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State Responses to Budget Crisis in 2004: An Overview of Ten States

Case Study - New York

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New York

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Background

Prior to the September 11, 2001 terrorist attacks, New York's financial situation was better than had been for quite a while. Since 1995, when Republican Governor George Pataki began his first term, the state had enjoyed strong revenue collections, especially in the late 1990s when personal income tax receipts grew by double digits.[1] During this same period, New York implemented a multi-year tax reduction plan. While cutting taxes, New York also managed to build its "rainy day" reserve fund and produce budget surpluses.

Also beginning in the mid-1990s New York undertook several major health program initiatives, building on the state's long-standing history of funding a comprehensive health care system for its low-income population. Some of the more important initiatives were the expansion of the Child Health Plus program as part of the federal State Children Health Insurance Program (SCHIP) and the establishment of the Family Health Plus Program that provides Medicaid coverage to nearly 700,000 low-income parents and childless adults.

Reflecting its large network of public health programs, in 2002 New York's Medicaid program covered about 30 percent of children and 10 percent of adults in the state; by comparison, national Medicaid coverage rates for children and adults were 23 and 6.7 percent, respectively.[2] Importantly, despite having comparatively high public insurance coverage rates, the share of adults lacking insurance in New York was higher than the national average in 2002

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[1] Fiscal Policy Institute. 2003. "Balancing New York State's 2003-2004 Budget in an Economically Sensible Manner." Latham, New York, February.
[2] Urban Institute tabulations from the 2002 and 2003 Current Population Surveys.

(21 percent versus 19 percent), owing to lower rates of employer-sponsored insurance for adults in the state.[3]

Like many other states, beginning in late 2001 New York's economic picture began to dim owing to the emerging national recession and the World Trade Center attacks. Within a short period, state tax revenue declined dramatically. A particular issue for New York was the drop in the net amount of capital gains on personal income tax returns, which went from $62 billion to $28 billion between 2000 and 2001. At the start of the state fiscal year 2002-03, which began in May 2002, New York faced a budget deficit of $6.8 billion, accounting for about 17 percent of the state's $40 billion general fund budget.

Fiscal Year 2002-03

Despite facing a bleak financial situation, New York's 2002-03 budget debate was described by study interviewees as relatively painless with limited policy action. Governor Pataki and leading state legislators negotiated a budget that used a broad array of revenue measures--rather than service cuts--to close the state's $6.8 billion general fund. The overall strategy to fill the budget gap was to rely on the state's reserve funds, borrowing and one-time revenue actions. These additional revenues enabled New York policymakers to avoid making deep cuts to services.

While Governor Pataki and legislative leaders expressed satisfaction with the enacted budget, others were critical charging that it relied too heavily on one-shot revenues and borrowing, and did not squarely deal with the state's structural budget problems.[4] Many

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[3] In contrast with adults, the number of uninsured children in New York was lower than the national average (10 percent versus 12 percent).

[4] McKinley JC. 2002. "Year of a Shrinking Budget and Tough Choices in Albany." Section B, Page 1, Column 2, *The New York Times*, January 7. McKinley JC. 2002. "Budget for New York: Overview: Pataki's Budget Would Close $5 Billion." Section B, Page 1, Column 2, *The New York Times*, January 23.

interviewees attributed the limited service cuts in the 2002-03 budget to the fact that 2002 was an election year for both Governor Pataki and the entire New York legislature.

Key revenue actions included allocating most of the state's reserve funds as well as balances from existing dedicated funds such as the Environmental Protection Fund and TANF reserves to cover general fund spending. Revenue measures also entailed increasing or imposing taxes and fees on a range of items--for example, cigarettes, cellular telephones, alcoholic beverages, and motor vehicle licenses and registration. In addition, New York's budget balancing involved accounting strategies, including moving some spending "off" the general fund to dedicated state fund accounts.

On the spending side, the budget provided for an overall increase in spending of about $600 million across the major budget sectors—school aid, higher education, state operations, and health programs. Spending levels for most budget sectors were kept at about the same level as 2001-02 or received modest increases. For example, local aid for schools received a 1.5 percent spending increase over 2001-02. State spending on Medicaid for 2002-03 was estimated at $5.85 billion, about a $360 million decline from the previous year. However, the reduction in state Medicaid spending was offset by an increase in taxes on nursing homes, increased use of intergovernmental transfers and upper payment limit payments to get extra federal Medicaid matching dollars, and shifting selected Medicaid spending categories from the general fund to dedicated funds.

Fiscal Year 2003-04

By the January 2003, New York's budget picture had worsened and the state faced an estimated budget gap totaling $11.5 billion--$9.3 billion for 2003-04 and $2.2 billion that was carried over from 2002-03. Put another away, New York needed to find a way to fill a 25 percent shortfall in its general fund.

In distinct contrast with the previous year, the 2003-04 budget process was a major political struggle between Governor Pataki and the legislature. At the heart of the debate was whether to close the gap through service cuts or raising taxes. Governor Pataki's proposed budget strategy relied heavily on cutting services. Service cutbacks totaling more than $5.6 billion were proposed for virtually all the major budget categories, including state aid to local schools ($1.3 billion), state operations ($1 billion), Medicaid ($1 billion) and higher education ($580 million).

For Medicaid a laundry list of service cuts was put forth that affected all the key stakeholders (beneficiaries, providers and health plans). Some of the most important proposed cuts were reducing Family Health Plus[5] eligibility, establishing a prescription drug formulary and freezing hospital and nursing home reimbursement. In addition to Medicaid programmatic changes, the governor's budget proposal called for increasing taxes on hospitals and home care providers.

Governor Pataki's 2003-04 budget plan contemplated several other revenue actions. About $1.4 billion worth of fee increases, surcharges and other revenue enhancement strategies to be imposed on individuals and businesses (such as elimination of tax exemptions on clothing items less than $110 and closing corporate tax loopholes) were included. In addition, the budget called for using one-shot revenue strategies. Chief among these was Governor Pataki's proposal to securitize a share of New York's tobacco settlement money. Specifically, the plan proposed

[5] Family Health Plus provides health insurance to lower-income parents and other adults and is included as part of New York's Medicaid Section 1115 waiver program, the Partnership Plan. Coverage to parents is provided to adults with incomes up to 150 percent of the federal poverty line and for adults without children, coverage is offered to those with incomes up to 100 percent of FPL. The governor's 2003-04 budget proposal called for rolling back FHP eligibility for parents from 150 percent to 133 percent of FPL.

securitizing \$3.8 billion (\$1.5 billion to cover the 2002-03 shortfall and \$2.3 billion for the 2003-04 shortfall) in tobacco funds. The budget proposal also included delaying Medicaid payments so they would not count against the 2003-04 budget. While the governor's budget contained some tax measures (such as doing away with tax exemptions), raising broad-based taxes (such as income taxes) were not included.

The popular press as well as many study interviewees acknowledged that Governor Pataki's budget proposal was not well received by the legislators in either political party.[6] Democrats did not like the heavy reliance on service cutbacks while some conservative Republicans complained that the proposal relied too much on accounting gimmicks and taxes in disguise. Beyond legislators, important players in the budget process—including labor unions, health care providers and citizens —were unhappy with the budget proposal. Labor unions and health care providers were unhappy with cutbacks in Medicaid reimbursement, whereas citizens feared that with the proposed cutbacks in local school aid and Medicaid, communities would have to raise local property taxes to make up the shortfall or experience declines in education and health programs.

The concern about the budget's potential impact on local property taxes was cited by interviewees as being a driving force behind the formation of an unusual political alliance between the Republican-led Senate and the Democrat-led Assembly. The budget crafted by the legislature—and what ultimately became the New York budget for 2003-04-- restored many of the service cuts proposed by Governor Pataki, and, in distinct contrast to most other states, raised income and sales taxes to pay for the restoration. Specifically, a temporary three-year increase in

[6] Baker A. 2003. "The Governor's Budget Plan: Overview, Pataki Seeks Cuts in Aid to School and Health Care." Section A, Page 1, Column 2, *The New York Times,* January 30. Odato JM. 2003. "Governor's Budget Proposal Avoids Use of Tax Increases; Pataki Plans to Trim Government, Use One-Time Revenue Funds to Reduce Deficit." Main Section, *The Time Union*, January 27, 2003.

the personal income tax on higher income residents was imposed and the state sales tax was increased by one-quarter of a percentage point. In addition to these tax measures, the legislature adopted all of Governor Pataki's proposed revenue actions, including fee increases, eliminating corporate tax loopholes, and securitizing tobacco settlement money.

Charging that the revenue sources identified by the legislature were not sufficient to fully finance the restoration of the service cuts, Governor Pataki cast 119 vetoes to the legislature's submitted budget. On the very next day, with the broad support of Democrats and Republicans, the Assembly and the Senate gathered enough votes and overrode all 119 vetoes, the first time the New York legislature has reversed a vetoed budget plan in more than 20 years.

While the legislature restored many of the Governor's proposed cuts, virtually all budget categories sustained some reductions. For example, on a school year basis general fund spending for school aid declined by about 1 percent compared to 2002 levels while spending for higher education was cut by an estimated 8 percent. About $1 billion was cut in the state operations general budget, representing a 13 percent reduction compared to fiscal year 2002-03. Included in this cutback was savings derived from a continuation of a strict hiring freeze for state employees and aggressive use of a retirement incentive program.[7]

For Medicaid, the legislature restored about two-thirds of the Governor's proposed $1 billion cuts to the program. Importantly, no eligibility or benefit changes were enacted; instead, Medicaid spending reductions were targeted primarily at providers. Cutbacks were spread across a range of providers and services, thereby making the scope of cuts to any one group relatively

[7] The contract with state employees expired in spring 2003 and negotiations for a new contract are currently underway. In the meantime, state employees are working under the rules of the expired contract. As a result, the full 2003-04 budget impact on state employees is unclear as of this writing. For example, cost-of-living adjustments have not been determined. Further, enacted 2003-04 budget calls for restricting pharmacy benefits and increasing employee copayments for doctor visits and prescription drugs for state employees. However, these changes are subject to the pending negotiations with state employees unions.

modest—for example, program reductions to prescription drugs totaled about $25 million, hospitals $10 million and home care providers $6 million.

The state fiscal relief provisions contained in the federal Jobs and Growth Tax Relief Reconciliation Act passed in May 2003, just after New York had enacted its 2003-04 budget.[8] The provisions provide New York with a total of $1.4 billion through the Medicaid match rate increase (of which $900 million goes to the state and $500 million to counties) and $645 million in revenue sharing. According to study respondents, the revenue sharing funds were deposited in the general fund to cover existing general state expenses. Similarly, the temporary increase in federal Medicaid match went to cover general program expenses. With the infusion of federal dollars, both from the revenue sharing and the increase in the match, the Pataki Administration felt that 2003-04 budget became balanced; previously, the administration claimed that the enacted budget had a $900 million shortfall.

The Future

While revenues are improving, New York's budget gap for fiscal year 2004-05 is estimated to be between $5 and $6 billion. Owing to the improving economy and the increased revenues obtained the temporary tax increases passed in 2003-04, the budget shortfall is projected to be about half the level of the previous fiscal year. Despite this sharp decline, however, several interviewees felt that they may have a bigger problem closing the gap because fewer strategies are available. Respondents, for example, noted that the state has all but exhausted several of the one-time budget strategies such as using TANF reserve funds or tobacco securitization.

[8] Unlike most other states, New York's fiscal year runs April 1 to March 31.

Interviewees also felt that imposing another increase in the personal income tax is not likely given that what was passed last year was a temporary tax making it very difficult to add to. Unless there is a significant improvement in the state's revenue picture, many believe that service cuts will likely be a central budget strategy in the upcoming fiscal year. However, several respondents also noted that that cutting services may be problematic because all 212 seats in the New York legislature are up for reelection in 2004. Other possible budget balancing strategies mentioned were closing more corporate loopholes and obtaining savings from more efficient purchasing (for example, prescription drugs for Medicaid beneficiaries).

Beyond revenue and spending matters, respondents identified other factors that will likely be important in the 2004-05 budget debate. A key one is the recent ruling by the New York State Court of Appeals finding that the state's financing of its educational system has deprived New York City students of their constitutional right to a decent education. In a case brought by the Campaign for Fiscal Equity, the ruling mandates that the state implement corrections by June 2004. Described as "the elephant in the room" and a "wild card," the budget implications of the ruling are at present unclear, but several interviewees believe it could have a major financial impact on the state's 2004-05 budget.[9]

Another uncertain factor that could have important consequences for the 2004-05 budget debate is if the state changes how it finances its Medicaid program. Unlike most states, New York counties contribute a significant share of the state financing for Medicaid, about 17 percent of total spending on Medicaid. Counties, however, are eager for the state to assume the full financial responsibility for Medicaid. While various realignment proposals have been put forth

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[9] Of note, in December 2004 the Campaign for Fiscal Equity recently called on New York to include funding for a $2 billion "down payment" in the upcoming 2004-05 budget to comply with the court ruling (Campaign for Fiscal Equity. 2003. Campaign for Fiscal Equity. 2003. "CFE and AQE Call for $2 Billion Immediate 'Down Payment' and Prompt Phase In of Court-Mandated Funding Reforms." http://www.cfequity.org/PressRelease12.18.03.PDF).

in the past, some interviewees felt that the idea may have some political traction this year.[10] According to several respondents, counties have become increasingly vocal about the state assuming the full share of non-federal Medicaid costs. Counties maintain that local portion of the Medicaid bill has become particularly onerous in the last few years with the economic downturn and rapid growth in health care costs. Further, state aid to localities (including educational assistance) has not kept pace with rising costs and revenues from local sales taxes (one major source of income for localities that is independent of the state) are not up to projections. As a result of these pressures, some counties have had to raise local taxes (sales and property taxes, the other major independent income source for local areas) while cutting back on some services such as special education programs and libraries.[11]

Finally, state officials expressed concern about the potential budget implications of recent interactions with federal officials about obtaining matching funds for some Medicaid payments, including Medicaid disproportionate share hospital payments and school-supported health services.

As of this writing it is not known what strategies New York will adopt to close its projected budget gap but, without doubt, the issues and challenges the state faces in its 2004-05 budget will be difficult and certain to raise a number of tough policy issues and choices.

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[10] Indeed Governor's Pataki's 2003-04 budget proposal included a Medicaid realignment plan. This provision, however, was not enacted. The governor's budget proposed realignment of state and local responsibilities for selected parts of the Medicaid. Specifically, the state would have assumed the full non-federal cost for prescription drugs. In return, counties would have paid 37 percent of non-federal costs for fee-for-service hospital, outpatient and clinic services, costs, up from the 25 percent share of non-federal Medicaid costs that New York counties are required to contribute for these services.

[11] Steinhauer, J. "Bloomberg and County Leaders Urge Albany to Reduce their Medicaid Burden." *New York Times*, March 12, 2003; Polgreen, L. "Hard Times Get Harder Upstate As Fiscal Crisis Spans New York." May 18, 2003.

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