
by Jim Jaffe, EBRI

- The United States faces the growing societal problem of a dramatic increase in the proportion of retirees relative to workers, and how to finance their care, due to such well-documented demographic trends as the largest generation (the baby-boomers) nearing retirement, longer average lifespans, and far greater time spent in retirement.

- According to a recent EBRI analysis done in collaboration with the Milbank Memorial Fund, the total annual national retirement income shortfall will grow to as much as $57 billion by 2030, an increase of approximately $25 billion from its projected level in 2005. During the decade ending in 2030, aggregate retiree income shortfall could exceed $500 billion.

- The results show that for the median individual in birth cohorts on the verge of retirement there is little possibility of them saving enough to supplement the simulated retirement wealth to provide adequate retirement income to meet basic needs. However, younger-birth cohorts would benefit from the increased years of contributions and would have savings targets that are feasible for most groups. However there are some notable exceptions: Single females in the lowest income quartile are predicted to need in excess of 25 percent of compensation per year to have sufficient retirement wealth regardless of birth cohort—an improbably high goal.

- This Issue Brief briefly summarizes the initial results from the national version of the Retirement Security Projection Model (reported in greater detail in the November 2003 EBRI Issue Brief), and provides analysis and comments on the implications of these findings from numerous professionals with policy expertise on the issues involved.

- An important issue in retirement security is large unanticipated health care costs—particularly if retirees need extended nursing home care or extended home health care. Furthermore, fewer retirees are going to have health insurance from a former employer and Medicare is projected to be severely underfunded once the baby boom generation starts retiring. All of this indicates more insecurity for future retirees about their ability to cover health expenditures in retirement.

- Besides the personal implications for individual Americans who are likely to outlive their assets, the increasing national retirement income gap is expected to put heavy stress on state programs—particularly Medicaid—that finance long-term care for indigent retirees. However, because of budget difficulties, states are cutting spending on such programs rather than expanding them.
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Introduction

This Issue Brief discusses a new study that quantifies the shortfall in retiree income that is anticipated over the next third of the century. It also presents information on how relevant institutions are dealing with today’s shortfall and how they may, could, or should respond to the problem in the decades ahead. The findings and data in this report were initially presented at a policy forum sponsored by the Employee Benefit Research Institute Education and Research Fund (EBRI-ERF) on Dec. 4, 2003, in Washington, DC, and attended by about a hundred health and retirement policy experts.

The new study, released by EBRI last November and the result of collaboration between EBRI and the Milbank Memorial Fund, concludes that older Americans will be receiving about $57 billion less in 2030 from retirement plans than they’ll require to maintain a basic standard of living and afford needed nursing home or home health care. That figure is more than double the current estimated deficit. During the decade ending in 2030, the aggregate shortfall will exceed $500 billion.

Rather than asking, as previous studies have done, whether the average retiree will have adequate income, this research estimates the probability that any given individual—especially one who lives well beyond the normal lifespan or incurs extraordinarily high medical or nursing home expenses—will have adequate income from retirement plans and Social Security alone. Posing the question this way is particularly apt now, when a growing number of workers are being asked to take increasing responsibility for retirement income adequacy. The shifts toward defined contribution plans and lump-sum payments both push in this direction.

The study assumes that workers will remain on the job until they reach Social Security’s normal retirement age—65 or older, depending on when they were born. But it does not yet include the as-yet-uncalculated impact of the new Medicare drug benefit that was enacted a few weeks prior to the discussion and won’t become fully effective until 2006 (P.L. 108-173, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003).

While many retirees could adequately fund their future needs by saving a modest amount—in many cases less than 5 percent of annual compensation—beyond their current retirement savings (and some may already be doing so), certain groups lack the economic wherewithal to make such preparations. The situation is particularly dire for single women in the lowest income quartile. Even if they saved more than 25 percent of their income annually—an improbably high goal—most would still face an income deficit in retirement.

Some retirees could protect themselves from some unanticipated expenses by purchasing long-term care insurance that would cover large nursing home or home health expenses, but such insurance products have yet to win broad popularity.

Given the current organization of public programs, state governments are the entities most likely to be asked to pick up the resulting slack. But few are now considering expanding programs for the elderly, and indeed, given the dramatic budget deficits in many states, austerity is the order of the day. As state officials bore witness during the EBRI policy forum, it is unrealistic for states to debate broader programs when they appear unable to fund those already on the books. And given the federal government’s mushrooming budget deficits and recent tax cuts, there appears to be little prospect of a federal bailout to help the states cope with the looming retirement funding shortfall.

Policy forum speakers noted that numerous federal tax laws exist that encourage greater retirement savings, but they appear to be most successful at reaching the more affluent groups. These tax advantages for retirement plans tend not to reach the millions of workers in the lowest income brackets who have no income tax liability and thus receive no incentive from tax-deferred retirement...
plans. The laws could be modified to reach these groups, but the most recent legislative proposals in Congress are aimed at expanding existing programs.

Several speakers maintained that currently there is considerable denial of the problems involved, given the size of the shortfall in Americans’ retirement income adequacy and the complexity and difficulty of the issues. But for many elderly in the years to come, failing to address the policy implications now may translate into real pain in the future.

“Tolerate more human suffering among our seniors. This is the likely result of what several speakers identified as ‘denial’: A situation in which people don’t fill their prescriptions, don’t take their drugs, change their diet because they can’t afford to eat,” said Dan Fox, president of the Milbank Memorial Fund. “Tolerate more suffering is an alternative. Countries have been in decline before.”

Growing Retirement Income Shortfall Seen

As detailed by the EBRI-ERF retirement security model, millions of retired Americans will find themselves struggling in 2030 because they lack adequate income from retirement plans to finance the basic costs of living and pay large unanticipated bills for health and long-term care, particularly those for home health or nursing home care. The model projects that this aggregate shortfall will exceed $40 billion annually by 2030 if housing equity is liquidated when needed and near $60 billion annually if housing equity is not liquidated. The baseline assumption of the model assumes that anticipated Social Security benefits are paid.

The EBRI model shows that most of today’s workers born prior to 1941 cannot save enough prior to retirement—if they haven’t already done so—to achieve a 75 percent certainty of having an adequate income to cover projected expenses. By contrast, most workers born subsequent to 1960 could assure such adequacy by saving less than 5 percent of their income beyond their current retirement savings for the remainder of their career. As a rule, those in the higher income brackets fare better, and some of them may already be saving the required amounts beyond their retirement savings plan. Couples tend to have more economic security than single people, while single males tend to fare better than single females. Nursing and home health care expenses are often the issues that push retirees into income inadequacy (see Figures 1−3, pgs. 9−12).

“The thing that would probably have the single biggest determination on whether or not the amount of money you retire with turns out to be sufficient is whether or not you have one of these potentially catastrophic health care expenses, things like home health care and nursing home care,” said professor Jack VanDerhei, Temple University, research director of the EBRI Fellows Program, and co-author of the EBRI model.

Despite widespread public discussion about new products like reverse mortgages that allow retirees to liquidate the value of their residence, the EBRI model shows that this action makes little overall difference to retirement financial security. Rather, it is the savings rate over time that is critical. As many observers have concluded, too many Americans are saving too little to finance a comfortable retirement. But the EBRI/Milbank study goes a step further, concluding that savings often will be inadequate even for a basic or austere retirement. Given current trends (such as the move away from employer-provided “traditional” defined benefit pensions, as well as the decline in employer-provided retiree health care), workers should not expect that employers will step in to solve this problem for them.

“As depressing as some might find some of these results [from the EBRI model], there are levels at which they are a best-case scenario,” said Dallas Salisbury, EBRI president and CEO. “The over-age-65 population is on course to grow from 13 percent to 22 percent of the population. That’s in an economy where 70 percent to 80 percent of economic growth is based on individual consumption. There are major challenges ahead for U.S. firms that sell to the retired population (which most do),
challenges for tax revenues and for entitlement programs, and challenges for children, grandchildren, even great-grandchildren. These are big issues.”

Nicholas Latrenta of Metlife pointed out that the projected shortfall results from large numbers of Americans living longer (Figure 4, pg. 13)—which although is good news, could result in exploding lifetime medical expenses—and greater individual responsibility for retirement income decisions, which were not always optimal. Customers used to buy life insurance to protect their families if they died prematurely, but now they also seek insurance to protect themselves if they outlive their assets.

Noting the trend away from defined benefit pension plans, he stressed the need for better education of the public about meeting retirement needs and tax policies that provide the proper incentives to individuals to meet those needs. Some members of Congress are sponsoring incentives for tax breaks for retirees who opt for an annuity rather than a lump-sum payment.

“It was only a few short years ago that people thought that baby boomers would have enormous wealth in their 401(k) plans. They would be inheriting enormous sums from their parents. They’re going to retire early. They’re all going to go off to Boca to retire,” Latrenta said. “Those thoughts have all faded away as reality has set in.”

No one at the EBRI policy forum presented a scenario in which employers would take broader responsibility or defined benefit pension plans would make a dramatic comeback. Indeed, several speakers noted, the evidence is quite to the contrary.

Charles Tharp of Rutgers University raised several questions about whether retirement plans were keeping up with demographic changes in the society. At a time when people are living longer, many plans offer early retirement options that encourage workers to retire at younger ages. This policy made sense when physical labor was involved and people simply wore out after years of heavy lifting, he said, but it may be increasingly inappropriate in today’s knowledge society in which workers develop growing expertise throughout their careers. In some cases, it may be encouraging people to leave when their skills peak. Responding to these demographic changes in a more rational way could help develop a system that limited employer expenses while also providing greater retirement income adequacy, he suggested. The current trend toward forced early retirements may cause companies major problems in the future as they compete for talent.

“Most companies in their employment policies are encouraging and paying people to start learning how to voluntarily retire early and start making that transition—phased retirement and all those issues—at a time when, in fact, I think we want to be retaining more workers as we see labor force shortages,” Tharp said.

From the employer perspective, the priority is restraining costs, a policy that could worsen the projected retirement funding shortfall. Chris Bone of Aon Consulting reported that 15 percent of large employers surveyed had actually frozen their pension plans in the past two years, and another 6 percent were considering it at the time the survey was taken. At best, this means that new entrants to the work force will not enjoy the same benefits accrued by previous generations, he said. Other employers were attempting to create a structure with greater predictability by shifting to hybrid or cash-balance retirement plans that do not require retrospective adjustments based on market movement or an employee’s career trajectory.

Interestingly, during a period when large employers are moving to limit retirement costs or curtail coverage, small employers appeared to be moving in the opposite direction by offering a retirement plan more often than they have in the past. However, they are still far less likely than large employers to offer an employer-funded pension plan, and instead almost exclusively offer some type of defined contribution plan (such as a SIMPLE IRA or 401(k)) that participating workers may contribute to.
More than half (55 percent) of workers employed by firms with fewer than 100 employees have no employment-based retirement plan at all, added Chris Bowman of the Principal Financial Group, despite substantial and projected continuing growth of plans within this group in recent years.

Bowman said employers were very wary of long-term commitments and therefore “very interested in plans that require no employer contributions. That’s a little scary. We know the power of the [401(k)] match. We know the power of how employer contributions can accumulate, but of course we’d still maintain that there are plan designs where no employer commitment is required. Getting people started and giving them a wholesale way to invest, to learn about the program, is still very powerful.”

The problem is particularly acute for women, because they tend to work fewer years (usually due to leaving the work force to care for children or family members) and at lower wages than men. They also have longer average life expectancies (thus requiring greater aggregate retirement income) and tend to have more physical limitations in old age than men (Figure 5, pg. 13). Inasmuch as women are more likely to be part-time workers who are denied benefits, the disparity becomes even more serious, reported Sheryl Ruzek of Temple University. For younger, professional women who face less significant pay disparities than were once the norm, the situation is improving, but disparities remain, she added.

“The evidence shows that younger women working full time are starting to catch up with pension contributions,” Ruzek said, “but I think that there is clear evidence that there is still a tremendous gap for the youngest cohort of women.”

**Health Care Costs Responsible for Gap**

Compounding these changes in the retirement plan sector, a critical factor in retirement income security is large unanticipated health care costs—particularly if retirees need extended nursing home care or extended home health care. More Americans are living to retirement, and those who do are living longer in retirement. As most retirees already know, the cost of health care regularly outpaces inflation. Taken together, these trends are a threatening combination for retirees, particularly those on fixed incomes. And employer-provided retiree health insurance, which typically does not pay for the home health or nursing home expenses that can exceed available income, is becoming rare.

As earlier EBRI research has documented, fewer Americans retiring in the decades ahead will have such coverage and those with such protection are likely to find it both less extensive and more expensive. Fewer than 1 in 4 Medicare-eligible retirees currently has employer-subsidized coverage, and that number is expected to diminish (Figure 6, pg. 14). Paul Fronstin, director of EBRI’s Health Research and Education Program, cited research predicting that employers were seeking ways to further reduce these costs. He referred to an EBRI report issued in November 2003 that found a $28 billion shortfall in meeting retiree health costs and noted that this figure will grow as employer coverage shrinks.

The research Fronstin and Dallas Salisbury did shows that retirees with employer coverage face lifetime out-of-pocket health costs of up to $750,000. For those lacking this coverage, the maximum bill can be as high as $1.5 million.

“Besides fewer employers offering those benefits, when they are offered retirees are often paying more in terms of the premium,” said Fronstin. “They’re also paying more for health care services when they need them, so we’re seeing deductibles and co-insurance and co-payments increasing.”

Although beset by fiscal pressures, Medicare (the federal health care insurance program for the elderly and disabled) has had a positive role in helping elderly Americans afford retirement. As a rule, older Americans are more likely to have health insurance—and more likely to be happy with the coverage they have—than younger Americans. Despite general satisfaction with the existing programs, current questions about how to maintain solvency of the program overwhelm any serious
consideration of providing broader benefits. The recent addition by Congress of a prescription drug benefit, which puts added fiscal stress on a program that was already facing huge deficits, makes further significant expansions less likely.

Medicare serves nearly all Americans age 65 and over and, with Social Security, is seen as one of the nation’s most valued and successful social programs. Beneficiaries are generally more satisfied than those insured by the private sector, reported Cathy Schoen, vice president of the Commonwealth Fund, and costs have risen less rapidly. But, the program faces insolvency within a decade. The new Medicare drug benefit will ease financial pressures on some seniors while hastening the day of reckoning on how to keep the program financially viable, she said.

The net impact of the new Medicare drug law is difficult to determine, although it contains several elements designed to ease certain problems; for instance, it will provide subsidies to employers that continue to provide retiree health prescription drug coverage, and creates new “health security accounts” that will encourage workers to save in tax-advantaged accounts that can be tapped to pay future medical expenses. But together, these elements could tend to be least helpful to the low-income workers who are most likely to face a significant income shortfall in retirement, Schoen said.

“We often forget that before a universal health insurance program came in that made it easy to get coverage, half the elderly were uninsured,” said Schoen. “And we’ve had major life expectancy, quality of life, and health improvements since the enactment of Medicare.”

Also unclear is how many workers will purchase long-term care insurance or relocate to a life-care community where needed support services can be easily provided when required. About 11 percent of Americans age 65 and older now have long-term care insurance. As a result, reported Robert Friedland, of Georgetown University’s Center on an Aging Society, Medicaid paid for 45 percent of long-term care in 2001, nearly double the percentage paid directly by individuals and four times the amount paid by private insurance.

Friedland said that the growth of group sales for long-term coverage might alter this picture in the years ahead. But it is too early to tell whether this new marketing focus will make a major difference, and he could not anticipate a day when a majority of retirees would be protected by such insurance.

“Many older people in the future face the risk of outliving their assets,” Friedland said. “The question that remains is whether the choices individuals make and the market responses to those choices will be adequate without government interventions and government incentives.”

**Federal Tax Policies: New Targets, Rules Required**

Today’s tax policies tend to reward those who need help the least, according to J. Mark Iwry, a former Clinton administration Treasury official dealing with pension issues, who is now a fellow at the Brookings Institution. Iwry pointed out that tax breaks for retirement savings are the government’s largest tax expenditure, but provide little incentive to the majority of lower-income workers who are in the 10 percent or 15 percent tax brackets—or who pay no income taxes at all. Iwry characterizes the current system as inefficient, using tax dollars to reward people who are already saving to put their money into certain types of tax-advantaged accounts.

Changing the policy to use tax credits, especially refundable ones, could redress this imbalance, he said. He also endorsed a government match to encourage low-income Americans to save, a proposal initially floated by the Clinton administration.

And, Iwry added, many of those who do save don’t do so well, putting their money into suboptimal investments, such as the excessive investments in employer stock that became so apparent during the stock market’s retraction. “It’s a shame that we have to look to undiversified investment in employer stock as an offset or partial solution to excessive investment in money market funds,” he said.
Iwry doesn’t think proposals to encourage employers to make available more and better investment advice is the best response. This problem could be solved by having a default investment option in retirement plans that would automatically place workers’ contributions in a safe, diversified mutual fund. Finally, he expressed concern about retirement asset “leakage” that removes needed savings from the system when people switch jobs or when they receive lump sums upon retirement and don’t annuitize them.

For the moment, Congress seems more interested in extending existing tax breaks for retirement savings. Iwry noted that Bush administration proposals to allow more tax-deferred savings would also be most advantageous to those in high tax brackets already taking advantage of existing laws.

“A key question in evaluating private pension policies is whether the taxpayers are getting their money’s worth for their tax dollars, including in comparison to expanding Social Security, Medicare, or alternative uses,” Iwry said. “I posit that the types of tax expenditures that are useful mainly to [upper income] people tend to be inefficient.”

States Under Increasing Pressure for More Elderly Aid

In the absence of any evidence suggesting that employer-provided retirement plans would become more generous, and many hints that the employment-based system is moving in the opposite direction, analysts foresee a growing pressure on state programs—particularly by elderly individuals who are low-income and who were not offered employer-provided retirement plans to supplement Medicare. State officials are aware of this growing demand and are increasingly worried about how to respond to it.

A growing retiree income shortfall, largely precipitated by custodial and medical expenses, will inevitably put greater pressure on state Medicaid programs (federal-state health care program for the poor), which already serve more than 6 million low-income Medicare beneficiaries and pay almost half of the nation’s long-term care bills. Because nursing home care is so expensive, 27 percent of Medicaid dollars in 2002 was spent on the 9 percent of beneficiaries who were elderly. The average Medicaid expenditure for an older American was nearly $13,000 a year in 2002, roughly seven times the per capita rate for younger adults or children.

Diane Rowland, executive director of the Kaiser Commission on Medicaid and the Uninsured, noted that 24 percent of the increase in Medicaid spending during the 2000–2002 period was attributable to the aged population. In recent years, Rowland pointed out constricted revenues have resulted in more focus on controlling Medicaid spending than in expanding the program (Figure 7, pg. 14).

“The states are not in a very good position to be growing their program budgets for Medicaid, at a time when we have greater aging of the population and greater demands on the health care system, because they are experiencing one of the most substantial revenue drop-offs in their history,” Rowland said.

The changing economics of aging impact the states in several ways. The situation in Oregon, summarized by George Naughton, a senior analyst in that state’s budget office, offers a case in point. State and local government are more likely than other employers to offer costly defined benefit pension programs but, increasingly, are hitting dramatic spending constraints. In Oregon, the employer pension-funding rate was scheduled to rise from 15 percent of salaries in 1995 to nearly 25 percent by 2005. In 2001, the state faced an unfunded pension liability of $5.6 billion.

Reforms enacted in 2003, which are still subject to court challenges, reduced the employer contribution to 10.7 percent of salaries. While that eases fiscal pressure on the state, it also cuts anticipated benefits for future retirees, he noted.

Spending on the Oregon medical assistance programs has increased sixfold to $1.2 billion in the past decade, but the state has also implemented a controversial prioritization system for indigent medical care.
“If you looked at the state long-term care system 20 years ago, you could track people from the public welfare system when they were younger and you could watch them move into the state long-term care system,” Naughton said. “We now have a system that is serving much more of the middle-class folks. They have spent down through their resources.”

Massachusetts State Sen. Harriette Chandler reported that the combination of aging populations and spending cuts (or tax increases) required by most state constitutions to maintain a balanced budget is creating extremely unpleasant political conflicts. The over-65 population of Massachusetts, now 13 percent, is projected to reach 20 percent by 2050, and the number of residents over 85 is expected to jump 11 percent by the end of this decade. Long-term care is already eating up the bulk of the state’s Medicaid budget.

Chandler noted the state is trying to induce residents to buy long-term care insurance, by modifying the spend-down Medicaid threshold for those who are insured and by offering a policy that offers a full refund of premiums if services aren’t used. But with revenues going down and demands on government going up, the pressure on policymakers is intense, she said.

There aren’t any easy ways out. An effort to tighten current law, which now allows a non-institutionalized spouse to retain nearly $91,000 in assets and annual income of about $27,000, was explosively rebuffed in 2003. She added that financial advisors were becoming increasingly adept at teaching seniors how to shelter assets from spend-down requirements.

“People see this as an issue of either denial—they don’t want to think about this—or they believe quite rightly that the state will take care of their problems because they’ve come to believe in the whole issue of elder care being a public-sector entitlement,” Chandler said.

**No Quick, Easy, or Cheap Solutions Seen**

The issue of retirement income adequacy is not a problem that defies solution, but rather than that may mandate some difficult choices, according to Dan Fox of the Milbank Memorial Fund, which helped develop the EBRI retirement security projection model. Fox listed several options:

- Delaying retirement. While the retirement age has been declining for years, it isn’t clear whether this trend is continuing.
- Encouraging greater individual savings with a strategy based on fear, public policy, and employer policy.
- Expanding health insurance coverage to better deal with chronic diseases that can lead to disability.
- Embracing policies, including policy incentives, which induce families to take on greater responsibilities.
- Welcoming the assumption of new and increased responsibility for the charity community to build on the key role that philanthropy, and especially religious charity, has played in creating many of America’s hospitals and nursing homes.
- Tolerating a greater amount of suffering among seniors, who are increasingly asked to choose between rent, heat, food, and needed drugs.

Fox said “the first task” of trying to avoid that last alternative is to increase public awareness and understanding of the evidence—something he said will be greatly furthered by the new EBRI model retirement security projections.

**Endnotes**

Figure 1
Percentage of Added Compensation That Must Be Saved Annually Until Retirement For a 75% Chance of Covering Basic Retirement Expenses
(assumes current Social Security and housing equity is never liquidated)


*a 25% = 25% or more.
Figure 2
Percentage of Added Compensation That Must Be Saved Annually Until Retirement For a 90% Chance of Covering Basic Retirement Expenses (assumes current Social Security and housing equity is never liquidated)


a 25% = 25% or more.
Figure 3
Percentage of Retirees Estimated to Have Sufficient Retirement Income/Wealth\textsuperscript{a} by Saving Additional 5% of Compensation Each Year From 2003 Until Retirement (assumes current Social Security benefits)

Assumes current Social Security, and that housing equity is never liquidated. The model includes the possibility of chronic long-term home health care and nursing home expenses.

Figure 5
Older Women Have More Limitations in Functioning Than Men

Percentage of persons age 70 or older who are unable to perform certain physical functions, by sex, 1984 and 1995

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<td>Climb Stairs</td>
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<td>Stoop</td>
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<td>Reach Up</td>
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<td>Any 1 of 9</td>
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Note: The nine physical functioning activities are: walking a quarter mile; walking up ten steps without resting; standing or being on your feet for about two hours; sitting for about two hours; stooping, crouching or kneeling; reaching up over your head; reaching out as if to shake someone's hand; using your fingers to grasp or handle; lifting or carrying something as heavy as ten pounds. A person is considered disabled if he or she is unable to perform an activity alone and without aids. Rates for 1984 are age-adjusted to the 1995 population.

Reference population: These data refer to the civilian noninstitutional population.
Source: Supplement on Aging and Second Supplement on Aging.
Figure 7
Medicaid Enrollees and Expenditures, by Enrollment Group, 2002

- Elderly: 9% of enrollees, 27% of expenditures
- Blind & Disabled: 16% of enrollees, 43% of expenditures
- Adults: 25% of enrollees, 12% of expenditures
- Children: 50% of enrollees, 18% of expenditures

Enrollees Total = 50.9 million
Expenditures Total = $216 billion*

* Expenditure distribution based on CBO data that includes only spending on services and excludes DSH, supplemental provider payments, vaccines for children, and administration.
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