820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

*November 16, 2001*

# SENATE FINANCE COMMITTEE ECONOMIC STIMULUS BILL PROVIDES ESSENTIAL FISCAL RELIEF TO STATES

## Temporary Increase in Medicaid Matching Rate Would Lessen the Degree to Which States Facing Budget Shortfalls Are Compelled to Undercut Federal Stimulus Efforts by Cutting Programs and Raising Taxes

by Iris J. Lav, Edwin Park and Kevin Carey

On November 8, the Senate Finance Committee approved an economic stimulus bill that includes fiscal relief to states. The bill would provide approximately $5 billion in federal assistance to states by modestly raising for fiscal year 2002 the percentage of Medicaid costs that the federal government pays (and thereby lowering the percentage that states bear). The National Governors Association strongly supports this provision — which largely follows its recommendations — as a recent letter from Governors John Engler of Michigan and Paul Patton of Kentucky (NGA's chair and co-chair) makes clear.[1]

The fiscal relief included in the Finance Committee bill should be an essential element of any economic stimulus legislation. Nearly all states are required by their state laws or constitutions to balance their budgets, even in recessions. Yet because of the economic downturn and the aftermath of the terrorist attacks, state revenues are now declining markedly while the demand for state services such as health care is increasing as people lose their jobs. Without federal financial assistance, states will have no choice but to cut program expenditures and raise taxes significantly, as they did during the recession of the early 1990s. At least 30 states have implemented or begun consideration of budget cuts. Eight states already have approved significant tax increases. Such actions by states dampen the prospects for economic recovery and will offset some of the effect a federal stimulus package aims to have.

A further problem is that the federal Medicaid matching rate for more than half of the states is scheduled to drop in fiscal year 2002. Due to lags in collecting data, state Medicaid matching rates for fiscal year 2002 are based on state per capita incomes in *1997-1999*, a period when many state economies were growing robustly. Many states whose economies — and revenue collections — are now in decline are having the federal share of their Medicaid costs reduced this year because their economies grew significantly several years ago. This increases the extent to which most of these states must cut expenditures or raise taxes.

[1] Letter from Governor John Engler (R-MI), Chairman of the National Governors Association, and Governor Paul Patton (D-KY), Vice-Chairman of the National Governors Association, to Senators Max Baucus (D-MT) and Charles Grassley (R-IA), November 8, 2001.

Unlike the Finance Committee legislation, a number of the leading federal stimulus proposals would not only fail to provide fiscal relief to states but would make state budget deficits larger, which would necessitate still-larger state budget cuts and tax increases. The House stimulus bill and the Administration's stimulus proposals would reduce state revenues by an additional $15 billion over the next three years, because of the effects a business tax cut included in those proposals would have in lowering state revenue collections. A "Centrist Coalition" proposal issued by a group of senators led by John Breaux and Olympia Snowe would create a loss in state revenues of nearly $4 billion in the coming year.

The Senate Finance Committee bill takes a different approach. Although a business tax provision of that legislation would cause states to lose $2 billion in revenue in the coming year, this loss would be more than offset by the provision of $5.1 billion in increased federal funding for Medicaid. The result would be net fiscal relief of $3.1 billion.[2]

Economic experts such as Robert Reischauer, former director of the Congressional Budget Office, and Joseph Stiglitz, co-winner of this year's Nobel Price in Economics, as well as economic experts at Brookings have said in recent weeks that state fiscal relief is one of the best ways to stimulate the economy, since federal dollars used for this purpose will reduce the magnitude of state budget cuts and tax increases that otherwise will be implemented. Providing fiscal relief to states thus would lessen the degree to which federal stimulus legislation is undercut by contractionary policies at the state level.

## States Are Suffering Severe Budget Shortfalls

Almost every state has felt the effects of the economic downturn. Revenue collections in 44 states are below the levels that states projected when developing their budgets for the current fiscal year.[3]

Moreover, the fiscal stress that states are facing goes well beyond a simple decline in revenue *growth*; in 24 states, revenue collections in the period from July through September 2001 fell below the level of revenue collections for the comparable period in 2000. In fact, total state revenue collections in that quarter were 3.4 percent lower than revenue collections in the same quarter of 2000. This was the first such decline in more than a decade.[4]

---

[2] The $5.1 billion in increased Medicaid funding would be provided by raising the federal matching rate in fiscal year by 1.5 percentage points for all states, providing an additional 1.5 percentage-point increase for states with unemployment rates above the national average, and permitting the 29 states whose federal Medicaid matching rates are scheduled to drop this year to use last year's rate as their base rate.

[3] National Conference of State Legislatures, *State Fiscal Outlook for 2002: October Update.*

[4] Rockefeller Institute of Government, *State Fiscal News, November 2001.*

Even these discouraging figures do not convey the full scope of the fiscal problems that states now confront. The events of September 11 affected only the last two and one half weeks of the July-September quarter. As the effects of the attack on state revenues are felt more fully, the number of states whose revenues are shrinking is likely to rise.

Adding to the fiscal difficulties that states are encountering, states expect the demand for state services such as health care to increase as more people lose their jobs (and their health insurance). A new analysis by the Urban Institute estimates that if the average unemployment rate for fiscal year 2002 rises to six percent, Medicaid enrollment will increase by 2.4 million people nationally, climbing more than five percent above the level the Congressional Budget Office earlier projected.[5] The study also estimates that Medicaid expenditures, which CBO earlier projected would rise 9.3 percent between 2001 and 2002, could increase by more than 11 percent, further straining state budgets.

State officials now are working to revise their budget projections in the aftermath of the terrorist attacks. Early indications are that major budget deficits are in the offing in states across the country. Among the states projecting large deficits are California: $8 billion to $14 billion; New York: $9 billion over 18 months; Arizona: $1.6 billion over two years; Ohio: $1.5 billion over two years; and Florida: $1.3 billion. The National Governors Association has estimated that overall, state budget deficits for fiscal year 2002 may be as high as $30 billion.

## States Already Are Cutting Spending and Raising Taxes for Fiscal Year 2002

Some 49 states are required by state laws or constitutions to balance their budgets, even during recessions. Because state revenue losses and increased expenditures for programs based on need are resulting in budget shortfalls, many governors have ordered agencies to identify or implement substantial expenditure cuts. These reductions are coming even as the need for state services is rising as a result of more people losing their jobs and their incomes.

Budget cuts are currently being considered or have already been implemented in at least 30 states. State agencies have been ordered to find cuts in fiscal year 2002 and/or fiscal year 2003 of 15 percent in California, seven percent in Indiana, six percent in Ohio, five percent in Georgia, and four percent in Arizona, Iowa, North Carolina, and South Carolina. Because Medicaid, along with education, constitutes the largest portion of state budgets, a number of states have targeted their Medicaid programs as a primary candidate for reductions. A new survey of 20 state Medicaid agencies, conducted for the Kaiser Commission on Medicaid and the Uninsured, found that more than half of the agencies have been asked by their governors to prepare proposals to reduce Medicaid expenditures in the current state fiscal year. Medicaid

---

[5] John Holahan and Bowen Garrett, "Rising Unemployment and Medicaid," The Urban Institute, Oct. 16, 2001, available at http://www.urban.org/pdfs/HPOnline_1.PDF.

agencies in a number of other states are considering reductions for the coming fiscal year.[6] For example, Florida is considering the elimination of its "medically needy" program, which covers persons with catastrophic health care expenses. Tennessee has proposed changes that would reduce the number of beneficiaries it serves in its Medicaid program by 180,000. Arizona may transfer funding intended for a Medicaid expansion for adults to its general fund, cut the number of Medicaid eligibility workers (in part to discourage enrollment), and eliminate coverage for older foster children.

A number of states also are raising taxes. Eight states — Arizona, Indiana, Maine, Nevada, New Hampshire, New Jersey, North Carolina, and West Virginia — raised taxes and fees significantly when they enacted their FY 2002 budgets. Since the September 11th attacks, governors in Ohio and South Carolina have proposed closing corporate tax breaks to help raise revenue and eliminate budget deficits, while policymakers in Florida have tentatively agreed to delay a tax cut previously scheduled for January 1, 2002. Proposals to delay tax cuts also are being considered in Massachusetts and Virginia.

Large numbers of states are expected to cut programs or raise taxes further when their state legislatures convene this winter. That many states will have no alternative but to take fiscal actions that will work at cross-purposes to federal stimulus policies now appears to be a virtual certainty, unless the federal government intervenes and provides fiscal assistance.

## Likely Business Tax Cuts in Stimulus Legislation Would Further Reduce State Revenues

Making the state fiscal situation even more adverse, a business tax provision that is included in the economic stimulus bill the House approved — and that also is supported by the Administration and Senate Republicans — would further shrink state revenues by more than $15 billion over the next three years. A comparable but smaller provision is included in the Finance Committee bill and would result in a state revenue loss of about $2 billion in fiscal year 2002. (A group of Senators known as the Centrist Coalition has proposed an alternative stimulus package that contains a variant of this proposal, which would state revenues by more than $3.5 billion this year.) Table 1 provides state-by-state estimates of the revenue losses under these various proposals.

The House provision in question, which also is part of the Administration's stimulus proposals, would allow partial expensing of business investments. This provision would enable firms to subtract immediately 30 percent of the cost of new investments in equipment or similar business property when figuring their federal tax liabilities (rather than depreciating the costs of these investments over a number of years, as under current law). This provision would remain in effect for three years. Some 44 states use the federal rules on expensing and depreciation in the

[6] Vern Smith, *Medicaid and State Budgets: An October 2001 Update*, Kaiser Commission on Medicaid and the Uninsured, Oct. 16, 2001.

calculation of their own state corporate and other business income taxes; these 44 states would experience significant state revenue losses if this provision becomes part of federal law. Another state, Michigan, would lose some individual income tax revenue if this provision is enacted, while South Dakota would lose "bank excise tax" revenue. (The District of Columbia and New York City also would experience revenue losses as a result of the provision.) These 46 states would lose an average of more than $5 billion a year in corporate and individual income tax revenue in each of the three years the House provision would be in effect.

The Finance Committee bill has a comparable, although smaller, provision, which would allow firms to subtract 10 percent (rather than 30 percent) of the cost of new investments put in place over the next year (rather than over the next three years). Under the Finance Committee provision, states would lose $2 billion in revenue in the year ahead.

## Federal Medicaid Funding Is Scheduled to Decline in 29 States

Despite the economic downturn that is affecting most areas of the country, the proportion of Medicaid costs that the federal government bears is being reduced in more than half the states in fiscal year 2002. The federal government pays a specified percentage of each state's expenditures for health care benefits provided under Medicaid. This percentage varies by state (the poorer the state, the higher the percentage) and is revised on an annual basis. To measure the relative incomes of states — and compute each state's Medicaid matching rate each year — the federal government compares the average per capita income for each state with the national average per capita income. States with lower relative per capita incomes have higher federal matching rates.

The per-capita calculations used to determine these matching rates each year are based on each state's average per capita income for the three most recent years for which these data are available. Because of lags in data, the new Medicaid matching rates for fiscal year 2002 are based on state per capita income for the years 1997, 1998 and 1999. This was a period when state economies were growing.[7]

Medicaid matching rates for 29 states are now being reduced. These are states whose economies were growing strongly in the late 1990s, the years on which the FY 2002 matching rates are based. In most of these states, however, the economy is now in a downturn, and as a result, these states can ill afford to lose federal Medicaid matching funds. The 29 states will lose about $565 million in federal funds this year as a result of their matching rates being reduced and

---

[7] Office of the Secretary of Health and Human Services, "Federal Financial Participation in State Assistance Expenditures for October 1, 2001 through September 30, 2002", *Federal Register*: November 17, 2000. Rates for Alaska were subsequently changed by legislation in December 2000.

will have to increase their state general fund contributions to Medicaid by that amount.[8] (See Table 2.) In 22 of these states, the reductions in projected federal Medicaid funding exceed $10 million in fiscal year 2002: Alaska, Arizona, Florida, Georgia, Kentucky, Louisiana, Minnesota, Mississippi, Nebraska, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota Texas, Utah, Virginia, Washington and Wisconsin.

## Temporary Increase in Medicaid Matching Rates Would Provide Relief

It is important that the federal government provide fiscal relief to states. Such assistance should serve three purposes. It should hold states harmless from the state revenue losses caused by the business depreciation provisions that Congress and the President ultimately adopt. It also should grant states a reprieve from the reductions in Medicaid matching rates that otherwise will affect 29 states. Finally, it should provide fiscal relief that appreciably lessens the magnitude of the budget cuts and tax increases that states otherwise will have to implement.

The Senate Finance Committee economic bill takes a good step in this direction. It would temporarily increase the fiscal year 2002 Medicaid matching rate for all states by 1.5 percentage points and provide an additional 1.5 percentage-point increase in the matching rate for states whose unemployment rates exceed the national average. The Finance Committee proposal also would permit the 29 states whose Medicaid matching rates are being reduced this year to use last year's matching rates instead.

The Finance Committee provision also has one other virtue — it would have an immediate effect. The increase in federal matching rates would be extremely simple for the federal government to implement; little or no start-up time would be needed before the additional funds could begin being distributed to states. In addition, states would not have to enact legislation or establish new administrative structures to receive or use the additional federal funds.

Through these measures, the Finance Committee bill would produce net fiscal relief for states of approximately $3.1 billion. The bill would provide $5.1 billion in increased federal funding to states by raising the Medicaid matching rates, while the partial-expensing tax cut in the Committee bill would cause states to lose $2 billion.

A final point should be noted here. The expensing provision that ultimately is adopted is likely to be larger than the Finance Committee's expensing provision. If that occurs, the state revenue loss will be larger as well. As a result, if Congress and the Administration approve an expensing provision larger than the Finance Committee proposal, the fiscal relief the Finance Committee bill provides ought to be increased accordingly.

---

[8] The Medicaid matching rate is unchanged in 2002 in 11 states (including the District of Columbia) and has increased in 11 states. States with increased matching rates will receive about $230 million more under the new matching rates than they would have received under the 2001 matching rates.

**Table 1**

| Estimated Loss of State Tax Revenues Due to Tax Provisions of Stimulus Proposals (in millions of dollars) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **House Bill (each year for 3 years)** | **Centrist Coalition (1 year)** | **Finance Bill (1 year; does not include offsetting fiscal relief)** | | **House Bill (each year for 3 years)** | **Centrist Coalition (1 year)** | **Finance Bill (1 year; does not include offsetting fiscal relief)** |
| **ALL STATES** | **$5,430** | **$3,630** | **$2,010** | | | | |
| Alabama | $56 | $37 | $21 | Montana | $22 | $14 | $8 |
| Alaska | 70 | 47 | 26 | Nebraska | 33 | 22 | 12 |
| Arizona | 110 | 73 | 40 | Nevada | | not affected | |
| Arkansas | 53 | 36 | 20 | New Hampshire | 42 | 28 | 16 |
| California | | not affected | | New Jersey | 260 | 180 | 97 |
| Colorado | 87 | 58 | 32 | New Mexico | 40 | 26 | 15 |
| Connecticut | 99 | 66 | 37 | New York | 710 | 480 | 260 |
| Delaware | 31 | 21 | 11 | North Carolina | 190 | 130 | 72 |
| Florida | 210 | 140 | 78 | North Dakota | 15 | 10 | 6 |
| Georgia | 180 | 120 | 65 | Ohio | 200 | 130 | 73 |
| Hawaii | 21 | 14 | 8 | Oklahoma | 48 | 32 | 18 |
| Idaho | 31 | 21 | 11 | Oregon | 100 | 68 | 38 |
| Illinois | 360 | 240 | 130 | Pennsylvania | 340 | 230 | 120 |
| Indiana | 180 | 120 | 66 | Rhode Island | 19 | 13 | 7 |
| Iowa | 60 | 40 | 22 | South Carolina | 58 | 39 | 21 |
| Kansas | 57 | 38 | 21 | South Dakota | 8 | 5 | 3 |
| Kentucky | 73 | 49 | 27 | Tennessee | 110 | 73 | 40 |
| Louisiana | 57 | 38 | 21 | Texas | 340 | 220 | 120 |
| Maine | 30 | 20 | 11 | Utah | 43 | 29 | 16 |
| Maryland | 120 | 78 | 43 | Vermont | 11 | 7 | 4 |
| Massachusetts | 270 | 180 | 99 | Virginia | 140 | 92 | 51 |
| Michigan | 60 | 40 | 22 | Washington | | not affected | |
| Minnesota | 180 | 120 | 66 | West Virginia | 36 | 24 | 13 |
| Mississippi | 55 | 37 | 20 | Wisconsin | 140 | 93 | 52 |
| Missouri | 87 | 59 | 32 | Wyoming | | not affected | |
| **ADDITIONAL AFFECTED JURISDICTIONS** | | | | | | | |
| District of Columbia | 40 | 27 | 15 | New York City | 390 | 260 | 140 |

**Table 2**

| States with Federal Medicaid Matching Rate Reductions in Fiscal Year 2002 | | | | |
|---|---|---|---|---|
| **State** | **FY 2001 Matching Rate** | **FY 2002 Matching Rate** | **Difference FY 01 - FY 02** | **Projected Reduction in Federal Funds in FY 2002** |
| | | | | (millions of $) |
| Alaska | 60.13% | 57.38% | -2.75% | -$13.2 |
| Arizona | 65.77% | 64.98% | -0.79% | -$26.3 |
| Arkansas | 73.02% | 72.64% | -0.38% | -$7.6 |
| Florida | 56.62% | 56.43% | -0.19% | -$18.0 |
| Georgia | 59.67% | 59.00% | -0.67% | -$36.2 |
| Kentucky | 70.39% | 69.94% | -0.45% | -$15.3 |
| Louisiana | 70.53% | 70.30% | -0.23% | -$10.0 |
| Minnesota | 51.11% | 50.00% | -1.11% | -$48.9 |
| Mississippi | 76.82% | 76.09% | -0.74% | -$19.1 |
| Montana | 73.04% | 72.83% | -0.21% | -$1.3 |
| Nebraska | 60.38% | 59.55% | -0.83% | -$10.7 |
| Nevada | 50.36% | 50.00% | -0.36% | -$2.8 |
| New Mexico | 73.80% | 73.04% | -0.76% | -$12.8 |
| North Carolina | 62.47% | 61.46% | -1.01% | -$65.7 |
| North Dakota | 69.99% | 69.87% | -0.12% | -$0.6 |
| Ohio | 59.03% | 58.78% | -0.25% | -$23.3 |
| Oklahoma | 71.24% | 70.43% | -0.81% | -$18.8 |
| Oregon | 60.00% | 59.20% | -0.80% | -$20.7 |
| Rhode Island | 53.79% | 52.45% | -1.34% | -$17.8 |
| South Carolina | 70.44% | 69.34% | -1.10% | -$37.0 |
| South Dakota | 68.31% | 65.93% | -2.38% | -$12.4 |
| Tennessee | 63.79% | 63.64% | -0.15% | -$8.7 |
| Texas | 60.57% | 60.17% | -0.40% | -$52.7 |
| Utah | 71.44% | 70.00% | -1.44% | -$13.4 |
| Virginia | 51.85% | 51.45% | -0.40% | -$16.1 |
| Washington | 50.70% | 50.37% | -0.33% | -$18.5 |
| West Virginia | 75.34% | 75.27% | -0.07% | -$1.1 |
| Wisconsin | 59.29% | 58.57% | -0.72% | -$25.5 |
| Wyoming | 64.60% | 61.97% | -2.63% | -$6.8 |
| **Total for 29 States** | | | | **-$565.1** |