Recent Updates to Section 1115 Waiver Budget Neutrality Policy: Overview and Implications for States

Prepared by Manatt Health

STATE Health & Value STRATEGIES | *Driving Innovation Across States*

A grantee of the Robert Wood Johnson Foundation

December 2022

Background

Section 1115 Medicaid demonstrations are a powerful tool for states to pursue a range of innovative programs aimed at improving the health and well-being of Medicaid enrollees by allowing the secretary of the Department of Health and Human Services to waive components of federal Medicaid law and provide federal funding to support demonstration initiatives. States have used 1115 waivers for a variety of purposes, including expanding coverage to new populations, providing enhanced benefits to enrollees, and implementing programs targeting health-related social needs (HRSNs).

While not required under federal law or regulation, longstanding federal policy requires that 1115 waivers be "budget neutral" to the federal government—in other words, demonstrations must not increase federal spending relative to a state not pursuing an 1115 demonstration. At a high level, this involves projecting what a state would have spent in the absence of the demonstration (known as "without waiver" expenditures) and comparing this amount to actual expenditures (known as "with waiver" expenditures). States that spend less than their without waiver projections have historically been permitted to carry forward savings to finance new initiatives [including certain "costs not otherwise matchable" under federal Medicaid law, subject to approval by the Centers for Medicare & Medicaid Services (CMS)] while those that exceed their without waiver projections may be required to pay back the federal government.

Though conceptually simple, budget neutrality policy has evolved over the years into a complex process that is burdensome to states and CMS, hamstrings states' ability to respond to emerging events on the ground (e.g., public health crises, provider workforce shortages), and increasingly bears little resemblance to actual Medicaid cost growth trends. Prior to recent policy changes, states without waiver projections were generally trended forward in perpetuity from the launch of each state's demonstration, allowing some states with longstanding waivers to "bank" significant savings over many years. At the same time, many states faced budget neutrality constraints when attempting to implement policies that would have been approvable under Medicaid state plan authority, such as routine provider payment rate increases. The policy has also faced increasing scrutiny in recent years from federal oversight agencies, which have raised concerns over CMS' approach to budget neutrality and urged CMS to strengthen its fiscal oversight of the program.

CMS first attempted to fix some of the key issues with budget neutrality policy through a 2018 State Medicaid Director Letter (SMDL) establishing a new budget neutrality "rebasing" policy. This policy attempted to reduce inequities across states by changing the without waiver baseline calculation to be set based on actual spending (rather than continuing to trend forward historic spending in perpetuity). While this policy did level the playing field across states to some extent, it did not create room for innovation in states with newer waivers and created a situation where states with longstanding investments would be forced to make drastic cuts.

Recent Efforts to Improve Budget Neutrality

Over the past two years, CMS has engaged closely with a group of states organized by the National Association of Medicaid Directors to align on key challenges with existing budget neutrality policy and identify principles for a new policy moving forward.

During the summer of 2022, CMS began to roll out a series of changes to budget neutrality policy through state waiver approvals. On June 17, CMS approved an amendment to Kansas' 1115 waiver for the sole purpose of adjusting the demonstration's budget neutrality caps to account for changes to a state-directed payment program. In the recent past, CMS generally would not allow states to amend demonstrations solely for the purpose of making changes to budget

neutrality, even if the policy necessitating the change would otherwise have been allowable under federal Medicaid law. On June 28, CMS approved an extension to Vermont's longstanding demonstration and provided ongoing authority for the state to make adjustments to budget neutrality to account for provider rate increases without having to submit a formal amendment.

In late September, CMS rolled out a series of more comprehensive and far-reaching updates to budget neutrality policy through renewals of longstanding waivers in Oregon and Massachusetts. These include significant changes to: the way that without waiver baselines are calculated; which trend rates are applied; how savings are rolled over across demonstration periods; which expenditures may be included as "hypothetical"; and processes for states to make mid-course changes to budget neutrality. While CMS noted in the Oregon and Massachusetts waiver approvals that it intends to evaluate future demonstrations on a case-by-case basis, it also noted that it "anticipates that it will apply these or similar updates in its approach to budget neutrality consistently to all similarly situated states, going forward." Shortly after approval of the Oregon and Massachusetts waiver renewals, CMS approved similar changes to budget neutrality through a renewal of Arizona's demonstration and an amendment to Arkansas' demonstration, further signaling its commitment to this new policy.

In the below table, we summarize the key policy changes established through the Oregon and Massachusetts waiver renewals (and reinforced through the Arizona and Arkansas approvals) and discuss key implications for states.

Overview and Implications of CMS' New Approach to Budget Neutrality

Policy	Previous Approach (as established in CMS' 2018 SMDL)	New Approach	Implications for States
Without Waiver Rebasing	• Without waiver baseline rebased every five years based on actual expenditures	• Without waiver baseline rebased every five years using a weighted average of 20% of the state's pre-2018 SMDL without waiver baseline (as applicable) and 80% actual expenditures	• Allows states with longstanding waivers to continue to generate some savings based on historical without waiver projections (though savings will be constrained relative to the pre-2018 SMDL policy, which allowed for indefinite trending of without waiver baseline expenditures and did not involve rebasing)
Without Waiver Trend Rate	• Without waiver baseline trended forward by the lower of the state's historical trend rate and the President's Budget trend rate	• Without waiver baseline trended forward by the President's Budget trend rate	• No longer applies a budget neutrality "penalty" to states that have low Medicaid cost growth • Previously, states with cost growth under the President's Budget trend rate would receive lower budget neutrality trend rates compared to states with higher spending growth

Policy	Previous Approach (as established in CMS' 2018 SMDL)	New Approach	Implications for States
Savings Roll-Over	• Banked savings able to be carried forward for five years • Newest savings used first	• Banked savings able to be carried forward for 10 years • Oldest savings used first	• Allows states to benefit from savings generated over a longer period time; this will likely increase the availability of banked savings in most states and improve the ability of states to make waiver investments • Applying oldest savings first (as opposed to newest savings) will generally reduce the amount of savings that will "expire"
Savings Cap	• None (after rebasing applied)	• Savings capped at the lower of total savings (i.e., savings carried forward from previous demonstration periods and savings generated during the current period) or 15% of total Medicaid expenditures during the most recent five-year period	• Limits the amount of accessible savings as a share of overall Medicaid program spending • This will likely only have an impact on states with longstanding waivers that have accumulated significant savings over many years

Hypothetical Expenditures	• Expenditures for services that are the same or similar to state plan services [including expenditures on the Affordable Care Act (ACA) new adult group]	• Expenditures for services that are the same or similar to state plan services
		• Expenditures on certain programs addressing HRSNs[i]
		  • Programs must be likely to improve the quality and cost of downstream services
		  • Expenditures will only be approved under an aggregate cap
			• Creates significant new flexibility for states to develop programs targeting HRSNs without having to rely on banked budget neutrality savings—instead, approved expenditures are added to the without waiver baseline calculation to offset the increase in with waiver expenditures
			• Unlike with traditional hypothetical expenditures, HRSN-related hypothetical expenditures are capped—i.e., states will not be able to use budget neutrality savings from elsewhere in the demonstration to fund expenditures that exceed the cap
			• Expenditures associated with the ACA new adult group will continue to be treated as hypothetical (as has been the case since the implementation of Medicaid expansion in 2014); states will still be unable to generate budget neutrality savings on this group, despite some states having nearly nine years of historical data on expansion expenditures

i Approved services targeting HRSNs include a range of evidence-based housing supports (e.g., pre-tenancy and tenancy sustaining services, medically necessary air conditioners and air filtration devices), nutrition supports (e.g., nutrition counseling, medically-tailored meals), and case management. Massachusetts will provide transportation to assist with access to tenancy and nutrition support services. Oregon also received authority to pay for up to six months' rent and temporary housing.

Policy	Previous Approach (as established in CMS' 2018 SMDL)	New Approach	Implications for States
Mid-Course Corrections	• States required to submit a formal amendment to make changes to budget neutrality	• States permitted to adjust budget neutrality without an amendment under certain, limited circumstances • States must submit data demonstrating that actual expenditures have exceeded the without waiver baseline • Changes to budget neutrality may be applied retroactively	• Allows states to make routine policy changes that are otherwise allowable under the Medicaid state plan (e.g., payment rate increases for state plan services) without being constrained by budget neutrality • Reduces risk that states will exceed their budget neutrality cap for circumstances outside of their control (e.g., introduction of a high-cost drug, state legislative changes necessitating rate increases, provider workforce shortages) • Potentially encourages more states to pursue new 1115 demonstrations by reducing the downside risk of being "stuck" with unfavorable budget neutrality terms

Conclusion

While historical 1115 waiver budget neutrality policy arose from a desire to promote fiscal accountability, the policy had become excessively complex, constrained states' ability to make worthy investments, and treated states inequitably.

Through several recent waiver approvals, CMS introduced a suite of significant policy changes aimed at addressing many of the core problems of the agency's historical budget neutrality policy. These changes include taking a more flexible approach to savings, creating new opportunities for states to finance innovative programs addressing HRSNs without using savings, and allowing states to make mid-waiver adjustments for routine policy changes and circumstances outside of a state's control. While 1115 waiver budget neutrality policy will likely continue to be a challenging exercise for both CMS and states, this change in direction from CMS is a significant step toward rationalizing the agency's approach to budget neutrality and streamlining pathways for states to develop ambitious, innovative programs aimed at addressing some of our nation's most pressing health-related challenges.

Support for this brief was provided by the Robert Wood Johnson Foundation. The views expressed here do not necessarily reflect the views of the Foundation.

ABOUT THE ROBERT WOOD JOHNSON FOUNDATION

The Robert Wood Johnson Foundation (RWJF) is committed to improving health and health equity in the United States. In partnership with others, we are working to develop a Culture of Health rooted in equity, that provides every individual with a fair and just opportunity to thrive, no matter who they are, where they live, or how much money they make. For more information, visit *www.rwjf.org/*. Follow the Foundation on Twitter at *www.rwjf.org/twitter* or on Facebook at *www.rwjf.org/facebook*.

ABOUT STATE HEALTH AND VALUE STRATEGIES—PRINCETON UNIVERSITY SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS

State Health and Value Strategies (SHVS) assists states in their efforts to transform health and healthcare by providing targeted technical assistance to state officials and agencies. The program is a grantee of the Robert Wood Johnson Foundation, led by staff at Princeton University's School of Public and International Affairs. The program connects states with experts and peers to undertake healthcare transformation initiatives. By engaging state officials, the program provides lessons learned, highlights successful strategies and brings together states with experts in the field. Learn more at *www.shvs.org*.

ABOUT MANATT HEALTH

This issue brief was prepared by Patricia Boozang, Anne Karl, and Adam Striar. Manatt Health integrates legal and consulting expertise to better serve the complex needs of clients across the healthcare system. Our diverse team of more than 160 attorneys and consultants from Manatt, Phelps & Phillips, LLP and its consulting subsidiary, Manatt Health Strategies, LLC, is passionate about helping our clients advance their business interests, fulfill their missions, and lead healthcare into the future. For more information, visit *https://www.manatt.com/Health*.