as a 60-month limit on lifetime MFIP benefits, and a family cap that prohibits families on MFIP from having their grant level increased when another child is born.

This section briefly describes how these policies work, while the next provides evidence from the best national research on the likely impacts of these policies.

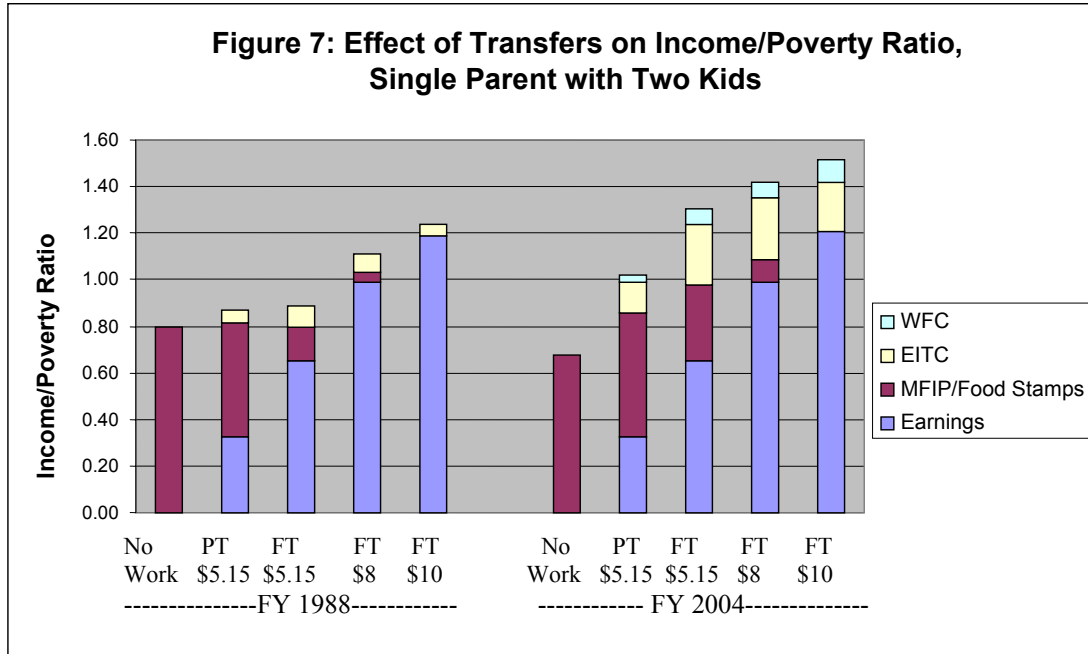
Benefit Structure

The following chart shows how the maximum earnings and transfer income of a single parent with two children has changed since FY 1988. The estimates include earnings, MFIP, Food Stamp benefits, the Earned Income Tax Credit, and the Working Family Tax Credits; they also include federal and state income and payroll taxes.¹⁰ This chart shows that the financial rewards to full-time work have increased substantially. While a single parent would have earned about 10 to 40% more if she worked full-time in FY 1988, in FY 2004 her income would have increased by 90 to 120 percent

The chart also shows that the system is now more effective in reducing poverty for families with full time full year workers. In FY 2004, the transfer system roughly doubled the income of parents working full time full-year at the minimum wage, making it possible for them to move from 30 percent below to 30 percent above the poverty threshold. By contrast, in FY 1988, a single parent working at the minimum wage would have remained 10 percent below the poverty line, even if she chose to work full-time.

¹⁰ These estimates do not make any adjustments for child-care costs or benefits, and they exclude other in-kind benefits such as Medicaid and Housing Assistance. For a more complete analysis of the impact of these programs, see [Minnesota Office of the Legislative Auditor, 2002].

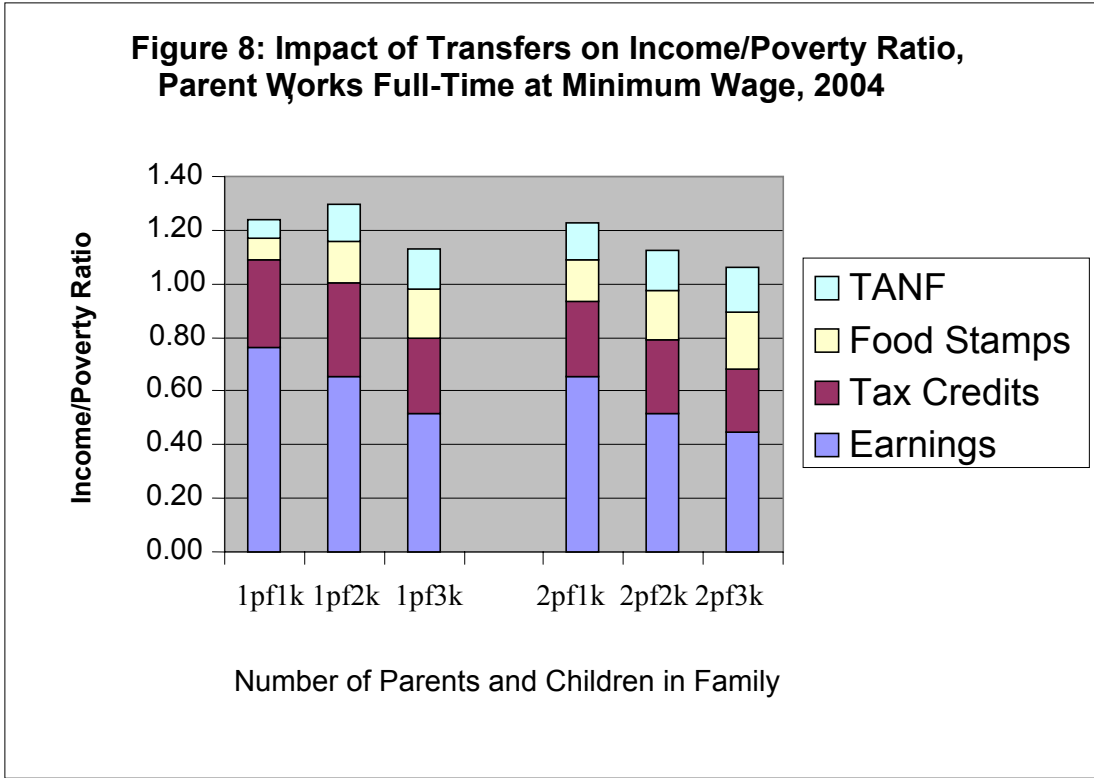
As shown, the system is much less effective in reducing poverty for families without stable employment. A single parent who worked part-year at the minimum wage would earn an income that just barely fell above the poverty level in FY2004. If she did not work at all, her maximum income would fall 33 percent below the poverty threshold – a substantial decline from her potential income of 20 percent below poverty in FY1988.



Source: Minnesota Office of the Legislative Auditor, 2002, and Minnesota House Research department, 2004a and 2004b.

The following figure shows how the impact of transfers varies by family size in FY2004. The estimates assume that one parent works full-time full-year at the minimum wage—or roughly 8 months at \$8 per hour. This figure makes it clear that families who work at low-wages, or who work intermittently will require access to MFIP and Food Stamp Benefits to maintain their family incomes above the poverty threshold. Without MFIP and Food Stamp benefits, single parents with less than three children would have incomes that just cleared the poverty threshold. Single parents with more than two children and all married couples with children would have incomes that remained below poverty.

Figure 8: Impact of Transfers on Income/Poverty Ratio, Parent Works Full-Time at Minimum Wage, 2004



Source: Minnesota House Research Department, 2004a and 2004b.

Access to Program Benefits:

While the Minnesota transfer system has the potential to move many families out of poverty, its impact may be limited, if families do not have access to program services. The following table presents estimates of the extent to which Minnesota’s welfare programs reach their target populations. The numbers shown in this table are equal to the ratio of administrative reports of monthly caseloads in FY 2004 to estimates drawn from the Current Population of the number of families in Minnesota who are in groups that are likely to be eligible for assistance. Because they are based on relatively small samples, and they do not apply the full range of program eligibility rules to determine eligibility, they give only a rough estimate of the size of the eligible population.

**Table 2:
Number of Recipients Receiving Transfers in FY2003,
Relative to Target Population**

Program	Participation Rate	Target Population
MFIP	0.454	Families with incomes Below 135% Poverty Line, and Child < 18
Child Care	0.344	Families with income below 200% Poverty, All Parents Work, and Child Under 12
Food Stamps	0.612	Poor Individuals

Notes:

- 1) MFIP cases exclude child-only cases. MFIP target population estimate is based on the number of Minnesota families with incomes below poverty, adjusted by national estimates of the proportion of families with incomes below 135% of the poverty level who have children under age 18.
- 2) Child-care cases represent BSF and MFIP cases. Target Population is based on number of Minnesota families with incomes below 200% poverty, adjusted by national estimates of the proportion of families with incomes below 200% of the poverty line that have a youngest child under age 13, in which all parents are working.
- 3) Food Stamps estimate is based on number of recipients per poor individuals in Minnesota.

Sources: Minnesota Department of Human Services, Reports and Forecasts Division, *Family Self Sufficiency and Health Care Program Statistics*, August 2004. Minnesota Department of Human Services, *Child Care Facts and Figures*. U.S. Census Bureau, Current Population Survey Annual Demographic Supplement, *Detailed Poverty Tables*, 2003.

This table suggests that only a small proportion of potentially eligible families are receiving assistance, with participation ratios of 45 percent for MFIP, 34 percent for child-care subsidies, and 61 percent for the Food Stamp program. These estimates are consistent with results from a recent phone survey conducted by the Wilder Institute that also found that a small proportion of low-income families with children were receiving child-care subsidies (Chase and Shelton, 2001).

While some families may not want to receive program benefits, others may face barriers to participation, such as lack of knowledge of program benefits, administrative hassles, or the “stigma” attached to receiving welfare. In addition, as the MFIP program has been configured to promote short-term, rather than long-term welfare stays, many of

its current policies, such as MFIP time limits, full benefit sanctions, and family caps may discourage families from taking advantage of MFIP benefits.

In addition, the low utilization rate of child-care subsidies may partly reflect a lack of adequate funding. The Department of Human Services reported that in November 2003, there were 6000 families on the waiting list for Basic Sliding Fee child-care assistance, compared to the 12,500 families receiving assistance (Minnesota Department of Human Services, 2004). The Wilder study found evidence that the unmet demand for child-care subsidies may be even larger. They found that 19 percent of low-income families with children under 14 reported that they were on a waiting list or that they would have been on a waiting list if it had not been so long. This estimate was 1.6 times larger than the number who said they were receiving subsidies—suggesting that there may be a large untapped demand for child-care subsidies (Chase and Shelton, 2001).

Impacts of Welfare Reform in Minnesota—Results from the Welfare Research

Roundtable

A recent report by more than a dozen researchers at the “Welfare Research Roundtable” summarizes the results of more than 50 studies on the impacts of the first seven years of welfare reform under MFIP in Minnesota (McDonnell, 2005). One of the conclusions of this report is that while some families have had largely positive experiences under MFIP welfare reform, others have fared much more poorly. Moreover, these outcomes were clearly linked to the ability of families to find employment.

For example, the state’s longitudinal survey of welfare recipients found that as of the three-year follow-up, 60 percent of former recipients were working. Of these, roughly two-thirds were no longer on MFIP and earning an income that was 170 percent of the poverty line, while one-third were still on welfare and earning an income 18 percent above the poverty threshold. By contrast, the 25 percent of welfare recipients not working and still on welfare after three years were living on an average income that was 68 percent of the poverty line, with a poverty rate of 92 percent (Chrichton and Meyer, 2003)

The longitudinal survey also indicates that many MFIP families remain in unstable jobs, with relatively low wages. Average hourly wages for employed former MFIP recipients ranged from \$8 per hour in the first year to \$9 per hour in the third follow-up year of the survey. Moreover, as of the third follow-up year, only 17 percent reported that they had worked full-time full year in the prior year. Another 21 percent worked part-time during every month of the prior year, while 27 percent worked for 6 to 11 months (Chrichton and Meyer, 2003).

These relatively poor labor market outcomes of former MFIP recipients reflect the realities of today’s labor market for low skilled workers. Over the past thirty years,

aggregate economic forces—such as the expansion in trade, the introduction of new technologies, and the deterioration in the role of institutions such as unions and the minimum wage—have contributed to a reduction in the relative economic position of low-skill workers (Freeman, 1994).

Nationwide the hourly wage of male workers in the bottom ten percent of the wage distribution have decreased from \$7.06 in 1978 to \$6.36 per hour in 1999, while the wages of the bottom ten percent of women have remained at a little over \$5.00 per hour (Mishel et al, 1999). A sizeable share of Minnesota’s labor force now works at low wages--over 30 percent of all workers earned less than \$10.00 per hour in 2000; and these workers experience high rates of job turnover (Minnesota Department of Employment and Economic Development, 2005).

Recent research has also found that low-wage workers have low rates of wage growth, and thus they are unlikely to “earn” their way out of poverty. For example, one recent study of welfare leavers found that, controlling for other factors, their annual wages grew at 2.5% per year (Card et al, 2001). At this rate, a worker starting out at \$7.00 per hour would still be earning only \$9.00 per hour after ten years. This finding has been confirmed by a much longer-term analysis of two different cohorts of workers, which also found that the rate of mobility from low-wage to high-wage jobs has declined over time (Bernhardt et al, 2001).

Options for Reform

Employment and Training Activities

Given the importance of employment for families to move out of poverty, it is instructive to ask whether expansions to the State’s mandated employment activities might move more families out of poverty. This approach has a strong intuitive appeal, since it has the potential to address the underlying causes of low family incomes, without raising the fear of creating welfare dependency.

Unfortunately, there is very little evidence that employment and training programs--particularly programs that focus on Job Search activities—are likely to be effective on their own in moving families out of poverty. The Manpower Demonstration Research Corporation has recently completed a review of over 20 different experimental evaluations of welfare-to-work programs that operated in the United States in the 1980s and 1990s. These programs are comparable to the Minnesota program in that they coupled extensive job search requirements with limited education and training activities.

This study found that welfare-to-work employment programs produced modest increases in employment and earnings—typically an average of \$500 per year over a five-year period (Gueron and Hamilton, 2002). However, because any earnings gains were offset by reductions in welfare receipt, there were no measurable gains in family incomes or reductions in poverty. Moreover, as of five years into the program, there was no evidence that the program’s income effects increased over time. This suggests that

these programs did not produce behavioral changes that led to longer-term increases in family incomes.

There is some evidence that more extensive employment and training activities produce somewhat larger increases in earnings. The two most effective programs in the MDRC review of welfare-to-work programs pursued a mixed approach that Job Search activities with education and training services. These programs increased earnings by \$1000 per year (Gueron and Hamilton, 2002; Hamilton, 2001).

A recent synthesis of research on voluntary programs found that these programs produced somewhat larger gains for adult women—around \$1600 per year. These programs offered more intensive training services than current programs, and cost an average of \$7400 per participant. This study also found that most types of employment training programs increased earnings. By contrast, basic education activities, such as GED preparation or ESL courses, had minimal impacts (Greenberg et al, 2003).¹¹

Taken together, this research suggests that expanded employment and training services could increase family earnings somewhat, and reduce poverty. However, it is unlikely that employment and training programs will produce large enough earnings gains that families can move out of poverty without additional financial assistance.

Financial Assistance to the Non-Working Poor

As noted above, programs that offer financial assistance to the working poor have the potential to be particularly cost-effective in moving families out of poverty, because they can be structured in a way that promotes increases in work that reinforce the impact of the program on poverty. However, shifting towards a work-based system also leaves people who are not able to work in a more vulnerable position. Thus, there may be strong equity grounds for increasing resources in this area.

Since 1993, real expenditures on MFIP and General Assistance, the two main programs that help the non-working poor, have decreased by 75%, and their share of total spending for welfare assistance has decreased from 88% of all spending on poor families to 23% in 2005. Real grant levels have also deteriorated, so that currently MFIP pays benefits for a family of three that fall 33% below the poverty threshold.

These changes may increase the vulnerability of people who cannot find work either due to substantial personal barriers to work, or due to downturns in the economy. Minnesota could offset some of these changes by increasing real grant levels under the MFIP and the General Assistance programs. It also could conduct more extensive outreach services, to ensure that eligible families receive assistance.

¹¹ The welfare to work demonstrations also found that basic education did not increase earnings more than pure Job Search or mixed programs. This may be because, even though they did increase GED's, they did not improve measured academic skills [Hamilton, 2002], pages 20-22.

While these changes may require further expansions in work incentives in other parts of the program to preserve current levels of incentives for families to work, they may be helpful to prevent serious deprivation among the non-working poor.

Financial Assistance to Working Poor Families

Some of the most promising results from the literature on the impacts of welfare reform efforts come from two welfare demonstration experiments in Minnesota and two provinces of Canada that substantially expanded earnings supplements for welfare recipients. As noted above, these programs have attracted national attention because they generated improvements in children's outcomes that did not occur in other welfare to work demonstrations.

In addition, these programs were particularly "cost-effective" in increasing family incomes because they created incentives for families to work that reinforced the program's impact on family income. For example:

- In the third year of the program, both the Minnesota MFIP and the Canadian SSP experiments reduced poverty rates of long-term single parent recipients by 11 to 12 percentage points, and increased incomes by 13 to 15 percent (Grogger, 2002).
- For every dollar of government spending, the MFIP demonstration increased the incomes of long-term single parents by \$1.19, while the Canadian SSP program increased the participant incomes by \$2.00. Traditionally, economists have estimated that every \$1 in spending on transfers increases family incomes by \$0.66, because they cause offsetting reductions in work (Burtless, 1987).
- These two programs were particularly cost-effective in increasing participant incomes, because they increased the employment and earnings of program participants by 10 to 20 percent (Grogger, 2002). In addition, both programs were targeted towards disadvantaged groups, who were otherwise unlikely to have substantial earnings.

Other programs that offer financial assistance to working families through refundable tax credits, such as the Minnesota Family Tax Credit, and the Federal Earned Income Tax Credit, also have the potential to decrease poverty, while at the same time promoting work. For example, a study of the impact of recent expansions to the Earned Income Tax credit concluded that they caused large increases in employment and earnings among single parents. This study estimated that an increase in the maximum EITC benefit of \$2000--an amount that corresponds with the actual increase in EITC benefits from 1993 to 1999--would increase employment rates of single parents by 7.2 percentage points (or half of the increase in employment for this group from 1993 to 1999). It also would increase weeks of work by 2.4 weeks, and increase annual earnings by \$1200. (Grogger, 2003)

Because the EITC causes such large increases in work effort, it is likely to increase the incomes of single parent families. It may have less of an impact for higher

income families who fall in the region where EITC benefits gradually decrease with increases in income. These families may reduce their hours of work, because their effective wage rates decline as the EITC benefit is “phased out”. This may be why the expansions to the EITC were also associated with decreases in work among married women (Eissa and Hynes, 2004).

Given these generally strong results, Minnesota may want to ensure that it maintains the effectiveness of its system of financial supports for the working poor. For example, while families in the original MFIP demonstration program were able to earn up to 138% of the poverty level and qualify for assistance, the income level at which families exit the MFIP program is now 115% of poverty. Given the evidence that income must raise above a threshold level to generate improvements in outcomes for children, Minnesota may want to consider raising the MFIP exit rate back to its level in the MFIP demonstration.

Minnesota may also want to re-evaluate its policies that inhibit access to MFIP program benefits. While policies such as welfare time limits, full family sanctions, and family caps may be effective in reducing welfare caseloads, they also may inhibit the ability of the program to provide a source of income support to families with persistently low wages.

Alternatively, Minnesota may want to expand benefit levels under the Working Family Tax Credit, to ensure that all families working full-time at the minimum wage are able to move out of poverty. This approach has the advantage that tax credits are more broadly acceptable to the general population, and they tend to have higher take-up rates than other welfare programs. However, they also redistribute resources to a more advantaged segment of the population than the current MFIP and General Assistance programs. In addition, because they usually make payments in one lump-sum per year, they are less responsive to individual family circumstances. For this reason, it may be optimal to pursue a balanced combination of MFIP and Working Family Credit benefits.

Child Care Subsidies

Given that there appears to be a large untapped demand for child-care subsidies, Minnesota could expand funding of child-care to reach a larger proportion of eligible families. This could achieve multiple goals, including increasing maternal employment and earnings, decreasing financial hardship of working families, and increasing family access to high quality care that could potentially improve children’s cognitive development.

The available evidence suggests that child-care subsidies increase employment rates of single parents. A recent review found that child-care subsidies increased the probability of employment for single parents from 7 to 32 percentage points, with the most relevant study finding an increase of 15.3 percentage points (Blau and Currie, 2004; Tekin, 2004a).

Providing assistance in the form of child-care subsidies is likely to have substantial impacts on family well-being, because it constrains families to spend a large proportion of their budget on child-care services. In FY2004, the average monthly spending on child-care services per family was over \$700 per month, compared to \$600 per month in MFIP and food assistance programs.

This shift in the composition of spending almost certainly changes the expenditure patterns of families. For example, a recent study found that receipt of child-care subsidies increased the number of single parent families working and using center-based care by 33 percent, while it decreased the percent working and using relative care by 16 percent. Subsidies also increased the probability that single mothers worked during standard hours (Tekin, 2004a; Tekin, 2004b).

Unfortunately, there is relatively little information available on how child-care subsidies affect other measures of child and family well-being. A recent review of the literature concluded that while there is some evidence that children who attend high quality child-care centers have better cognitive and behavioral outcomes, these impacts are highly sensitive to the method of controlling for underlying differences between families who choose different types of child care arrangements. For this reason, they concluded that the literature on the impacts of variations in quality among most standard types of child-care is largely uninformative (Blau and Currie, 2004).

This review did find that there is evidence that programs that offer enriched preschool and child-care services produce sustained improvements in child outcomes. For example, experimental evaluations of two small-scale programs that offered intensive services to preschool children found they produced long-term increases in academic achievement, high school graduation rates, college attendance, and reductions in crime and welfare use. These programs invested roughly twice as much per child as current child-care programs, but they also resulted in long-term savings for taxpayers.¹²

Large-scale programs that offer enriched services to these populations also have shown promising results. For example, evaluations of the Head Start program that carefully control for family background characteristics, find it improves long-term measures of well-being for some populations.¹³ Three-year evaluations of the Early Head Start Program have also shown improvements in children's cognitive development, reductions in problem behaviors, and increases in the ability of children to devote sustained attention to an object during play (Administration on Children, Youth and Families, 2002). It is not yet known whether these impacts will be sustained as children get older.

¹² The Carolina Abecedarian Project offered full-time enriched center-based child care at a cost of \$15,000 per child per year, while the Perry Preschool Project offered half day preschool services for eight months at a cost of \$7000 per child in 1999 dollars. (Blau and Currie, 2004).

¹³ (Currie and Thomas, 95;99) find participation in Head Start increases academic achievement scores and reduces grade retention for Whites and Blacks, but not for Hispanics. (Garces et al, 2000) find that Head Start increases college attendance for whites, and decreases arrest rates for blacks.

Conclusions

* Minnesota currently spends 2.2% of its state general fund budget on non-medical welfare assistance programs--including the Minnesota Family Investment Program, General Assistance, Child Care Subsidies, the Working Family Tax Credit, and the Dependent Care Tax Credit. State inflation-adjusted spending on these programs has decreased by 13 percent since FY1993. This implies that spending on these programs has not driven the recent increase in the State's budget deficit.

* Combined cash and food assistance benefits are high enough to bring family incomes above poverty, if families work full time and they receive all of the benefits they are eligible for. They are well much less adequate for non-working families, for families with intermittent employment, or for families who do not receive MFIP assistance.

* Investments in welfare assistance programs may be necessary to offset the negative impacts of poverty on children. Research shows that poverty negative affects children's cognitive, linguistic, emotional and social development, and that it limits their long-run economic prospects. Experimental evidence from Minnesota and two provinces of Canada found that programs that increased family incomes also improved children's cognitive and social development.

*To reduce poverty and thereby improve child well-being, Minnesota must either increase family earnings or enhance the financial supports available to low-income families. These supports must be sustained long-term, to offset the deterioration in real wages in the bottom tier of the labor market. Some policies are more effective than others in this regard:

*Welfare-to-work employment programs yield modest increases in employment and income and decreases in welfare receipt, but they have no measurable impact on family incomes or poverty.

*Intensive training programs produce larger increases in earnings, but the impacts are still modest. While most types of training are effective, basic education activities such as GED preparation or ESL courses do not perform better than the less expensive Job Search only programs.

* Programs that offer extended financial assistance to disadvantaged working families are particularly cost-effective in reducing poverty and promoting employment. Two experimental demonstration programs in Minnesota and Canada which allowed families on welfare to earn up to 1.4 to 2.0 times the poverty level and still receive program benefits produced substantial increases in family incomes and reductions in poverty. For every dollar of government spending, the Minnesota demonstration increased the incomes of long-term single parents by \$1.19 while the Canadian program increased incomes by \$2.00.

* Refundable tax credits, like the Minnesota Working Family Credit and the Earned Income Tax Credit, increase earnings and employment of low-wage families, and are also likely to increase family incomes. They may reduce work effort somewhat among families with higher incomes, who fall in the range where benefits are phased out.

*While it is clear that child-care programs increase family resources and increase employment, we do not yet know whether the typical child-care program improves children's outcomes more than cash assistance. Very ambitious programs (costing twice as much as current child-care programs) that offer enriched preschool and child-care services produce sustained improvements in child outcomes that may result in long-term savings for taxpayers. Large-scale programs, such as the Early Head Start program and the Head Start program also improve outcomes for some populations.

*Minnesota could enhance the anti-poverty effectiveness of its current welfare programs for working families, by expanding the maximum MFIP earnings eligibility threshold to its original level in that demonstration program. It also could make a concerted effort to ensure that income-eligible families receive MFIP, child-care, and Working Tax Credit benefits. Minnesota could also provide a more adequate income to families who are unable to work for personal or economic reasons, by increasing the level of the maximum MFIP grant.

* Minnesota may want to conduct careful evaluations to determine which particular mix of child-care, enriched preschool, and financial assistance programs offers the best potential payoff in terms of improving family and child well-being. For example, the state's At-home Infant Care program, which allows low-income families to have one family member remain at home to care for a newborn child and still receive child-care subsidies, may offer a promising way of meeting the need of families with infants. Older children may benefit from a benefit package that places higher emphasis on cognitive skills, or on increasing family incomes.

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