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Running on Empty: The State Budget Crisis Worsens

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OVERVIEW — *This issue brief reviews the status of state budget shortfalls and their growing impact on the Medicaid program. It describes the magnitude of the shortfalls, the forces behind them, and how states have responded with spending cuts and tax increases. It also discusses how long the budget crisis is expected to continue and what budget balancing options remain for fiscal year 2003.*



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Running on Empty: The State Budget Crisis Worsens

Federal and state governments have long been partners in financing the delivery of health care services to vulnerable populations. Maternal and child health, public health, mental health, and many other services all rely on this partnership for funding. Some of them, such as substance abuse prevention and treatment, require a substantial maintenance of effort by the state. And Medicaid, the largest joint federal-state health care financing effort, requires an even greater commitment of state funds. The ability of states to finance their share of these programs affects the health and well-being of millions. But, for the first time in a decade, states are experiencing recurring revenue shortfalls that are devastating their budgets, and finding the money to hold up their end of the partnership is getting harder by the minute.

The stakes for federal policymakers are substantial. Medicaid, once the much smaller of the two major health entitlement programs, is now virtually equal to Medicare in total expenditures and larger in number of beneficiaries.¹ It even exceeds Medicare, two to one, in terms of the federal general revenue dollars it devours.² If states cannot meet their financial commitments, the vulnerable populations served by this and the other state-federal programs are at risk of losing access to services.

States are in the second year of major declines in tax revenues, and there is a growing expectation that next year will be as bad, if not worse. State fiscal analysts fear that states will be plagued with continuous budgetary struggles for the next three to four years. A flood of stories from across the nation illustrate the states' budget woes. While the specifics of each story vary, they are usually very bleak:

- After a series of spending cuts and an increase in the sales tax to enact a balanced budget, the Kansas Legislative Research Department projects a \$108 million shortfall within the first six months of this fiscal year.
- The South Carolina revenue office projects a \$331 million deficit for the current fiscal year.
- With dismal revenue projections for next year, Rhode Island's budget officer has instructed agency heads to submit budgets at a level 8 percent below last year's already reduced levels.
- In August of 2002, Georgia experienced its 14th straight month of declining tax revenues and fee collections.
- In Maryland, the current budget has a \$400 million deficit and next year's budget has a projected \$1.3 billion shortfall.³

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In response to these problems, say observers, advocates for states, providers, and the uninsured will likely pressure federal health policymakers for additional assistance. Understanding the state budget process, the depth and breadth of the fiscal pressure states are facing, the responses they are mounting, and the length of time it will likely take them to recover is key to determining what the federal response can or should be.

FUNDAMENTALS OF STATE BUDGETS: REVENUE, RESERVES, AND RAINY DAY FUNDS

To finance state spending, which is estimated to be \$1.1 trillion in state fiscal year (FY) 2002, states receive revenues from a variety of taxes, fees, and federal monies.⁴ State revenues come from personal income taxes; sales taxes; business taxes; special taxes, such as those imposed on inheritance and cigarettes; lodging; and numerous fees, such as those for park use and various licenses (Figure 1).⁵

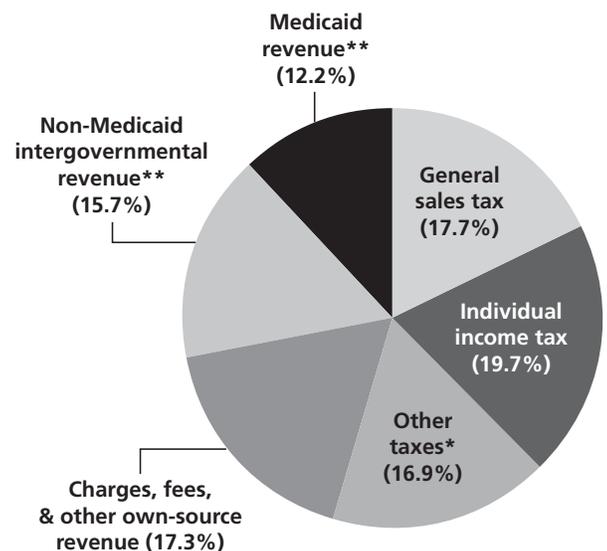
States also receive a substantial portion of their revenues from the federal government, through what is frequently called intergovernmental transfers. Medicaid, with a federal match rate of 50 percent to 77 percent, contributes 43.9 percent of the revenues states receive from these transfers.⁶ In contrast, the next largest categories of federal transfer are transportation, at 9.8 percent, and kindergarten through 12th-grade education (K-12), at 9.6 percent.

The federal Medicaid match comprises roughly 12 percent of total state revenue.⁷ While this number must be used with caution, since it combines two different data sources, it does provide a sense of how important this source of funds is to state governments.

There are some critical differences between federal and state budget rules. Unlike the federal government, which can incur budgetary deficits, virtually all states have some type of requirement for a balanced budget.⁸ This balanced budget requirement creates some challenges. For example, it is always difficult to project precisely both revenues and spending a year in advance, especially for entitlement programs such as Medicaid. If the projections underestimate revenues and/or overestimate spending and a surplus arises, problems are minimal; however, if the opposite occurs and a significant shortfall develops, the budget must be revised mid-stream.

To help protect against unanticipated budget shortfalls, states set aside a portion of their budget as "balances." These balances, really a form of reserve, serve as a cushion in case projected revenues fall short or spending exceeds projections. Over the last 10 years, the balances

FIGURE 1
Composition of State Revenue, 2000



Source: Rockefeller Institute of Government (derived from U.S. Census data).

*Includes corporate income tax; selective sales taxes, such as cigarette taxes; property tax; and other taxes.

**Author's estimates (based on National Association of State Budget Officers data).

have ranged from 1.1 percent to 10.4 percent of state spending, with the majority occurring between 3.0 percent and 7.0 percent.⁹

Forty-seven states have “rainy day funds” (also called budget stabilization funds) that are included in aggregate state balances.¹⁰ Rainy day funds are special accounts to which states appropriate monies during good economic times. As their name implies, the monies are to be used primarily during economic downturns. Unlike some budget balances that can be tapped by the governor, a state’s rainy day fund frequently cannot be used without special legislative authorization.

In some years, when spending greatly exceeds revenue, the balances are not sufficient to cover the shortfall, so other devices are used. For example, states can borrow or reallocate monies from special “dedicated” funds, similar in concept to the Medicare or Social Security trust funds. The states’ dedicated funds have been established to support special purposes, such as education, state capital facilities construction, and highways. During budget crises, states often borrow from these funds with the expectation that they will be repaid in the future (although that expectation is not always met).

The last state fiscal fundamental involves the dates of the state fiscal year. Two states, Michigan and Alabama, use the federal fiscal year; New York’s fiscal year starts on April 1 and Texas’s on September 1. Since the remaining 46 states use a fiscal year that begins on July 1 and ends on June 30, that period will be used when referring to “fiscal year” (FY) in this paper.¹¹ The year designation following the FY is determined by the calendar year in which the January encompassed by the fiscal period occurs (for example, FY 2002 ran from July 1, 2001, to June 30, 2002).

Besides having different beginning and ending dates for their fiscal years, states also vary in the length of the budgets they enact. Twenty states have biennial, or two-year, budgets, although they usually are two separate budgets or are tracked separately. Many review the budget in mid-term to make necessary adjustments to spending and taxes.

In recent years, states have often battled two fiscal deficits at the same time: balancing a shortage for the current fiscal year while trying to enact a balanced budget for the next. A recent article in the *Arizona Republic* mentioned the difficulty Arizona was having in dealing with three successive state budget deficits: last year’s \$930 million deficit, this year’s \$400 million shortfall, and next year’s projected \$1 billion dollar shortfall. The cumulative effect of yearly state budget shortfalls cannot be overestimated. With each successive year, as special funds are drained and spending cuts are implemented, the options for balancing the budget narrow and the choices become progressively more difficult.

THE 1990S: THE BOOM YEARS

In the 1990s—even during the recession of the early 1990s—there was no single quarter in which overall state tax revenue declined.¹² And,

With each successive year, the options for balancing the budget narrow and the choices become progressively more difficult.

during the late 1990s, the strong economy produced the largest state budgetary surpluses in 20 years. The revenue collections from sales and income taxes exceeded projections, which often surprised states, because they were at the same time enacting a series of tax cuts and increasing state spending.¹³ For states, it seemed to be the best of times. However, these surpluses temporarily masked underlying structural problems with many states' long-term revenue projections.¹⁴

FY 2001: FALLING STATE REVENUES

The threat of a sustained budget problem appeared in early 2001, when revenues in a few states fell short of their projections. Eleven states were forced to reduce their FY 2001 budgets by a total of \$1.6 billion.¹⁵ The strategies used to balance their budgets varied: 7 made across-the-board cuts, and 11 used some combination of hiring freezes, targeted reductions, drawing down of balances, and other methods. Many of these states, however, exempted from cuts certain programs, such as K-12 education, higher education, Medicaid, public safety, and local revenue sharing.

The 2001 revenue downturn was not, however, a guarantee that bad times had arrived: in 1996, when most states were experiencing both small increases in Medicaid costs and strong revenue growth, 13 states had to make budget cuts totaling \$1.6 billion. The following years were some of the best ever for states.

FY 2002

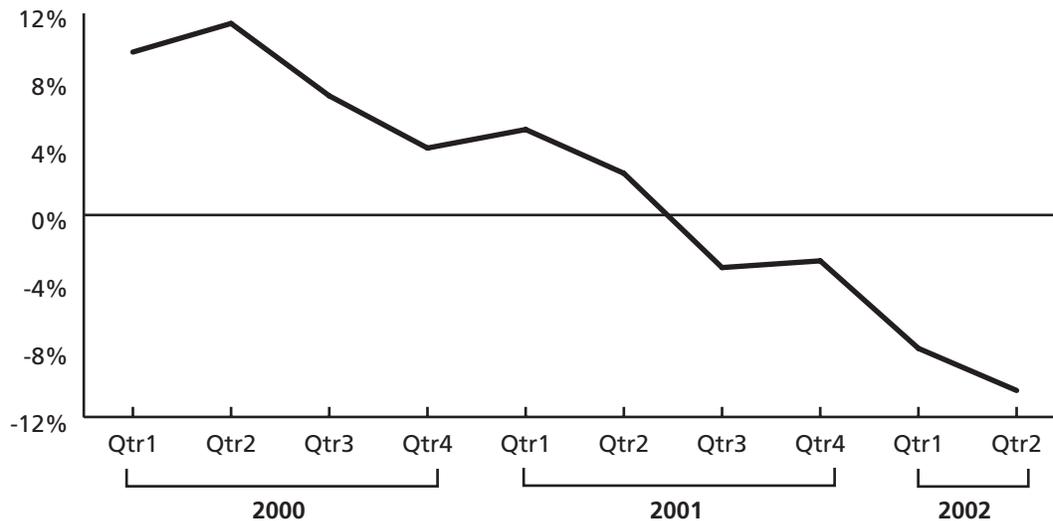
Crisis

Starting with the first quarter of FY 2002 (July through September 2001), however, budget shortfalls in a few states developed into a full-blown crisis. That quarter was the first of what is now a string of four in which overall state tax revenue fell compared to the previous quarter (see Figure 2).¹⁶ In FY 2002, the last quarter (April through June 2002), which usually provides states with the greatest amount of revenue, thanks to income tax returns, saw a huge decline of 11 percent. This series of declines had an immediate impact.

By April 2002, according to the National Conference of State Legislatures (NCSL), 43 states reported budgetary shortfalls that totaled \$27 billion.¹⁷ Just three months later, the shortfalls rose to \$37 billion. To put this gap into perspective, the \$37 billion would equal roughly 7.7 percent of all state general revenues, or 3.7 percent of total state spending, including federal revenue to states.¹⁸ In a little over one year, the fiscal environment for the nation's states had changed dramatically from comfortable surpluses to constrictive shortfalls.

The FY 2002 budget gap rose to \$37 billion, roughly equal to 3.7 percent of total state spending.

FIGURE 2
Changes in Quarterly State Tax Revenue, 2000–2002
 (in percent)



Source: Nelson A. Rockefeller Institute of Government Revenue Report Database.

State Responses

Cutting Programs — The first step in covering the FY 2002 budget shortfall was to cut spending. Least painful were administrative steps, such as restricting state employee travel (11 states) and placing a freeze on new hires (approximately 20 states).¹⁹ Another popular administrative strategy was to change projects involving capital expenditures. Thirteen states either delayed capital projects or shifted their financing from pay-as-you-go to debt.²⁰

But administrative cuts were not sufficient to balance the budget: 29 states implemented across-the-board or targeted cuts. These cuts included programs that were exempted from last year's cuts: higher education (19 states), K–12 education and Medicaid (12), local revenue sharing (6), and Temporary Assistance for Needy Families, or TANF (3).

Tapping Other Funds — A second strategy was to use monies from balances and a variety of other funds. For FY 2002, states saved money by reducing their enacted budget balances from 8.8 percent of the budget to 5 percent, the largest percentage drop since 1980. Nineteen states tapped into their rainy day funds.²¹ In one year, the balances for rainy day funds fell by one third (from \$16.5 billion to \$10.8 billion).

In addition to drawing from rainy day funds, states tapped a variety of other funds. Twenty states reallocated monies from various special or dedicated funds, such as those earmarked for education and capital facilities

construction, and 12 states used some of their tobacco settlement money for shortfalls in their state general revenues. For the most part, tax increases were not part of a state strategy for balancing the FY 2002 budget.

All in all, governors, state legislators, and agency directors who had grown accustomed to relatively easy fiscal decision making during great economic times found FY 2002 a difficult year. Yet, state fiscal experts claim the first full year of a sustained budget crisis is when the easy decisions are made.²² It is the following two fiscal years (FY 2003 and FY 2004), they say, that are going to be traumatic.

FY 2003

Continued Troubles, Borrowing, and Cutting

While governors and legislators were busy patching and balancing their tattered FY 2002 budgets that ended June 30, 2002, they were also busy enacting the FY 2003 budgets that began July 1, 2002. In comparison to the previous year, states became more conservative in forecasting economic and revenue growth.²³ The result was the smallest increase in proposed state general revenue since 1983.²⁴ With less revenue, states had to find ways to cover gaps in the budget.

A preliminary NCSL report that included responses from 40 states found many were using budget-balancing strategies in FY 2003 that were similar to those employed for FY 2002. States again reduced the amount for balances, from last year's 5 percent to 3.7 percent, thereby providing the smallest cushion since 1992.²⁵ Twenty-three states again tapped special, dedicated funds (such as those for transportation and state parks) and 12 tapped into the diminishing rainy day funds.²⁶

In a new development, 16 states used some of their tobacco settlement funds. And two states, California and Wisconsin, used their entire tobacco settlement allotments to help balance their FY 2003 budgets.²⁷

Twenty-six states found that tapping into the various funds was still not sufficient to balance the budget, so they cut programs. The most frequent target was higher education, where funds were cut by 16 states.²⁸ Other programs cut included corrections (14 states), Medicaid (12), K-12 education and local revenue sharing (11), and TANF (5). Despite these far-reaching efforts, many states needed to find additional ways to enact a balanced FY 2003 budget.

Tax Increases: No Longer a Sin

In contrast to FY 2002, when states were caught short because the budget gap appeared after the fiscal year began, in preparing for FY 2003 they were able to compensate for falling revenues by increasing taxes for the entire fiscal year. Consequently, for the first time in eight years, states

States proposed the smallest increase in general revenue since 1983.

as a whole saw an overall net tax increase of \$6.7 billion.²⁹ A variety of taxes, including personal income, business, and sales taxes were raised.

The single biggest revenue increase, and tax revenue story of the year, was the sudden popularity of increasing the tax rate on tobacco products. For FY 2003, 19 states raised their tobacco taxes and 2 others placed cigarette tax increases before their voters.³⁰ The other two “sin taxes”—those levied on alcohol and gambling—did not get as much attention, with only two states increasing their taxes on alcohol.

The proportion of state tax revenue raised by the new cigarette taxes far exceeds anything brought in by the old. Over 40 percent, or \$2.9 billion, of the states’ new tax revenue came from higher taxes on cigarette and tobacco products. In contrast, a peak year during the last state fiscal crisis (FY 1992) saw only 2 percent of the net tax increase derived from tobacco taxes.

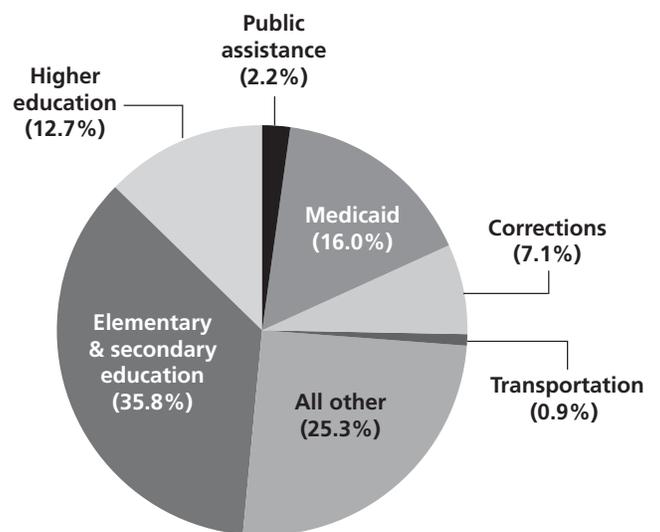
In addition to enhancing their revenues, states continued to cut spending as they enacted their FY 2003 budgets, although the overall magnitude of the cuts is as yet unclear. However, the fiscal situation appears to be deteriorating so rapidly that the FY 2003 cuts are almost certain to be more drastic than those made to balance the budgets for FY 2002.

Despite incomplete data on the magnitude of state budget cuts, NCSL reports seem to indicate that state policymakers have been making some difficult choices. For example, they have adopted cuts in education, which has long been a priority of governors and legislators. But the states had little choice: K–12 education and higher education are, respectively, the first- and third-most-expensive state programs (Figure 3). States are now focusing more of their attention on controlling the second-largest but fastest-growing program, Medicaid.

**MEDICAID DEJA VU:
RISING RATES ALL OVER AGAIN**

States were treated to a pleasant respite from runaway Medicaid costs during the mid- to late 1990s. During that period the average growth rates of total Medicaid spending were in the single digits.³¹ That respite is over. The summer 2002 report on FY 2001 budgets from the National Association of State Budget Officers notes that, during the FY 2001 fiscal year, states experienced a 10.6 percent increase in their expenditures for Medicaid, while the increase for FY 2002 is estimated at 13.3 percent.³² The trend of annual double-digit growth in cost has returned and is not expected to abate for the foreseeable future.

**FIGURE 3
State General Fund Expenditures, FY 2002**



Source: National Association of State Budget Officers

A survey conducted by Health Management Associates (HMA) for the Kaiser Commission on Medicaid and the Uninsured asked state Medicaid officials the top reasons for Medicaid expenditure growth in FY 2001. Thirty-six states listed pharmacy costs as the primary factor.³³ The next most frequent responses were provider payments and enrollment increases. Repeated for FY 2002, the survey found 25 states mentioning pharmacy as the primary reason.³⁴ Enrollment growth was cited by 18 states as the primary cause.

During FY 2002, 45 states took measures to contain costs: 32 instituted some type of pharmaceutical controls, 22 made some type of cut or freeze in a provider payment, and 16 beefed up their fraud and abuse control efforts. The effects on Medicaid beneficiaries were minimal: only eight states decreased benefits (five reduced adult dental benefits) and four states increased copays.³⁵

In enacting the FY 2003 budget, Medicaid received more attention. The HMA report revealed a 50 percent increase over the previous year in the number of cost containment actions to be undertaken during FY 2003.³⁶ Pharmaceuticals controls (40 states) and provider payment cuts or freezes (29 states) again lead the list targets for cost containment. But beneficiaries will also feel more of the pain. Seventeen states are making or continuing last year's eligibility cuts, 15 are increasing copays, and 15 are cutting benefits.

Medicaid is assured of receiving continued attention as legislators try to balance the enacted FY 2003 budget. That in itself is not unusual. Medicaid appropriations frequently fall short of required spending levels, even in good economic times, and the program is routinely in need of supplemental monies by the end of the fiscal year.³⁷ The HMA report noted that what distinguishes the current woes is "the increasing number of states where the need for supplemental funding was unexpected, and the amount needed was much larger than expected."

As troubling are findings of two surveys on Medicaid budgets for FY 2003. An NCSL survey found states had budgeted Medicaid to grow by only 8.2 percent, despite the recent double-digit cost increases.³⁸ The survey of Medicaid directors by HMA found total Medicaid appropriations would increase by only 4.8 percent.³⁹ So it is not surprising that two-thirds of the states responding to the NCSL survey anticipated a deficit in their FY 2003 Medicaid budget just after its enactment.

FY 2003 BUDGET REVISIONS: NOT IF BUT WHEN

The FY 2003 budgets were fragile when enacted, with the overall projected balances the lowest since 1994.⁴⁰ And, within the first month of the new FY 2003 fiscal year, the NCSL survey found, the states had a budget gap of \$58 billion, \$21 billion higher than the previous year's shortfall. (California alone accounted for \$24 billion of this gap.)

For FY 2003, states had budgeted Medicaid to grow by only 8.2 percent, despite recent double-digit cost increases.

With the overall state budget gap starting out so large, and with so many spending and revenue trends going in the wrong directions, most states will have to revisit their FY 2003 budgets to cut spending, increase revenue, or both. Moving quickly to make the needed changes would allow smaller, less disruptive spending cuts or tax increases to be made over a longer period of time; waiting to act would mean raising the same amount of money through more drastic measures over a shorter period of time.⁴¹

The fall elections, however, will complicate efforts to make immediate, significant changes in the FY 2003 budget. This November there will be 36 gubernatorial races and 46 state legislative elections involving more than 6,000 races. These elections will make it difficult for most states to reconvene their legislatures this fall. Many states may end up delaying the budget balancing decisions until the newly elected governors and state legislators assume office in January of 2003.

FY 2004: CUMULATIVE BUDGET DISASTER?

Although the recent budget woes have not been easy, the most contentious debates will occur when the state legislatures convene in January 2003. States will be facing the task of making immediate changes to balance their current FY 2003 budget shortfalls while simultaneously preparing the next budget (FY 2004) that begins July 1, 2003. This two-track process, which may collapse into one large reconciliation agreement for some states, will consume most of the state lawmakers' attention.

For FY 2003 revisions, it appears that making much deeper spending cuts and tapping into balances and special funds will be the primary options.⁴² Such options, however, will be difficult to use. States have cut spending for two years (in some cases, three) in a row. Rainy day funds have also been tapped for two consecutive years. Ohio's, for example, has been exhausted. As states are forced to make additional cuts to balance their FY 2003 budgets, the outcome for people served by state programs does not look promising.

Some tax increases are possible. Sin taxes, for example, will again be considered, especially on tobacco products, since the rates for many states are still low in comparison to the top rates of New York and New Jersey.⁴³ Some states will likely consider proposals to allow or expand gambling.⁴⁴

But raising sin taxes alone will not solve the FY 2004 problem for many states. Some seem destined to consider an increase in general sales or income taxes. Enacting such increases is always difficult, however. In 2002 Oregon's governor proposed an increase in the state income tax to address its budget shortfall but was rebuffed by the legislature. However, on September 17, 2002, the voters approved a tax increase of 60 cents on a pack of cigarettes that will help reduce but will still not solve the budget deficit.⁴⁵ For two years the governor of Tennessee fought vigorously for enactment of a state income tax (in part to help shore up

Next year, states will be facing the task of making immediate changes to balance their FY 2003 budget shortfalls while simultaneously preparing their budgets for FY 2004.

financing for TennCare, the state's Medicaid program) and failed (although the state did raise the sales tax). Kansas and Nebraska enacted sales tax increases to balance their FY 2003 budgets, although neither increase is permanent.

The ultimate resolution of the state fiscal crisis will not be known until the dust settles from the state legislative debates. Because some states will probably be late in enacting their FY 2004 budgets, that might not be until late summer to early fall of 2003. And, since the depth of the budget problem varies, each state will have a slightly different response. But all agree that difficult decisions will be required.

FROM CRISIS TO STABILITY: HOW LONG?

At the current rate, it seems the state budget crisis will never end. But past state budget crises, such as those that occurred in the early 1980s and early 1990s, suggest a pattern that leads eventually to budget stability. The early phase consists of minor cuts, such as hiring freezes and minor across-the-board cuts. The middle phase is usually a combination of borrowing from dedicated funds, drawing down of state balances, enacting major cuts in programs, and resorting to "accounting gimmicks."⁴⁶ For some states, especially if their economies are not suffering badly, the middle phase can also be the final phase.

The final phase in states' major economic troubles is indicated by the enactment of significant increases in tax rates, most notably of sales and personal income taxes.⁴⁷ Sometimes, to achieve a political consensus, additional spending cuts equal to the tax increases are required. By the time the final phase occurs, the economy is also starting to recover and is shoring up state revenues.

Whatever combination of spending cuts, tax increases, and economic recovery occurs, the final phase in a budget crisis is usually followed by a period of state fiscal stability. Whether or not this pattern plays out as it has in previous budget crises, many states still have some difficult times ahead.

FEDERAL FALLOUT

While the full impact of the state fiscal crisis on state and federal programs will not be known for a while, it is becoming clear that there are major implications for federal policymakers.

Changes in State Medicaid Programs

The Medicaid program has wide support among safety-net providers and the low-income mothers and children, disabled, and elderly persons the providers serve. Among the program's advocates are physicians and other practitioners, community health centers, hospitals, nursing homes, and

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other providers that rely on some level of Medicaid payment. Beneficiary advocates, whether for eligible low-income children and youth under 21, persons with physical and mental disabilities, or people 65 and older, also provide considerable backing for the federal-state program, both in Washington, D.C., and in state capitals across the nation.

Despite this combined clout, states will be forced to look at their Medicaid programs for fiscal relief. In addition to being the largest source of federal dollars to states, Medicaid is already the second-largest consumer of state general revenue funds and the primary cause of new state spending increases. Therefore, when states want to increase dollar flows from the federal government and cut their own budgets, it is inevitable that they focus on Medicaid.

States are eyeing various changes. One approach would be for the federal government to increase the percentage of funds it provides relative to state matching payments. The current federal formula, generally expressed in percentages (for example, 50 percent federal/50 percent state), matches federal to state dollars, with poorer states receiving more generous matching than richer states. Another strategy, used in various ways in the past through creative financing mechanisms, would be to draw a higher federal match without spending additional state monies.⁴⁸ For example, states have used the Medicaid disproportionate-share hospital (DSH) adjustment to avoid upper payment limit (UPL) restrictions in the Medicaid program and thereby to gain more federal dollars. This strategy proved particularly lucrative for some states during the fiscal crisis of the early 1990s. After Congress tightened the rules around DSH, states began drawing down additional federal funds using other loopholes in the UPL law.

However, it is uncertain whether states will have the same level of success this time around. The Centers for Medicare and Medicaid Services (CMS) has worked to restrict state use of UPL but in the process has created controversy with states and Congress. With Medicaid serving as the largest source of federal funds sent to states, maximization efforts will continue to be an attractive target for state budget makers.

Moreover, states have the option of making incremental changes in their programs by addressing benefits (other than those mandated by the federal government), eligibility, and payment levels. It is likely that many states will be submitting waivers that may end up restructuring their health programs. One type of restructuring would involve state pharmacy assistance programs. Thirty-four states that have a program of this type; 18 are looking to finance some Medicaid beneficiaries' drug costs through a waiver under the "Pharmacy Plus" guidelines issued by CMS in January 2002.⁴⁹

Other states are looking at fundamental changes that may have an even more significant impact on their Medicaid programs. The Health Insurance Flexibility and Accountability (HIFA) initiative was created

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to provide states with eligibility and benefit flexibility, but since its announcement in August 2001, the state budget environment has worsened. This new budget context may result in proposed changes in the way states use the greater flexibility. There may be less expansion in eligibility, greater trimming of benefits, more reduction in provider payments, and less state money for the Medicaid match. In June 2002, 17 states indicated that they were developing or considering HIFA waivers.⁵⁰

In summary, Medicaid appears to be entering a new era. After an explosion in Medicaid enrollment of low-income people that began in the late 1980s and was complemented by an influx of enrollees from the State Child Health Insurance Program (SCHIP) after it was created in 1997, future enrollment is not likely to increase at the earlier rates. States will be hard pressed to find the revenues both to provide the required match and keep up with the resurgence in health care inflation.

State Requests for Assistance under Medicaid

The states have gone directly to the federal government to seek short-term financial assistance in Medicaid. The governors have been active in supporting a temporary increase in Medicaid's federal match rate, and the Senate has included such a provision in its recent revisions in legislation overseeing generic drugs.⁵¹ Also included is a temporary increase in the Social Services Block Grant. The future of this proposal in the 107th Congress is uncertain. The House has not voted on it and the administration has opposed such assistance in the recent past.⁵²

Unknown Effects on Other Health Programs

While relatively systematic and timely information is available regarding changes in Medicaid (and, to a lesser extent, SCHIP and state pharmaceutical assistance programs) during the states' fiscal crisis, similar information on other state health programs (such as those providing mental health, maternal and child health, substance abuse, and public health services) is not as forthcoming. There is anecdotal evidence that these programs are suffering, perhaps more than Medicaid. One potential indicator is a series of state surveys conducted by the Maternal and Child Health Policy Research Center. The center found that about half of the states were cutting state FY 2002 Title V Maternal and Child Health Block Grant funds for children with special health care needs and that 58 percent of the survey respondents expected reductions in state FY 2002 funds for children's mental health services.⁵³ A report tracking tobacco prevention programs found 15 states recently cutting their programs, with some cutting them by 35 percent to 45 percent.⁵⁴ Given the depth and breadth of state cuts in priority programs such as education, it would seem that these other health programs would be vulnerable to major cuts. To more accurately assess the effects of budget cuts on these and other similar programs, however, more systematic reporting is needed.

States will be hard pressed to find the revenues both to provide the required Medicaid match and keep up with the resurgence in health care inflation.

A Weakened Partner in Federalism: Now and in the Future?

The short-term fiscal outlook for states is not good. State budget analysts hope that improvements in forecasting future revenue and an economic rebound will end the recent series of surprising shortfalls. Even if states' ability to project revenues improves and the economy rebounds, however, the next three to four years will be difficult, for history suggests that there is a 12- to 18-month lag between an economic recovery and a return to former levels in state revenues.⁵⁵ And, for a time, states will have to spend new revenues replenishing their rainy day funds and repaying monies borrowed from the numerous dedicated funds.

Even an improvement in the state's economy and budget does not guarantee a return to the boom days of the late 1990s, in which states were cutting taxes, increasing spending and showing comfortable balances in their budgets. Donald J. Boyd of the Nelson A. Rockefeller Institute of Government argues that a series of unusual events, including the following, aided states during that period:

- The tobacco settlement for states provided an unexpected windfall.
- The stock market grew tremendously, raising state income tax revenue.
- States benefitted from the TANF block grant, since the state funding levels were determined by data gathered in poor economic times but were applied during times of low unemployment.
- Inflation in both health care and Medicaid costs fell to single-digit levels.⁵⁶

Given the unlikelihood that such one-time events will again bail the states out of fiscal difficulties, Boyd concludes that, even with a good economic recovery, "state finances will be constrained quite tightly over the next several years." In reference to the windfalls and trends that negated past predictions of state fiscal stress, he acknowledges, "It could happen again. But of course unforeseen events need not be beneficial and it is best not to plan on that." One worry that economists have is that the nation could slip into another recession that would prolong the states' fiscal woes.

Even with a quick recovery, however, some states may struggle to find sufficient revenues to balance their budgets. The mainstays of state revenues, personal income taxes and the sales tax, both present challenges to state lawmakers. Clearly, much of the sudden and dramatic loss of income tax revenue can be attributed to the overall market downturn and the resulting loss of stockholders' income and capital gains. At the same time, the revenue from state sales taxes seems to be declining. In many jurisdictions, an increasing number of items have been exempted from the sales tax; these include food, clothing, and services—the last of which constitutes a growing proportion of consumer spending. Difficulties in collection persist (especially for items purchased via catalogue and the Internet).⁵⁷

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Finding the dollars for the projected health care costs will be difficult. Medicaid will continue to be a challenge to state budgets because of the resurgence in health care inflation. And with each passing year, the aging population looms as a growing threat to state Medicaid programs, a primary payer of long-term care services.

Probable Shift in State-Federal Health Care Relationship

The decisions states make in the midst of this fiscal crisis will have major impacts on the programs they jointly fund with the federal government. The likelihood is that states will seek to rely even more heavily on federal financing.

In turn, the federal government will feel increasing pressure to reexamine its role in financing the state-federal programs, especially the 35-year-old Medicaid partnership. The first step in this process may be consideration of a proposal by the governors to create a national commission on restructuring Medicaid.⁵⁸ The policy, adopted by the governors at their winter 2002 meeting, suggests the formation of a bipartisan commission.

The idea of reviewing the basic tenets of the Medicaid program and the federal-state relationship upon which it is built is not a new one. Almost since the program's inception in 1965, individuals and groups representing federal or state interests have periodically called for redefining roles, restructuring the program, rethinking the allocation of funding and programmatic responsibility, or considering a variety of cost-containment schemes.

Among the questions any reexamination of state and federal roles in Medicaid will raise are the following:

- How much should states be expected to contribute to the support of the Medicaid program? Is the federal government able or willing to define a basic required level of support across the country? If so, is it appropriate for the federal government to assume some greater portion of Medicaid funding?
- Is there a way to reconcile differences in states' willingness and capacity to support a basic program of benefits to needy people under Medicaid and related programs?
- If the federal government assumes additional financial responsibility for Medicaid, what does that imply in terms of additional national goals or mandates that would be required of participating states?
- How will state and federal government sort out the growing demand for long-term care and pharmaceuticals? Should these questions not be an integral part of the dialogue around the federal-state Medicaid partnership?
- Medicare and Medicaid, two programs of critical concern to many of the most vulnerable of our citizens, are grounded in markedly

different federal-state paradigms. What can be done to better coordinate both funding streams and care for those who are dually eligible for the two programs?

■ Is the notion of “swapping” some current state responsibilities for increased (or even total) federal funding of other responsibilities likely to gain more currency in the future?

The press of business this fall makes it unlikely that Congress will spend much time debating these questions in the short term. However, given the current pressures on state budgets, it does seem certain that considerable attention will be given to discussion of matching rates and state flexibility under HIFA. With the likelihood that state budget pressures will continue over the longer term, it appears that discussion of more fundamental Medicaid restructuring will remain a significant concern in the years ahead.

ENDNOTES

1. Vernon Smith, Health Management Associates, e-mail communication with author, September 20, 2002. Smith has made estimates for comparing Medicare and Medicaid based on March 2002 Congressional Budget Office projections. He estimates total Medicaid spending, net of premiums, patient payments, collections, and administration (and assuming an average federal matching rate of 57 percent) for FY 2002 to be \$243 billion, while Medicare, net of premiums, patient payments, collections, and administration is estimated at \$226 billion. Vic Miller, Federal Funds Information for States, email communication with author, September 16, 2002. Miller notes that Medicaid vendor payments in 2002 are expected to be higher than Medicare vendor payments. National Governors Association (NGA), “HR-41. NGA Commission on Medicaid Reform Policy”; accessed September 18, 2002, at http://www.nga.org/nga/legislativeUpdate/1,1169,C_POLICY_POSITION^D_3404,00.html. NGA provides its own estimates of costs and beneficiaries: for FY 2002 it estimates Medicaid to be \$245 billion and Medicare to be \$230 billion. The numbers of beneficiaries are estimated at 44.75 million for Medicaid and 40 million for Medicare.
2. Cathy A. Cowen, Patricia A. McDonnell, Katherine R. Levit, and Mark A. Zezza, “Burden of Health Care Costs: Businesses, Households, and Governments, 1987-2000,” *Health Care Financing Review*, 23, no. 3 (Spring 2002): 131-159.
3. Legislative Tracking Service, National Conference of State Legislatures, “State Actions Affecting Health Care Budgets,” scheduled for publication on September 16, 2002. Liz Anderson, “Budget Woes Lead Official to Raise Specter of State Layoffs,” *Providence Journal*, September 13, 2002; accessed September 13, 2002, at http://www.projo.com/cgi-bin/gold_print.cgi. Lori Montgomery and Craig Whitlock, “Maryland Says Budget Deficit is Growing,” *Washington Post*, September 19, 2002, A1.
4. National Association of State Budget Officers (NASBO), *State Expenditure Report, 2001*, forthcoming, 2; to be posted at <http://www.nasbo.org>.
5. The rough estimate for the Medicaid portion of state revenues in Figure 1 was calculated by the author from information contained in two separate databases. The overall figure for intergovernmental transfers was based on information presented in Donald J. Boyd, Nelson A. Rockefeller Institute of Government, “State Budget Blues: Western States in the National Context,” PowerPoint presentation to fiscal committee chairs at the annual meeting of the Council of State Governments-WEST, Lake Tahoe, Nevada, July 16, 2002; accessed, September 20, 2002, at <http://www.rockinst.org>. The most recent breakdown of intergovernmental revenue for states was derived from NASBO, *State Expenditure*.
6. NASBO, *State Expenditure*, 5.

7. The 12 percent estimate for state revenue was achieved by multiplying the percentage of states' revenues from federal intergovernmental transfers that are derived from Medicaid (NASBO data) times the percentage of federal intergovernmental funds for FY 2000 (Nelson A. Rockefeller Institute of Government compilation of U.S. Census Bureau figures).
8. For example, governors in 45 states must submit a balanced budget, and 41 states require the legislature to enact a balanced budget. These requirements vary in source, with some in the state constitution and others in state statutes. NASBO, *State Expenditure*, 3.
9. National Association of State Budget Officers and National Governors Association (NASBO and NGA), *The Fiscal Survey of States*, National Association of State Budget Officers and National Governors Association, Washington, D.C., May 2002, table 9, 15; accessed June 12, 2002, at <http://www.nasbo.org/Publications/fiscsurv/may2002fiscalsurvey.pdf>.
10. National Conference of State Legislatures (NCSL), *State Budget and Tax Actions 2002*, preliminary report, August 2002 update, August 28, 2002, 1; accessed September 20, 2002, at <http://www.ncsl.org/programs/fiscal/presbta02.pdf>. Also, NASBO and NGA, *Fiscal Survey*, 14. NASBO uses the term budget stabilization fund instead of rainy day fund.
11. National Association of State Budget Officers, *The Fiscal Survey of States: June, 2001*, v; accessed September 9, 2002, at <http://www.nasbo.org/Publications/PDFs/FSJUN2001.pdf>.
12. Nicholas W. Jenny, Fiscal Studies Program, Nelson A. Rockefeller Institute of Government, e-mail communication with author, August 8, 2002.
13. Elizabeth I. Davis and Nicholas W. Jenny, "Can We Call It a "Surprise" the Sixth Time It Happens?" Nelson A. Rockefeller Institute of Government, *State Revenue Report*, No. 41 (September 2000).
14. Randy Desonia, "Disappearing State Surpluses: How Come, How Long, and How Will They Affect Social Service Programs?" Issue Brief No. 769, National Health Policy Forum, October 30, 2002; available at <http://www.nhpf.org>.
15. NASBO, *Fiscal Survey*, 1.
16. Nicholas W. Jenny, "Large Decline in April-June 2002 Quarter Caps Terrible Fiscal Year for States," Nelson A. Rockefeller Institute of Government, *State Fiscal News*, 2, no. 10 (August 2002).
17. NCSL, *State Budget and Tax*, 1.
18. The 3.5 percent estimate of total state spending was derived by dividing the \$37 billion shortfall by the FY 2001 total spending estimate of \$1 trillion, and the 7.7 percent estimate of state revenues other than federal funds was derived by dividing the \$37 billion by the \$477 billion that represents an estimate of state-derived revenue. It must be noted that the state general revenue figure not only excludes federal intergovernmental transfers but also other state revenue restricted by law for particular governmental functions (for example, gasoline tax revenues for a highway fund, revenues from the sales of bonds, and other Medicaid revenues derived from provider taxes, fees, donations, assessments, and local funds). NASBO, *State Expenditure*, 2-3.
19. NCSL, *State Budget and Tax*, 6. The estimate of 20 states with across-the-board cuts was provided by Donald J. Boyd, Nelson A. Rockefeller Institute of Government, e-mail communication with author, September 17, 2002.
20. NCSL, *State Budget and Tax*, 6.
21. NCSL, *State Budget and Tax*.
22. Boyd, "State Budget Blues." Also, James Fossett, Nelson A. Rockefeller Institute of Government, "Health Spending and State Budgets, FY 2003," presentation made at annual conference of National Academy of State Health Policy, August 6, 2002; accessed September 10, 2002, at <http://www.rockinst.org>.
23. Nicholas W. Jenny, "State Budgetary Assumptions in 2002—The Economic Forecast Roller Coaster," Nelson A. Rockefeller Institute of Government, *State Fiscal Brief*, no. 65 (June 2002); accessed August 16, 2002, at http://www.rockinst.org/publications/fiscal_studies/FB_65.pdf.

24. NASBO and NGA, *Fiscal Survey*, 2.
25. NASBO and NGA, *Fiscal Survey*, table 9, 15.
26. NCSL, *State Budget and Tax*, 7-8.
27. Robert E. Pierre, "Tobacco Tempts States in Financial Need," *Washington Post*, June 30, 2002, A3.
28. NCSL, *State Budget and Tax*, 7.
29. NCSL, *State Budget and Tax*, 7. One key indicator, net state tax increase/decrease, is used to measure the overall effect of new tax increases and decreases across the 50 states. For each year, the figure takes into account all the new state revenue resulting from new tax increases for that year and then subtracts the total amount of revenue lost due to tax cuts. For seven straight years, from 1995 to 2001, there was a net decrease in state taxes. (That is, the new revenue from tax increases was more than offset by lost revenues due to tax cuts.)
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31. Donald J. Boyd, "State Fiscal Issues and Risks at the Start of a New Century," Nelson A. Rockefeller Institute of Government, June 2000, table 15, 26; accessed June 18, 2002, at http://www.rockinst.org/publications/fiscal_studies/state_fiscal_new_century.pdf.
32. National Association of State Budget Officers, "Medicaid and Other State Health Care Issues: The Current Situation," May 2002, table 1, 3; <http://www.nasbo.org/Publications/PDFs/fsmedicaidmay2002.pdf>.
33. Vernon Smith and Eileen Ellis, *Medicaid Budgets under Stress, Survey Findings for State Fiscal Year 2000, 2001, and 2002*, Kaiser Commission on Medicaid and the Uninsured, Washington, D.C., January 2002, 17.
34. Vernon Smith, Eileen Ellis, Kathy Gifford, Rekha Ramesh, and Victoria Wachino, *Medicaid Spending Growth: Results from a 2002 Survey*, Kaiser Commission on Medicaid and the Uninsured, Washington, D.C., September 2002, 17; accessed September 20, 2002, at <http://www.kff.org/content/2002/4064/4064.pdf>.
35. Smith et al., *Medicaid*, 26.
36. Smith et al., *Medicaid*, table 4, 26.
37. Smith et al., *Medicaid*, 14–15. See the discussion on pages 14–15 that describes a variety of reasons for this frequent shortfall in Medicaid.
38. NCSL, *State Budget and Tax*, 7.
39. Smith et al., *Medicaid*, 30.
40. NCSL, *State Budget and Tax*, 3.
41. To use a hypothetical example, assume a state has identified a budget shortfall of \$100 million. If it acts quickly so that cuts or tax increases are in effect for 10 months of the fiscal year, the state needs to cover \$10 million per month. However, if it does not act until the last five months of the fiscal year, then it must cover \$20 million a month.
42. Boyd, "State Budget Blues"; Fossett, "Health Spending."
43. FFIS, "Sin Taxes," 20.
44. Matthew Mosk, "Tight Times for States Improve Gambling's Odds," *Washington Post*, August 5, 2002, A1.
45. Campaign for Tobacco-Free Kids, "Oregon Vote to Increase Cigarette Taxes Is a Win for Kids and Taxpayers," press release, National Center for Tobacco-Free Kids, Washington, D.C., September 18, 2002; accessed September 18, 2002 at <http://www.tobaccofreekids.org/Script/DisplayPressRelease.php3?Display=546.html>.

46. Boyd, "State Budget Blues."
47. FFIS, "Sin Taxes," 17.
48. See Karen Matherlee, "The Federal-State Medicaid Match: An Ongoing Tug-of-War over Practice and Policy," Issue Brief No. 760, National Health Policy Forum, Washington, D.C., December 14, 2000; Karen Matherlee, "The Federal-State Struggle over Medicaid Matching Funds: An Update, Background Paper, National Health Policy Forum, Washington, D.C., May 31, 2002; and Teresa A Coughlin and Stephen Zuckerman, "States' Use of Medicaid Maximization Strategies to Tap Federal Revenues: Program Implications and Consequences, Discussion Paper, Urban Institute, Washington, D.C., June 2002.
49. Smith et al., *Medicaid*, 30.
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56. Donald J. Boyd, "The Future of State Fiscal Conditions: Fiscal Boom, Fiscal Bust, Then What?" *Spectrum: The Journal of State Government*, Spring 2002; accessed July 12, 2002, at http://www.rockinst.org/publications/fiscal_studies/Spectrum_Article_Boyd.pdf.
57. Boyd, "State Fiscal Issues."
58. National Governors Association, Policy Position for National Commission on Medicaid Reform, Adopted at Winter Meeting 2002. Accessed September 18, 2002 at http://www.nga.org/nga/legislativeUpdate/1,1169,C_POLICY_POSITION^D3404,00.html.