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State Responses to Budget Crises in Fiscal Year 2004

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ABSTRACT

In this report we examine how ten states from around the nation have responded to their budget crises in fiscal year 2004. While states vary in the depth of the budget pressures they faced, as state revenues remained depressed, all were required to make difficult choices among spending reductions, tax increases, or other revenue measures. In general, we found states with few exceptions relied on targeted revenue measures, such as cigarette and alcohol taxes, but were unwilling to engage in significant increases in personal or corporate income taxes or sales taxes. States did continue the pattern of recent years of drawing on reserves or rainy day funds, transferring monies from dedicated trust funds and shifting spending or taxes across time periods to address current shortfalls.

In contrast to fiscal year 2003, states relied much more heavily on reducing spending for many state programs in fiscal year 2004. Perhaps most striking in the past year were policies that reduced support for higher education, aid to localities, and the size and compensation of the state workforce. States also found themselves with the need to make far more cuts in health care spending than in earlier years of the economic downturn. In addition to freezing or reducing provider reimbursement rates and cutting optional benefits in Medicaid, most of the states in this study made efforts to reduce enrollment in either Medicaid or SCHIP. The federal fiscal relief provided through the Jobs and Growth Tax Relief and Reconciliation Act helped most of the ten states reduce the extent of spending cuts or tax increases. A few states responded that decisions on spending or taxes were not affected and the new federal revenues were added to reserves as protection against future shortfalls.

Introduction

In 2000, the United States economy began to slow and the nation entered a recession early in 2001. The terrorist attacks of September 11, 2001 exacerbated the economic problems facing the nation. State revenues experienced a dramatic decline in the middle of 2001, and while beginning to increase again, have generally remained at depressed levels. At the same time, states were faced with strong public support for

increasing spending on elementary and secondary education, rising enrollment in higher educational institutions because of the baby boom echo, and sharply growing Medicaid expenditures.

Because of all these factors, states were dealing with their most serious fiscal crises since World War II.[1] The pressures facing states were particularly acute as they enacted their fiscal 2003 budgets. Conditions were, in most states, just as severe if not worse as they prepared their fiscal 2004 budgets, in part because prior budget actions foreclosed some options for this year. In this report we examine the decisions states made to solve their budget problems in fiscal 2004. Among other things, we look at the extent to which states attempted to increase revenues through taxes or fees, cut spending, or used reserves or rainy day funds, trust fund surpluses, or tobacco settlement revenues.

This report updates one that was completed a year ago that examined state decisions from fiscal 2003 made by seven states (California, Colorado, Florida, Michigan, Mississippi, New Jersey and Washington).[2] In that report, we concluded that states solved their budget problems in fiscal 2003 largely by the use of one time budgetary mechanisms, such as drawing down rainy day funds or reserves, using trust fund surpluses, or securitizing tobacco settlement revenues, and various Medicaid special financing mechanisms. Of particular note, several states relied on upper payment limit

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[1] National Governors' Association/National Association of State Budget Officers,, *The Fiscal Survey of States*, Washington, D.C.: National Association of State Budget Offices, 2002).

[2] John Holahan et al., *The State Fiscal Crisis and Medicaid: Will Health Programs Be Major Budget Targets? Overview and Case Studies,* Washington, D.C.: Kaiser Commission on Medicaid and the Uninsured, January 2003.

programs and intergovernmental transfers as a way to leverage additional federal Medicaid funds. With the exception of the cigarette taxes, most states generally avoided tax increases. Beyond revenue measures, states cut a broad array of programs. Within Medicaid, states mostly avoided cutting eligibility or benefits and instead relied heavily on provider reimbursement rate freezes or reductions to achieve savings.

In fiscal 2004 we found more reliance on increases in taxes, primarily tobacco or alcohol taxes, or fees and user charges. With a few exceptions, the lack of support for increases in income or sales taxes persisted. Surprisingly, states continued use of so-called "one time" budgetary mechanisms, such as reserves or trust fund surpluses, that had seemed nearly fully exhausted after fiscal 2003 actions.

Spending cuts were much more severe in fiscal 2004 than in the previous year. While most of the ten states avoided cuts in K-12 education, higher education was slashed in many of our states, requiring state university systems to adopt significant tuition increases. States also cut both the level and compensation of the state workforce. In addition to layoffs or reductions through attrition, many states froze salaries and state employees were required to contribute more to health benefits. Many states reduced aid to localities that could eventually affect at least lower income cities' and counties' ability to provide basic services, including education.

Particularly striking was the increased willingness of states to more aggressively cut health care programs. In addition to continuing to cut or freeze provider reimbursement, states eliminated some optional benefits, particularly for adults, and began to limit enrollment through reducing eligibility standards, imposing enrollment caps, reducing outreach, and making the enrollment process somewhat more

cumbersome. Enrollment reductions took place in both progressive states that had recently enacted broad eligibility expansions as well as states with historically more narrow levels of coverage where cutbacks focused on curtailing outreach, requiring more frequent eligibility redetermination, and capping SCHIP enrollment.

This report is based on a review of policy changes in ten states: Alabama, California, Colorado, Florida, Massachusetts, Michigan, New Jersey, New York, Texas, and Washington. These ten states are part of the focus of the Urban Institute's Assessing the New Federalism project, a large multi-state research effort that has followed state health, income support and social services policies in thirteen states since 1997. We collected information on state budgetary activity from state websites, newspapers, and public documents. We then conducted telephone interviews and site visits between October and December 2003 with key state government officials and representatives of provider and consumer organizations using an open ended structured protocol.

Budget Pressures

The ten states in this study varied greatly in the degree of budget pressure they faced in fiscal 2003-2004. As noted above, budget pressures were as great in FY 2003-2004 as they had been in FY 2002-2003, if not worse. It is difficult to quantitatively compare the degree of pressure because states differ greatly in what they include in their general fund budgets. For example, many have several earmarked trust funds with dedicated revenue streams for education, transportation and other activities with the rest of state funded services financed with general fund revenues. But all of the states in this study, with the exception of Florida, unquestionably faced serious budget problems in

fiscal 2004. A summary of the budget situations faced by our states, organized by region, is as follows.

New York experienced a $6.8 billion general fund budget gap (about 17 percent of the total general fund spending) in FY2002-03. The budget gap in FY2003-04 amounted to $11.5 billion or 25 percent of the general fund. New York's budget shortfalls were caused primarily by the national recession and the fiscal consequences of the September 11 attacks on the World Trade Center. The FY2003-04 gap was closed largely through borrowing onetime revenue measures, increases in cigarette and alcohol taxes, and of particular note, a temporary increase in income and sales taxes. Despite large service cuts proposed by the governor, only fairly modest cutbacks were enacted.

New Jersey faced an FY2004 shortfall of about $4.9 billion--about 18% of state appropriations. Spending was growing faster than expected because of higher Medicaid costs and employee benefits and the need to increase retiree pension contributions for the first time in several years. Revenues were down because of the economy. This pressure for FY2004 came on top of having had to fix a $5.3 billion shortfall for the FY2003 budget and implement a $2.8 billion mid-FY2002 supplemental appropriations, mainly because of unexpectedly low revenues. A big piece of FY2003 deficit reduction was a major increase in corporate income taxes. The FY2004 budget gap was solved through a range of spending cuts, tobacco securitization and fund transfers and some increase in taxes and fees, but not major taxes.

Massachusetts faced a projected budget deficit of $3 billion for FY2004 as of January 2003. This shortfall followed a $2 billion deficit that was filled in enacting the FY2003 budget and additional mid-year shortfalls met with supplemental appropriations of $650 million during FY2003. The main budget problem has been revenue shortfalls from the recession and to a lesser extent from a phase-out of a prior surcharge on income taxes implemented just as the recession hit. Spending pressures come heavily from health care and aid to localities, both projected to rise rapidly before cuts were made. The FY2004 budget gap was filled primarily with spending cuts or reductions in projected growth. However, the state also closed some corporate tax loopholes and increased fees, and shifted revenues among funds.

Michigan had a budget gap of $1.6 billion in FY2004. The FY2004 budget gap followed shortfalls of $1 billion in FY2002, another $800 million that developed during the course of FY2002, and $1 billion in FY2003. The state has been seriously impacted by the effect of the recession on employment and state tax revenues. In October 2003, Michigan had the highest unemployment rate in the country. More than half of the budget gap in FY2004 was resolved through spending reductions with most of the rest through revenue increases.

Alabama faced a $123 million shortfall in FY2003 that it solved with a number of one time measures, including the use of rainy day funds and trust fund transfers. In

FY2004 it faced a $675 million shortfall, amounting to 16.5 percent in the general fund and 11.4 percent in the education trust fund. Following the failure of a major tax reform initiative, the general fund budget gap was closed with a 5.3 percent reduction in spending that affected most state agencies.

Texas faced the largest revenue drop in state history -- $7.4 billion -- and an estimated shortfall of $9.9 billion, or 15 percent of projected general revenue spending for the FY2004-2005 biennium. Beyond this dramatic revenue drop, the deficit in Texas was attributed to increased state spending on Medicaid and SCHIP. The strong anti tax sentiment in the state meant that the solution to the budget crisis lay almost wholly in spending reductions.

Florida's budget was in fairly good shape, particularly in comparison with other states. The state has aggressively reduced taxes each year since 1999, and despite a relatively strong economy, faced an FY2004 shortfall of about $1.0 billion (about 2 percent of the state budget). Some cuts in spending were used to address the gap but the primary response was the use of one time revenues and a bond issue to fund voter-directed capital expenditures for school construction.

Colorado faced an FY2003-2004 shortfall of nearly $900 million or about 7.0 percent of the state's $13.4 billion budget. This followed a FY 2002-2003 shortfall of $850 million. Colorado's deficits occurred because the state was especially hard hit with the recession because of the importance of high technology in its industrial base, and a decline in tourism following September 11. Because of the strong anti-tax sentiment in the state, budget shortfalls were made up largely through spending reductions.

Washington faced an FY2003-2005 biennium budget gap of $2.7 billion out a budget of $23.1 billion. The budget gap occurred because of slower than expected revenue growth related to the recession, increases in health care costs because of rising caseloads, higher education enrollment, rising prison populations, and ballot initiatives requiring the state to increase spending on K-12 education. The budget gap was closed almost entirely with spending cuts.

California faced a $38 billion budget shortfall in FY2003-2004, primarily because of reduction in income tax revenues (especially capital gains) that resulted from the economic downturn was never offset by spending reductions or other revenues. The $38 billion consisted of a $14 billion carryover from FY2002-2003, as well as $24 billion for FY2003-2004. The budget agreement reached prior to the recall of Governor Gray Davis was balanced mostly by borrowing and accounting devices, with about one-third of the gap billed by spending cuts or tax increases. Governor Arnold Schwarzenegger and the legislature have agreed to try to get voter approval for these bonds to finance past deficits but the governor is still proposing deep spending reductions.

Revenue Increases

There are three broad strategies available to states for closing budget gaps. The first is to increase revenues, the second is borrowing, and the third is spending cuts. Among study states, the first option appeared to be the least favorite, though the three northeastern states (Massachusetts, New Jersey and New York) and Michigan all relied on revenue strategies to close their FY2004 budget gaps.

New York in FY2003-2004 enacted a temporary three-year increase in the personal income tax as well as a .25 cent increase in the state's sales tax. The state also enacted several fee increases and closed some corporate tax loopholes. New Jersey enacted a large increase in corporate income taxes in FY2003. While in FY2004 it did not seek new revenue from any of the major tax sources (sales taxes, corporate income taxes, or personal income taxes), New Jersey did increase cigarette taxes and fees on hotels, motels and casinos. Massachusetts enacted a $1.2 billion increase in taxes and fees in FY2003 and raised $100 million through closing corporate loopholes and another $400 million through increases in fees in FY2004. Similarly, following a five-year phase in of reductions in income and business taxes, Michigan increased its sales tax and closed various tax loopholes in FY2004.

Other than these four states, there was very little effort to increase taxes. Washington increased liquor taxes but no other tax increases were seriously considered. There were no new taxes in Colorado. The same was true in Florida, though there were some fee increases. Tax increases were proposed in Texas and Alabama but soundly

defeated. California actually eliminated an increase in vehicle license fees, thus reducing revenues, after the election of Governor Arnold Schwarzenegger.

All states indicated that they benefited from the increased federal payments provided through the Jobs and Growth Tax Relief Reconciliation Act of 2003 which allocated $20 billion in federal funds to states between April 2003 and September 2004. How states used these funds varied. States such as Alabama, California, Colorado and Texas that addressed their budget pressures primarily by cutting spending responded that the federal revenues reduced the breadth and depth of the spending reduction measures that were taken. States like Michigan, New York, and New Jersey that included tax increases as part of their budget strategy stated that the federal revenues affected the scope of both spending reductions and tax increases; each of these states used federal revenues to add to reserves as well. Two states (Washington and Massachusetts) responded that the deep spending reductions that they made were not affected by the availability of federal revenues; nor was either state willing to increase taxes. Thus, the federal revenues added to state reserves to protect against revenue shortfalls in the future. Florida used the new federal revenues in part for a onetime investment in an economic development project and added the rest to reserves to be used for anticipated budget difficulties in the 2004-2005 biennium.

Other Revenue Measures

As in FY2003, states continued to rely on onetime strategies to raise revenues, including using reserves and tobacco settlement funds, and borrowing from trust funds and from the public. Massachusetts, New York, California and New Jersey all shifted funds from trust funds to the general fund to relieve budget shortfalls. New York, for example, borrowed from its Environmental Protection Fund and TANF reserves whereas New Jersey borrowed from several funds, including transferring monies from the Unemployment Insurance Fund to the Hospital Charity Pool.

California is attempting to solve its budget problems with a substantial amount of borrowing. The Davis administration proposed a $10.7 billion bond issue at the end of FY2003 to resolve that year's budget problem. However, because of legal challenges, the bond issue requires voter approval which has not yet occurred. More recently, Governor Schwarzenegger has proposed a $15 billion bond initiative coupled with a constitutional amendment to limit spending as a way to solve California's budget woes.

New York, Colorado, New Jersey, and California are using funds obtained by securitizing tobacco settlement monies. Under these tobacco securitization arrangements, states issue bonds to raise revenues and use the flow of money from the tobacco settlement to pay principal and interest on the bonds. These arrangements provide states with an immediate influx of revenues but significantly reduce the amount of future money they otherwise would have received from the tobacco settlement. For example, Colorado securitized 47 percent of its tobacco settlement funds by selling $530 million of

the state's $1.2 billion total settlement award, and generated $313 million to help fill the state's FY2004 deficit.

States relied less on reserves in FY2004, primarily because these funds had already been used in previous years.[3] For example, Massachusetts, New York, Alabama and Michigan all used reserves or rainy day funds in FY2003, but they were not used much in FY2004. The one notable exception was Texas which used $1.3 billion from its rainy day fund to close its budget gap in FY2004-2005.

Two states took steps to sell state real estate to obtain immediate cash. Colorado enacted legislation allowing for the sale of $160 million of state buildings that it would then be leased back by the state (this authority has not yet been implemented). In FY2004, Massachusetts transferred title to state real estate in lieu of cash contributions to the state pension fund. Other creative measures included shifting spending or taxes across time periods. Texas, for example, deferred $1.3 billion in payments to local school districts until September 2005 (the first month of the next fiscal year), thus easing its FY2004-05 budget problem. Colorado delayed state employee pay checks for June of 2003 until July, thus moving $89.4 million in obligations to FY2004.

Three states--California, Colorado, and Texas--moved from accrual to cost based accounting for some Medicaid services. Rather than accounting for payments to providers when liabilities are incurred, they began to account for them when they are

[3] According to the leading survey, the average state year-end balance was 10.4 percent of state expenditures for fiscal 2000, 3.1 percent for fiscal 2003. National Governors Association and National Association of State Budget Officers, The Fiscal Survey of States (December 2003). http://www.nasbo.org/Publications/fiscsurv/fsfall2003.pdf.

paid, often in the next fiscal year. This results in shifting costs to the next fiscal year allowing the state to show savings in the current year, but increasing future obligations.

States also have increasingly relied on quality assessment fees as a revenue measure. These fees are essentially a tax on providers and are typically linked to a provider reimbursement rate increase. Generally, the state is able to increase provider rates, or avoid a reduction, without using state general funds. Among our study states, the design of the quality assessment fee is such that providers that serve large numbers of Medicaid patients end up being better off, i.e., the increased reimbursement rate more than offsets the fee. Providers that have smaller shares of Medicaid tend to be net losers with fees exceeding the revenues obtained from increased reimbursement rates. Quality assessment fees are used primarily for nursing homes; because it is largely a Medicaid industry, thus there are more winners than losers. For example, Massachusetts, Washington, and New Jersey have applied assessments to nursing home beds. Michigan is using quality assessment fees more aggressively, applying them to hospitals, nursing homes and HMOs. An attempt to apply them to pharmacies was strongly opposed and not implemented.

Spending Reductions

K-12 Education

Education is a major part of state budgets with K-12 schooling being the largest single item financed by states and higher education either second or third. K-12 education has been a high (if not highest) priority for states and not surprisingly most

generally protected K-12 education in their FY2004 budgets. For example, a ballot initiative passed in Florida required the state to reduce class sizes with the result that capital expenditures for education (financed partly through a bond issue) needed to double. The state also increased operating expenditures for K-12 education in FY2004. Likewise, Colorado, through a constitutional amendment, is required to increase spending on K-12 education by inflation plus enrollment growth plus 1.0 percent. Michigan, despite its budget deficits, maintained state payments at $6,700 per pupil and increased payments for early childhood education in FY2004.

Not all states, however, protected K-12 funding with Washington being a notable exception. In FY2003-2005, the state chose not to fund increases in teacher pay and reductions in class size required by ballot initiatives. The ballot initiatives did not provide a revenue source and the state chose to delay implementation. The Texas Education Agency laid off 125 of its 860 full time positions, and school transfers, counselors and libraries had state contributions to their health insurance reduced from $1,000 to $500 per year. New Jersey, and to a lesser extent New York, also made cuts in K-12 education.

Higher Education

More prominently, many states reduced payments for higher education. California reduced higher education spending by 9.0 percent, leading to tuition increases of 30 percent or more. In Florida, the higher education budget was reduced by $11 million and $40 million for community colleges and universities respectively, with the state allowing community colleges to increase tuition by 7.5 percent and universities by

8.5 percent. Colorado cut its higher education budget by $100 million or 30.0 percent, allowing tuition increases of 10.0 percent. Michigan made a 6.5 percent cut in higher education. Washington cut higher education budgets by $131 million, allowing undergraduate tuition increases of 7.0 percent for each year of the biennium. New Jersey cut higher education by $113.5 million, and Texas cut higher education research funds.

Aid to Localities

Several states made substantial cuts in aid to localities. Michigan and Massachusetts cut aid to localities in FY2004 by 3 percent, and 5 percent, respectively. California, by eliminating the vehicle license fee increase, which funded aid to cities and counties, in effect reduced state aid to localities. New Jersey reduced its payments from a program established to promote local property tax relief. New York was a prominent exception to the general trend in cutting aid to localities: Governor Pataki proposed substantial cuts to local aid but these were largely rejected by the legislature because of concerns over effects on local property taxes.

State Workforce

Virtually all of the states made reductions in spending on the state workforce. Most prominently, several states (for example, California and Washington) adopted actions to reduce the number of employees. States also froze salaries and increased employee contributions to health premiums. For example, Florida reduced the state workforce by 3.2 percent in FY2002-03 and by 1.0 percent in FY2003-04. Colorado cut 1,000 jobs in FY2003 whereas New Jersey and Alabama froze state employee compensation in FY2004. Washington froze state employee salaries, required increased

payments for health benefits and reduced the state workforce by 1,100. California cut state workforce expenditures primarily through layoffs and reduced compensation. Massachusetts increased the employee's share of health insurance premiums. Michigan reduced salaries and increased health insurance premiums. Moreover, the state threatened layoffs if the compensation changes were not accepted by the state employee's unions.

Health Care

In response to budget pressures faced in FY2003, states attempted to reduce Medicaid spending primarily through cuts or freezes in provider payment rates. In the past year, states had responded to rising health care expenditures much more aggressively than they had in the past. The FY2004 Medicaid budget actions adopted by the study states will likely affect Medicaid and SCHIP enrollment in many states as well as the scope of benefits. Further, for the second consecutive year, virtually all of the study states reduced or froze at least some provider payment rates.

Enrollment. Massachusetts, one of the leaders among states in its reliance on Medicaid to expand coverage, made major reductions in eligibility. It eliminated its program for long-term unemployed adults, replacing it with the new MassHealth Essential program that covers many of the same individuals but with capped enrollment and fewer benefits. The state also capped enrollment for its Family Assistance programs for near-poor children and working adults in small firms, its Common Health program for disabled individuals and its state funded Children's Medical Security program. Caps have seemingly been set at levels that do not yet disenroll people or create waiting lists,

but may be important in the future. Further, Massachusetts tightened eligibility determination and reduced outreach efforts.

Washington cut its state funded Basic Health Plan enrollment from 125,000 to 100,000. Further, it increased premiums and introduced a $150 deductible per person and 20 percent co-insurance up to $1,500 for the Plan. Washington also ended telephone applications, self declaration of incomes, and increased its frequency of eligibility redetermination for Medicaid. The state also terminated its medically indigent program, which helped hospitals pay for uncompensated care.

Texas reduced eligibility for pregnant women from 185 percent of poverty to 150 percent and eliminated its adult medically needy program. It further postponed implementation of an expansion of continuous eligibility in Medicaid from 6 to 12 months. In its SCHIP program, Texas effectively cut eligibility thresholds from 240 percent to 200 percent by switching to a net income rather than a gross income test. The state also reduced the length of continuous eligibility in SCHIP from 12 to 6 months, added an asset test for children in households with incomes above 150 percent of the federal poverty line, added a 90 day waiting period before coverage of newly enrolled children became effective, and increased premiums and co-payments.

Colorado attempted to cut legal immigrants (3,500) from the state Medicaid program (delayed at least temporarily by a court order) and capped enrollment in its SCHIP program in FY2004, limiting enrollment to about 53,000 children. It also ended SCHIP coverage of pregnant women, allowing no new enrollees. Further, it terminated outreach efforts for the SCHIP program.

Enrollment actions in California included moving to more timely eligibility redetermination in Medicaid so that people no longer eligible did not linger on the program rolls. Governor Davis had proposed a rollback of the state's expansion to cover parents up to 100 percent of poverty, but this proposal was not passed by the state legislature. Governor Schwarzenegger is now proposing enrollment caps in the state's SCHIP program.

Florida capped enrollment in its SCHIP program with spending limited to the appropriation. Outreach was eliminated and a waiting list was established and reached 44,000 by November 2003. In FY2003 New Jersey made cuts in its broad expansions to low-income parents and childless adults by reducing its Family Care program by 60,000 enrollment through attrition. The state continued to reduce adult enrollment through attrition in FY2004 but no further enrollment cuts were enacted. Alabama made no Medicaid enrollment changes but it did reduce outreach for its SCHIP program. New York and Michigan were the only two states that made no reductions in enrollment.

Reimbursement Rates. Although the eligibility reductions were new in FY2004, following FY2003 budget actions, states continued to freeze or cut provider reimbursement rates. California cut rates for physicians, pharmacies, and managed care plans, but not hospitals or federally qualified health centers. The new governor, Arnold Schwarzenegger, is proposing additional cuts of 10 percent across a range of provider rates and eliminating a recent supplement in nursing home rates that allows workers to receive higher wages. Massachusetts cut pre-existing rates for hospitals, nursing homes, physicians, community health centers, dentists, and managed care plans by 3.0 to 5.0

percent. In Alabama cuts of 2 to 3 percent in payment rates for physicians, hospitals and dentists are to be implemented this fiscal year and next. Texas reduced hospital and physician payment rates by 2.5 percent and nursing home rates by 1.7 percent. New Jersey froze physician fees but increased hospital and managed care rates. Florida cut nursing home rates, but postponed an increase in staffing requirements. Washington cut rates for hospitals and managed care plans.

Benefits. Benefit cuts were also widespread. Florida introduced 2.5 percent co-insurance on some prescription drugs and introduced co-payments for non emergency room use of emergency rooms. Michigan eliminated dental care, podiatry, and chiropractic services and expanded its estate recovery efforts from families of deceased nursing home patients.

Texas' Medicaid program eliminated several optional services (adult mental health counseling, podiatry, chiropractic, eyeglasses and hearing aids), introduced cost sharing to the maximum permitted by federal law and introduced additional limits on prescription drugs. The Texas SCHIP program also saw the elimination of numerous benefits, including dental, vision, hearing, chiropractor, home health, and hospital services, as well as the addition of several new layers of cost sharing.

Massachusetts maintained cuts in optional services (e.g., adult dental care, prosthetics, eyeglasses and drug co-payments) enacted in FY2003 and this year increased its generic substitution requirements and imposed prior authorization for 7 or more prescriptions per month. Washington cut dental care and sought a HIFA waiver to introduce premiums for non-poor children. New Jersey cut payments to pharmacists and

mandated generic substitution. Alabama was planning (again either this fiscal year or next) to implement cuts in optional services including hospice services, eye care and eye glasses for adults, limiting prescription drugs and physician visits, and limiting non emergency use of emergency rooms.

While the bulk of states enacted some benefit cuts, some rejected the call for such reductions. Washington and California both had considered elimination of dental care but agreed on a more carefully crafted reduction in the scope of dental benefits. Elimination of dental and chiropractic services for adults was proposed in New Jersey but was rejected. Michigan ended its cap on enrollment in its home and community based waiver program and expanded its drug program for seniors.

Special Financing Arrangements. States continued to rely on funding obtained through hospital disproportionate share payments (DSH) and upper payment limit (UPL) programs to finance Medicaid. Until the recent passage of the Medicare prescription drug bill, many states faced substantial cutbacks in federal DSH payments in fiscal 2004. With the passage of the bill, DSH cutbacks were restored for the current year and beyond. By contrast, federal legislation phasing out state use of UPL payments still holds, with cutbacks for many states beginning this fiscal year.

Recently, states have introduced a new version of special financing arrangements through the provider quality assessment fees discussed above. These fees have essentially the same effect as DSH and UPL programs. The key difference between most DSH and UPL programs and quality assessment fees, is that rather than being financed by intergovernmental transfers, the fees are a true tax on providers. Among our study

states, another difference is that under fee programs, providers -- rather than the state -- reap most of the financial gains.

Conclusion

In this report we have focused on decisions made by state executive and legislative branches in FY2004 as they faced the third consecutive year of severe budget pressures. In our previous report, we examined state budget decisions made in FY2003. One of our conclusions in last year's report was that choices would become more difficult in FY2004: The states had used up much of their reserves and rainy day fund surpluses in FY2003. Moreover, they were becoming increasingly limited in their ability to transfer funds from dedicated or earmarked funds to the general fund. Further, the anti-tax sentiment remained strong in most states, K-12 education was a high priority with most voters, and higher education spending was increasing because of rising enrollment.

Beyond these pressures, states in 2003 found that the Medicaid and SCHIP programs were difficult to cut because providing health and long term care coverage for low income children, disabled and elderly was politically popular. Further, reducing state general fund expenditures on Medicaid means losing federal matching funds. That is, a cut of a dollar in Medicaid does not translate into a dollar less in state spending. Indeed, depending upon a states match rate, it can be far less. Provider groups are also powerful politically, restricting (but not eliminating) the ability to cut payments. Finally, with the exception of drugs, cutting optional benefits does not generate much in savings, and these services are often of great importance to certain beneficiaries and providers.

Given all of these constraints, we found that in FY2004 states did in fact make less use of reserves and rainy day funds (simply because they were less available), and the use of trust fund transfers also seemed less frequent. We find that several states continued to tap tobacco settlement funds through securitization arrangements. Some states also used fairly unorthodox measures of dealing with budget deficits, including postponing the payment of bills until the next fiscal year and the sale of state real estate to obtain cash. In the coming months, California will be appealing to the voters to get approval of deficit financing through a major bond issue as a way to close its ever-growing budget shortfall.

Beyond these measures, states relied heavily on increasing fees and, in some cases, taxes to increase revenues. Importantly, while there was a general reluctance to raise personal or corporate income taxes or sales taxes, particularly in the southern and western states, our three northeastern states and Michigan did enact tax increases in FY2004.

On the spending side, elementary and secondary education were generally protected although a few states cut spending for capital and/or operating expenditures. A major budget target was higher education, with significant cuts in budgets for colleges and universities enacted in most states. Institutions were expected to make up for some of the lost revenues through increases in tuition. Another budget cutting measure was to cut state workforce expenditures through a combination of layoffs, salary freezes and increased employee contributions for health benefits. Many states also reduced aid to localities.

In FY2004, states also made cutbacks to Medicaid and SCHIP, sometimes substantial ones. Unlike in the previous year, state cuts in health care extended beyond lowering provider reimbursement. Among our study states, we saw more willingness to eliminate or cut optional benefits, particularly for adults. But more importantly, several states attempted to reduce the growth, if not the actual level, of enrollment.

The consequences of the FY2004 budget decisions are likely to be felt in states for many years. Even if revenues improve in the near future, states will need to replenish reserves and rainy day funds. And, some will need to replenish the trust funds that have helped bail out the general fund in the past few years. State tobacco settlement revenues that have been used in the current budget crisis will not be available in the future. The cuts in higher education are likely to affect both the number and the demographic characteristics of young adults who can seek higher education. Owing to widespread efforts to reduce spending on the state workforce, the quality of the state workforce may deteriorate, eventually requiring states to increase compensation if services are to be maintained. State cuts in aid to localities may affect basic services, particularly in lower income communities, if local areas are unable to make up the loss in state funds. Rising revenues with an economic turnaround will help, but the continued strong anti-tax sentiment likely means that states' ability to raise additional funds to address these problems will be limited.

The cuts in Medicaid and SCHIP could also have long term effects. The wide ranging cuts in provider reimbursement rates will likely affect beneficiaries' access to care. Rate cutbacks also raise questions about the financial viability of many institutions,

especially safety net hospitals. Owing to the eligibility and outreach changes, states will likely see a rise in the uninsured. When the fiscal environment improves, there may be calls to expand eligibility, but states may be reluctant to restore Medicaid cutbacks. In 2004, state legislatures made very difficult decisions to reduce coverage and benefits because of budget shortfalls. Whether they will be willing to risk again the significant financial commitments -- especially over the long-term -- that come with eligibility expansions is unclear. Medicaid and SCHIP, both through law and waiver policy, now offer states a broad set of options for expanding coverage and having the federal government share in much of the costs. Given recent budget pressures, states may be unwilling to take advantage of these options for many years to come.