

State Responses to Budget Crises in 2004: Alabama

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Background

Alabama is one of the poorest states in the nation, ranking 44th in median family income in 2000-2001.¹ Nonetheless, it has a smaller share of its under-65 population uninsured than the national average (10.0 percent versus 12.1 percent for children and 17.1 percent versus 19.1 percent for adults under age 65). Rates of employer-sponsored insurance are above the national average and rates of coverage by Medicaid are near national averages for both adults and children.²

Alabama's budget is characterized by a high degree of earmarking. About 87 percent of revenue is earmarked with specific taxes linked to specific purposes with limited ability to move funds between dedicated accounts.³ The two largest budget funds are the General Fund and the Education Trust Fund (ETF), which are estimated at \$1.2 billion and \$4.2 billion, respectively, for FY 2003. Medicaid is partly funded out of the General Fund and, at 18.3 percent of appropriations, it is the largest single category of General Fund expenditures. When all state funds are considered together, Medicaid represents 11 percent of overall state appropriations; the largest single category for all state funds is education at 56 percent.

The Medicaid program enjoys a very favorable federal match, nearly 71 percent, and Alabama has been successful in structuring its program to take advantage of this incentive. A substantial proportion of the state share of program funding, about three quarters in FY 2002, comes from "other state funds," a category that includes intergovernmental transfers, provider taxes, tobacco settlement revenues, and drug rebates. So, while Alabama's budget problems are severe, the state's financing of Medicaid is threatened more by changes in non-

General Fund revenue sources, particularly federal funding for the Medicaid disproportionate share hospital (DSH) and upper payment limit (UPL) programs.

Historically, one of the largest sources of revenue, about 11 percent, for the General Fund has been interest on state fund balances. Interest rates are at the lowest level in forty years; as a result, total income from this source to the General Fund was down by more than forty percent between FY 2001 and FY 2002.⁴ Estate taxes are also paid into the general fund, constituting about 7 percent of revenues. The state estate tax is linked to the federal estate tax, and the changes in the federal tax have reduced these receipts by one quarter each year since FY 2002. Total appropriations for the General Fund increased by less than one half percent between FY 2001 and FY 2004.⁵ The General Fund has no formal reserve provision but some \$13 million has been put aside in the past several years in an informal rainy day fund.

In fiscal years 1998 to 2000, Alabama saw exceptional growth in receipts in its General Fund.⁶ The Alabama Medicaid Agency took advantage of the growth to improve access to care under Medicaid, most notably by raising reimbursement rates for physicians and dentists in order to improve provider participation, rather than expanding eligibility or benefits. In addition, it streamlined its Medicaid enrollment procedures to improve the take-up rate and enrollee retention. During the same period, the Department of Public Health instituted an aggressive and effective outreach program for its SCHIP program, ALLKids, which had spillover effects on Medicaid enrollment. The number of Medicaid enrollees rose from 496 thousand in 1997 to 704 thousand in 2002.⁷ Growth in enrollment is expected to drop back to the historical rate of under four percent this

year after three years of growth of over seven percent a year.

Alabama's Budget Problem

Lean years followed this period of relative prosperity and, in FY 2003, Alabama again found itself in a tight budgetary position. The projected General Fund budget shortfall going into the fiscal year was \$123 million. The state used several one-time revenue strategies to fill this gap, including shifting funds from a tax escrow account that had been built up over several years⁸ and using settlement funds from litigation over off-shore drilling royalties and monies from an abandoned property reserve account. The informal rainy day fund in the General Fund was also tapped to help fill the FY 2003 budget gap.

When the new governor, Bob Riley, took office in January 2003, he found a budget gap of \$675 million projected for FY 2004 for the combined General Fund and ETF budgets, \$198 million of which was attributable to the General Fund. The gap represented about 16.5 percent of the General Fund; in the ETF, the gap was about 11.4 percent. In response, in his State of the State address in March 2003, Riley announced an ambitious plan to reduce unnecessary government expenditures and to reform state tax policy to address Alabama's budget problems.

In Alabama, certain changes in the tax system require a constitutional amendment passed by voter referendum. Riley put forward for a vote a comprehensive tax proposal designed not only to meet the projected budget shortfall but also to provide sufficient revenues to invest in a "world-class education" system for the state.⁹ The tax reform plan proposed both raising some tax rates and redistributing the burden of taxes across groups. Although the plan would have added an estimated \$1-1.2 billion in annual revenues, many Alabama residents, particularly the poor, would have seen reduced taxes. Property taxes would have been raised substantially but would still have remained the lowest in the country. Income taxes would have been reduced for the poorest state residents and raised for the highest income group. A variety of other tax increases were proposed including

taxes on cigarettes, sales, businesses, and utilities.¹⁰

The tax reform referendum was put to the voters in September 2003 and failed by a large margin. Those who would have been hurt by the proposed increases, notably large landowners and timber companies who would have paid substantially more in property taxes, campaigned hard against the plan, invoking Alabamians' distrust of government by asserting that there was no guarantee that legislators would use the money as they had promised.¹¹

After the resounding defeat of a voter referendum to raise taxes to address the budget shortfall, the state made major cuts in a broad range of programs.

A budget for FY 2004 reflecting the level of revenues projected without the reform had been proposed in March and, following the defeat of the referendum, passed the legislature in late September with little controversy. The FY 2004 General Fund budget represented a reduction of about 5.3 percent from the 2003 level. Most programs funded from the General Fund saw cuts of about 18 percent with some losing half or more of their funding.

Expenditures for government operations were cut by 26.3 percent in the legislative branch and 9.9 percent in the judicial branch. Expenditures for the executive branch, which, in addition to operational expenses, includes the Medicaid program as well as numerous small line items for local programs, were cut by 3.7 percent. Most of the small local programs had their funding cut completely. Merit raises have been eliminated in recent years for all state employees, and, in FY 2004, cost-of-living increases were skipped. In contrast, state employee benefits were protected. In addition to the many spending cuts enacted, there were some increased allocations. Notably, the allocation for debt service was doubled, and the budget for the Board of Pardons and Paroles was increased by 74 percent in order to facilitate the planned reduction in the prison population.

Expenditures from the ETF were cut by about 2 percent. Higher education and K-12 education were cut by similar percentages. Teachers' jobs were maintained but health insurance

copayment requirements were increased. Cuts were made in appropriations for books, computers, training, and tutoring programs, and allocations to private schools were cut in half.

Cuts in Medicaid and SCHIP

In FY 2003, Medicaid faced a projected shortfall of \$30-40 million in state funds. Officials were able to make it through the year without cuts in eligibility or services, however, by taking advantage of one-time funding sources. The temporary enhancement of the federal matching rate provided for under the Tax Relief and Reconciliation Act of 2003, in effect for the last two quarters of FY 2003 and the first three quarters of FY 2004, filled most of this gap.

Alabama's Medicaid program is already close to federal minimum program requirements and so offered few opportunities for further cuts.

The Medicaid FY 2004 General Fund appropriation was approved at \$220 million, a decrease of about 0.8 percent with respect to the FY 2003 General Fund appropriation of \$222 million. However, when the federal contribution and the non-General Fund contributions to the state share are included, the FY 2004 budget reflected an increase of 8.8 percent in total program expenditures over the previous year. General Fund appropriations for Medicaid have been decreasing since FY 2000 when the appropriation was \$245 million but total Medicaid expenditures have risen over that same period from \$2.9 billion in 2000 to \$3.7 billion projected for 2004.

The declining share of General Funds in the Medicaid program is evidence of the state's growing reliance on both one-time revenue sources (such as tobacco settlement funds) and federal funds drawn in through significant DSH and UPL payments. The state's continuing reliance on one-time revenue sources and DSH and UPL—which have come under considerable federal scrutiny in recent years—has put Alabama's financing of its Medicaid program in a precarious position. It is particularly

vulnerable to changes in federal funding sources such as DSH funding, which was expected to decline in 2003 and beyond (but was restored as part of Medicare Prescription Drug bill), and UPL payments, which are largely being phased out.

The state is keenly aware that its financing of Medicaid is not on solid financial ground, and sought to partly address the issue in this year's budget request. Specifically, in putting together the FY 2004 Medicaid General Fund budget request, the state moved some program expenditures that had been paid for with one-time funding sources that are being phased out to the General Fund. As a result, General Fund costs rose to an estimated \$330 million, the amount that was put into the budget request.¹² However, the state only appropriated \$220 million in Medicaid General Funding spending, \$110 million less than requested, leaving Alabama's FY 2004 General Fund Medicaid budget about one-third short of projected costs.

The state expects to meet about \$74 million of this gap through the enhanced FMAP provided as part of the federal relief package. In addition, in FY 2003 Alabama adopted a preferred drug list that will be phased in beginning in November 2003 and is expected to save about \$13 million in FY 2004. The remaining \$26.5 million of the gap will have to be funded through cuts in program expenditures. The details of the cuts were left to be decided after the passage of the budget.

To date, no cuts in eligibility or benefits have been made, but officials are currently considering which of several proposed changes in benefits they will make to meet the \$26.5 million shortfall. Eligibility changes for Medicaid are not currently being considered but outreach for the ALLKids SCHIP program has been reduced. Alabama's Medicaid program has historically been close to federal minimums in most areas so there are few options available. Attention is being given to those optional services that can be cut without causing a compensatory increase in expenditures in other areas. Officials expect to choose from among the following benefit changes (with estimated savings) to meet the shortfall:

- Elimination of hospice services for adults in the community (\$7 million);
- A decrease in the annual limit on inpatient days and inpatient visits from

16 to 14 (\$2 million):

- Elimination of routine eye care and eye glasses for adults (\$5 million);
- Imposition of a monthly limit on prescription drugs of seven per month without prior approval and up to ten per month with prior approval¹³ (\$33 million);
- Limitation of non-emergency use of hospital emergency departments to three visits per year (savings not yet projected); and
- Reduction of the nursing home income eligibility from 300 to 100 percent of the SSI income limit, and tightening of the nursing home medical criteria by incorporating activities of daily living criteria (\$85 million).

In addition, the state may have to reduce provider payments rates by two percent for physicians and dentists (\$9 million) and three percent for hospitals (\$9.3 million). The physician and dentist rate reductions are particularly painful for the state since they represent a rollback of the increases made three years ago that many credit with having improved provider participation in Medicaid. Nursing home rates are set statutorily and cannot be changed without action by the legislature.

The Future

The savings from the proposed cuts amount to more than the current year shortfall, and state officials expect that those that are not made in FY 2004 will be implemented in FY 2005 when the cumulative effects of the end of the enhanced FMAP, the end of Alabama's five-year phase-out period for its UPL program, the exhaustion of various repositories of one-time funds combine with an aging population and the continuing rise in pharmaceutical and other costs to present a nearly insurmountable budget hurdle for the program. Eligibility and benefits are as close to federal minimums as is practical, and further cuts to provider rates risk deteriorating access for beneficiaries. The restoration and expansion of federal DSH funding provided in the Medicare Prescription

Drug bill eases but does not solve Alabama's Medicaid financing problems.

An overarching issue is the defeat of the tax reform proposal, which implies that the vast majority of Alabamians prefer lower taxes to improved government services or possibly even maintenance of the current level of services. With the cuts in state funding for programs this fiscal year across the board, not just in Medicaid, the effect of diminished state budgetary resources will be highly visible and voters may reconsider their positions. The large margin of the tax proposal's defeat, however, argues against its being revisited in the near future. For the Medicaid program, the consequences are stark. With very little room to cut the program further because of basic federal requirements and no new funding on the horizon, Alabama faces serious fiscal challenges and tough policy choices in the maintenance of its Medicaid program.

Funded by the Kaiser Commission on the Future of Medicaid and the Uninsured and the Urban Institute's Assessing the New Federalism project, this study is part of a broader project that examined state responses to the 2004 budget crises in ten states (Alabama, California, Colorado, Florida, Massachusetts, Michigan, New Jersey, New York, Texas, and Washington). An overview paper and other state report reports can be found at www.urban.org. A combined volume of both the overview and state reports can be found on www.kff.org.

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Endnotes

¹ Kaiser Family Foundation State Facts Online, <http://www.statehealthfacts.kff.org/cgi-bin/healthfacts.cgi?action=compare&category=Demographics+and+the+Economy&subcategory=People+in+Poverty&topic=Distribution+by+FPL>.

² Urban Institute calculations using data from the Current Population Surveys, 2002 and 2003 Annual Social and Economic Supplements.

³State of Alabama, Legislative Fiscal Officer, Presentation to the Permanent Joint Legislative Committee on Finances and Budgets, February 11, 2003, http://www.lfo.state.al.us/pdfs/BudgetHearingPres2_03.pdf.

⁴ State of Alabama, Legislative Fiscal Officer, Presentation to the Permanent Joint Legislative Committee on Finances and Budgets, February 11, 2003, www.lfo.state.al.us/pdfs/BudgetHearingPres2_03.pdf, accessed October 3, 2003.

⁵ Urban Institute calculations using data on General Fund appropriations at the State of Alabama, Executive Budget Office website, <http://www.budget.state.al.us/stgovfin.html>.

⁶ State of Alabama, Legislative Fiscal Officer, Presentation to the Permanent Joint Legislative Committee on Finances and Budgets, February 11, 2003, http://www.lfo.state.al.us/pdfs/BudgetHearingPres2_03.pdf.

⁷ Alabama Medicaid Agency, FY 2002 Annual Report and FY1997 Annual Report, <http://www.medicaid.state.al.us/ABOUT/MediciadAR2002.pdf>, and

<http://www.medicaid.state.al.us/ABOUT/97anrep/97anrep.htm>

⁸ Specifically, the tax escrow account is an administrative fund that was established to provide for potential refund requests associated with previous franchise and shares taxes.

⁹ Governor Bob Riley, State of the State Address, March 04, 2003, <http://www.governorpress.state.al.us/pr/sp-2003-03-04state-of-state-2k3.asp>.

¹⁰ Paul Prosofski, The Alabama Tax and Budget Situation: History, Effects, and Alternatives (draft), Americans for Tax Reform, http://www.atr.org/alabamareport_files/frame.htm.

¹¹ Kim Chandler, "The Choice is Yours," Birmingham News, September 9, 2003, <http://www.al.com/news/birminghamnews/index.ssf?/base/news/106309905165000.xml>.

¹² The budget request sought FY2003 eligibility and benefit levels for FY 2004.

¹³ Long term care patients and children under EPSDT are exempted since these benefits are mandatory.