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BEFORE THE HOUSE COMMITTEE ON THE BUDGET**

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Thank you for the opportunity to discuss with you today why federal fiscal relief for states is a particularly necessary and effective part of a stimulus plan at this time.

State finances are in dire straits. At least 36 states are experiencing fiscal stress.¹

- There are 29 states that closed shortfalls of \$48 billion in enacting their fiscal year 2009 budgets (for the year beginning July 1, 2008 in most states). The shortfalls equaled 9 percent of these states' general fund (operating) budgets.
- Since fiscal year 2009 budgets were enacted, budgets have fallen out of balance producing new, mid-year deficits in 22 states and the District of Columbia that total more than \$11 billion or 4 percent of budgets.
- The latest revenue collection numbers suggest that the situation is rapidly worsening. Third quarter 2008 sales tax and income tax revenue are coming in well below prior year levels and well below states' initial projections in most of the states that have released figures. These latest figures have not yet been taken into account in most states' budget forecasts.
- At least 16 states have announced that they are expecting deficits for state fiscal year 2010 that so far total \$18 billion, but that number is very low because it is very early in the year for most states to make such a projection and because revenue collections continue to weaken. Deficits during the downturn in the early part of the decade reached \$75 billion and \$80 billion in the second and third year of that fiscal crisis, and economic conditions are now projected to be significantly worse than they were then. Judging from the rate at which revenue is deteriorating and the history of prior recessions, **the 2010 gaps are likely to be in the \$100 billion range.**

¹ This includes states with deficits that were closed in enacting their fiscal year 2009 budgets, states with mid-year gaps, and three states (Kansas, Oregon, and Washington) that did not have fiscal year 2009 deficits but are projecting deficits for fiscal year 2010.

These state deficits are particularly problematic because, unlike the federal deficit, they lead directly to spending cuts and tax increases that reduce demand, which further harms the economy.

Whenever the national economy stagnates or falls into recession, state revenues also stagnate or decline. This happens just at the very time that states face upward pressure on their budgets as residents lose jobs and income and health insurance and become eligible for Medicaid or other safety net programs. This produces deficits.

These state deficits are not like the increase in the federal deficit that typically also occurs during a recession. This is because all states but one have a requirement to balance their general fund (operating) budgets. States with flagging revenues cannot provide even the normal level of services — let alone meet the increased demand for services and supports.

Under balanced budget requirements, states have three primary actions they can take during a fiscal crisis: they can draw down available reserves, they can cut expenditures, or they can raise taxes.

Most states do keep “rainy day funds” and other reserves to try to anticipate this problem. States entered this period of economic weakness with the largest reserves they have ever had, totaling \$69 billion or 10.5 percent of their general fund budgets at the end of fiscal year 2007. But those funds are on the road to being depleted for the purpose of budget balancing — and that was before the events of the last four weeks that undoubtedly have weakened fiscal conditions in the states.

The other two options states have to meet their balanced budget requirements are tax increases and budget cuts. These options both are *pro-cyclical*. That is, they intensify the economic downturn rather than help the economy recover.

The spending cuts and tax increases states make when they must balance their budgets under conditions of falling revenue can further slow a state’s economy during a downturn and contribute to the further slowing of the national economy, as well. When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or reduce payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy.

Tax increases also remove demand from the economy by reducing the amount of money people and businesses have to spend.

In contrast to the states, the federal government can run a deficit, and it does not have to take the actions damaging to the economy (and to low- and middle-income families needing state services) that state balanced budget requirements force on states during recessions. Thus, one of the best ways to stimulate the economy in a downturn is for the federal government to provide short-term, additional funding to states.

You will recall that in 2003, you enacted a \$20 billion fiscal relief package for states. It provided two types of assistance to states: 1) a temporary increase in the federal share of the Medicaid program; and 2) general grants to states, based on population. Each part was for \$10 billion.

While extremely important, the 2003 fiscal relief package was not enacted until after 1 million people lost eligibility for Medicaid because of state cutbacks, and deep cuts had been made in K-12 education, child care, state workforces, and a variety of other areas. In the best of all worlds, it would have been enacted before those demand-reducing cuts were made.

States already have begun cutting their budgets; about half of the states have made cuts in public health programs, services for the elderly and disabled, K-12 education, or universities and colleges. At least 18 states have cut their workforce. And states are on the verge of making far more drastic cuts as they deal with their mid-year deficits and begin to enact fiscal year 2010 budgets.

There is the opportunity to prevent many of these damaging actions through providing fiscal relief. Preventing these pro-cyclical state actions is among the best forms of stimulus you could provide, because it both prevents budget cuts to programs that are needed by people who are losing jobs and incomes in this recession, and prevents state actions from worsening the economy.

This time around, however, it seems that much more than \$20 billion in relief will be necessary.

- To stop the most damaging of the budget cuts, fiscal relief of approximately \$50 billion would be needed. This would be about one-half of the expected deficit for state fiscal year 2010 (or less than one-third the combined deficits for state fiscal years 2009 and 2010).
- The majority of the fiscal relief (\$30 billion to \$35 billion) would be most effective as an increase in the federal share of the Medicaid program (FMAP), accompanied by a ban on states reducing eligibility in that program and thereby driving up the ranks of the uninsured. Without such assistance, the number of uninsured in this country could rise to 50 million.
- The remainder of the relief could be made available to prevent cuts in education and other critical state programs, as well as to lower the likelihood that states will cut aid to localities.

Federal fiscal relief of \$50 billion would provide a substantial stimulus by averting that amount of pro-cyclical actions by states that otherwise would be inevitable. It would be sufficient to prevent many of the state budget cuts that would be most harmful to low- and moderate-income households, including the newly unemployed. But, relative to the size of the deficits, it would not create a “moral hazard” that could in any way induce states to be less responsible with their own finances. The need to amass substantial “rainy day funds” and other reserves during strong economic times would remain.

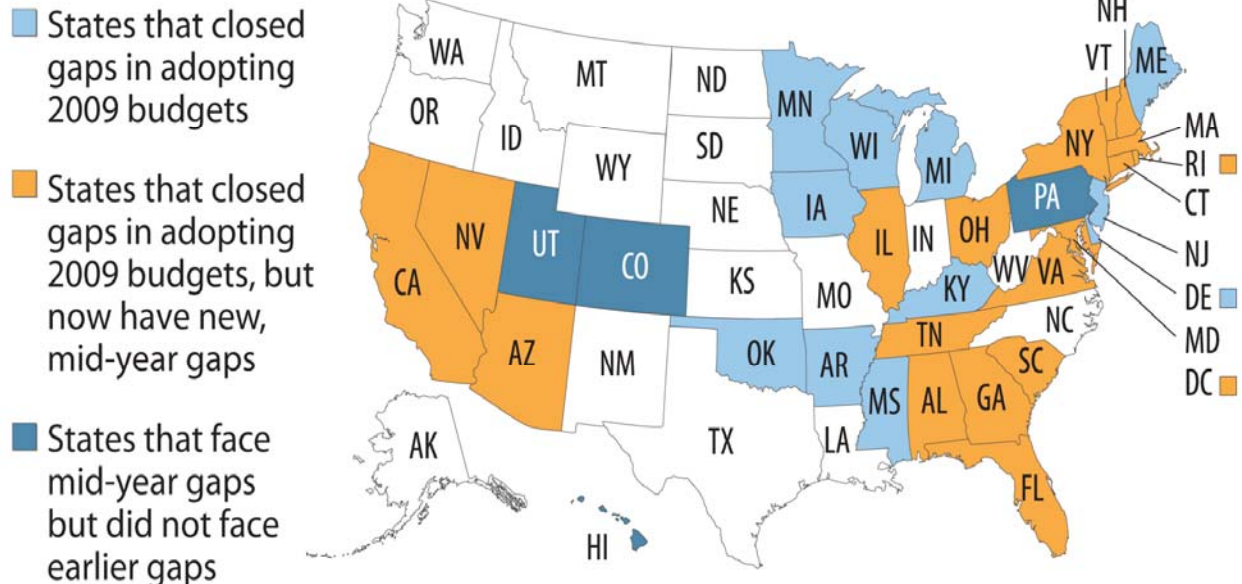
I would stress that the payments to states would be temporary. States should be allowed to use fiscal relief over a 15 month or 18 month period after enactment.

The hallmark of a good stimulus is that it is well-targeted, temporary, and timely. Federal fiscal relief to the states fits well on all of those dimensions. For these reasons, a number of economists have called for fiscal relief to the states to be a key part of a stimulus package, including Mark Zandi, Paul Krugman, Laurence Summers, Jered Bernstein, and Alan Blinder, among others.

The following reviews some of the details of the current situation and the case for fiscal relief.

FIGURE 1

State Budget Problems Worsening: 33 States with FY2009 Gaps



State Fiscal Conditions

When states project deficits — gaps between projected revenue and projected spending — for an upcoming fiscal year, they have to take action to close those deficits. As noted above, 36 states are already experiencing fiscal stress. Twenty-nine states closed shortfalls of \$48 billion in enacting their fiscal year 2009 budgets. In many states, however, the revenue estimates used to project their budget shortfalls were still far too optimistic; the economy has seriously deteriorated since those budgets were enacted. As a result, budgets have fallen out of balance producing new, mid-year deficits in 22 states and the District of Columbia that total more than \$11 billion or another 4 percent of budgets² (See Figure 1.) And that is a snapshot of the situation last week. Virtually every day, additional states are announcing shortfalls or increasing their estimate of the size of their shortfalls.

States are just beginning to release revenue collection data for the 3rd quarter of 2008 (which is the first quarter of fiscal year 2009 in most states). The sales tax data certainly reflects the slump in retail sales and consumption, while the income tax data reflects, among other factors, the increase in the unemployment rate.

There are revenue declines in most of the states that have released data. For example, sales tax revenues for the third quarter 2008 compared to the third quarter 2007 are down 8.8 percent in California, 12.1 percent in Florida, 8.0 percent in Georgia, 7.3 percent in Massachusetts, and 8.5 percent in Missouri, after adjustment for inflation. (See Table 1.)

² The gaps are 4 percent of the budgets of the 20 states that have provided specific estimates. There are no estimates for California and Illinois.

Looking ahead to 2010, it is difficult to overstate the fiscal problems states will face. It seems increasingly likely that this recession will be more severe than the last recession, and thus state fiscal problems are highly likely to be worse than they were in 2003 when fiscal relief was last enacted.

This is true for at least three reasons:

- Unemployment, which peaked after the last recession at 6.3 percent, has already reached 6.1 percent, and many economists expect it to rise to 7 percent or even 8 percent. This would reduce state income taxes, and increase participation in Medicaid and other services, to a greater degree than in the past.
- The decline in the stock market now has matched the decline in the last recession by some measures and may yet fall further. This affects states' capital gains taxes, which in many states are a major component of income taxes.
- Consumers' access to home equity loans and other sources of credit is far less than it was in the last recession, so consumption expenditures and therefore sales taxes are likely to fall more steeply than in the past.

Even though this recession and fiscal crisis is likely to be considerably deeper than the one at the beginning of the decade, it is still instructive to look at what happened in that prior recession. That recession was relatively short and mild, yet created large state fiscal deficits over a four-year period. The fiscal year 2002 deficit was \$40 billion, but it rose to \$75 billion in 2003 and \$80 billion in 2004.

This year, the deficit for the first year of the fiscal crisis, fiscal year 2009, is \$59 billion and still growing.³ (See Figure 2)

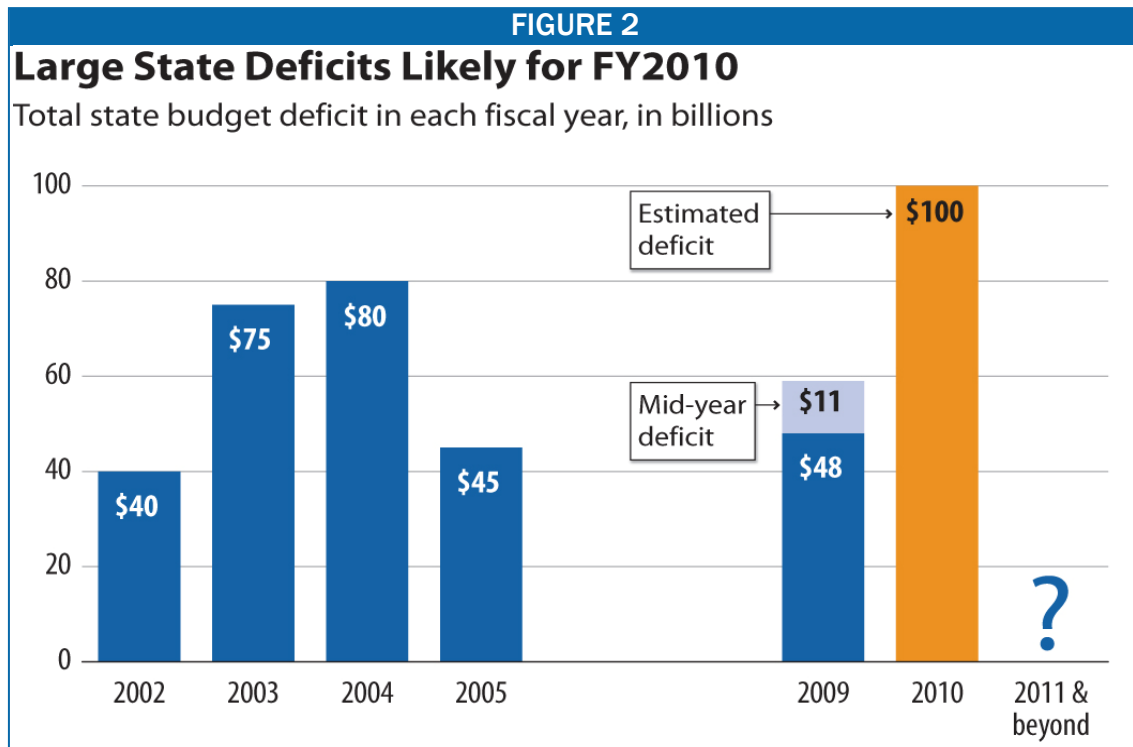
Some 16 states have already announced that they face deficits they will have to close in enacting their fiscal year 2010 budgets.⁴ Ten of those states have estimated the size of those gaps for a total of \$18.2 billion. As additional states announce gaps, and the size of the gaps are reevaluated for deteriorating economic conditions, the size of the 2010 gap will grow substantially. The 2010 gap is

State	Revenue Source (inflation-adjusted dollars)	
	Sales Tax	Income Tax
California	-8.8%	-5.3%
Florida	-12.1%	X
Georgia	-8.0%	-7.3%
Illinois	-2.5%	-1.3%
Massachusetts	-7.3%	-2.0%
Minnesota	-8.4%	0.8%
Missouri	-8.5%	-2.8%
Tennessee	-6.9%	X
Texas	1.9%	X

Source: CBPP calculations based on data from state revenue departments, adjusted by the Consumer Price Index (CPI-U).

³ This includes the deficits states closed in enacting their 2009 budgets and the mid-year deficits for which there are estimates.

⁴ They are Alabama, Arizona, California, Connecticut, Florida, Hawaii, Kansas, Maine, Maryland, Minnesota, New York, Oregon, Vermont, Virginia, Washington, and Wisconsin.



likely to be in the range of \$100 billion — or even more if the economy experiences additional deterioration between now and then.

Under state balanced budget constraints, deficits of this size inevitably mean very large cuts in Medicaid, education, and other vital programs. If the deficits were evenly spread over the states, \$100 billion would represent about 14 percent of state general fund expenditures.

Budget Cuts

In the last recession, 1 million people lost health insurance because of cutbacks in Medicaid and SCHIP in 34 states. In addition, one-third of the states cut child care subsidies or otherwise limited access to child care, two-thirds cut per-pupil expenditures for K-12 education, and most raised tuition at public colleges and universities. Aid to local governments for functions other than education also was cut in many states, which led local governments to scale back services on which low- and middle-income people rely.

The worst of the budget cuts generally come in the second or third year of a state fiscal crisis, and that pattern is likely to hold this time around. That is because in the first year of an economic slowdown, states can draw down rainy day funds and reserves. They also can take actions such as instituting hiring and travel freezes, as well as finding items in their budget that are more marginal to their core functions.

So far this year, about half the states have enacted budget cuts that affect low- and moderate-income people — reductions in funding and services in public health programs, services for the elderly and disabled, K-12 education, or universities and colleges. While these reductions are quite

serious to anyone who is hit by them, they are not yet at the devastating level seen in the last recession or the even deeper cuts in some previous recessions.

For example, in enacting its fiscal year 2009 budget, Rhode Island eliminated health coverage for 1,000 parents and will require 7,800 low-income families to pay higher monthly premiums for public insurance (which is likely to result in some who cannot afford the premiums becoming uninsured). States such as Arizona and California are reducing their Medicaid rolls by increasing the frequency with which some recipients must reapply for benefits, which research suggests will cause eligible people to become uninsured. On another front, tuition at state universities and community colleges has been increased in at least 11 states, with increases ranging from 4 percent to 15 percent. Rhode Island, for example, hiked community college tuition by 14.3 percent. Tuition increases such as these affect the ability of students with limited means to attend college.

As states cope with the reality that the economic assumptions they used in enacting their fiscal year 2009 budgets were too optimistic, they are poised to make another round of budget cuts for the current fiscal year. Cuts are in the process of being made in Maryland, Massachusetts, Virginia, Utah, and Georgia. Another set of states are getting ready to consider cuts, including South Carolina, New Jersey, Connecticut, New York, New Hampshire, Florida, Nevada, Arizona, and California. These states either have scheduled special legislative sessions after the elections to make additional cuts, or will be doing so through executive powers.

It will not be long, however, before states will begin to deliberate their fiscal year 2010 budgets in early 2010. It is in those budgets — as states cope with what is likely to be \$100 billion in deficits after they have already taken all of the “easier” actions — that the most damaging cuts will occur. Since portions of state budgets, such as courts, corrections, public safety and homeland security, and others cannot be cut or cut much, states budget cuts typically fall on health care, education, and aid to local governments.

Some of the deepest cuts are likely to occur in state health programs, particularly Medicaid and SCHIP, as they did in the last recession. Medicaid is often high on the list when states need to make budget cuts. Unlike aid to schools, for example, which generally is committed at the beginning of the school year, Medicaid is a program that is spent monthly. A change in Medicaid in any month will affect expenditures for the remainder of the fiscal year. And since Medicaid costs generally rise rapidly as enrollment is boosted by people losing jobs and income, it becomes a target for cuts. With the number of uninsured already 46 million in 2007, the combination of people losing jobs and some businesses dropping health insurance to try to stay afloat, the number of uninsured could reach 50 million if public program cut eligibility or cannot finance insurance for those newly eligible for Medicaid and SCHIP.

Education is also a major concern. In the last recession, we saw new or higher fees for textbooks and courses, shorter school days, reduced personnel, and reduced transportation. States or school districts took actions that resulted in teacher layoffs and larger classroom sizes, or eliminated offerings such as music, enrichment programs and the like — all of which arguably affect the quality of the education children receive. And, as noted above, when tuition at universities and community colleges are increased, it reduces the ability of students from low- and moderate income families to access higher education.

Size of Stimulus

We estimate that federal fiscal relief to states should total about \$50 billion. This would be about one-half of the expected deficit for state fiscal year 2010 (or less than one-third the combined deficits for state fiscal years 2009 and 2010 and probably an even smaller fraction of total deficits states will face, since fiscal problems are likely to continue into state fiscal year 2010).

The number \$50 billion sounds like a lot, particularly compared to the \$20 billion provided in the last downturn. This downturn is likely to be considerably deeper than the one in the early part of the decade, with higher unemployment, greater drops in consumption, and the additional factor of the housing sector weakness. Deficits will be larger, and more aid is needed.

Some people raise the issue of whether a large federal payment to the states raises the specter of “moral hazard.” Some may ask whether, if the federal government provides aid to states in a recession, this will create a moral hazard problem in which states overspend, cut taxes too much, and/or fail to build up “rainy day” funds during periods of economic growth because they expect the federal government to bail them out when an economic downturn comes.

It is highly unlikely that the \$50 billion would create a moral hazard, because it would be far from the total amount of deficit states have to close. They still will have to take actions that negatively affect their residents — actions most policymakers are quite loathe to take. The need for such actions provides a significant incentive to states to be prudent and save funds during the next economic expansion.

Moreover, the evidence suggests that the federal fiscal relief provided in the past did *not* have this effect. The federal government provided such relief in the last downturn, and states have not overspent or slashed taxes since then in the expectation that they would be bailed out during future downturns. On average, state expenditures as a share of the economy at the beginning of the current downturn were *lower* than they were in state fiscal year 2001, while state taxes as a share of the economy were at about the same level. In addition, states built up substantial “rainy day” reserve funds to draw upon in a downturn; at the end of 2006, those reserves were actually a little *larger*, as a share of annual state expenditures, than before the recession at the start of this decade.

The problem is that recessions can have such large effects on state budgets that they tend to wipe out rainy day reserves and produce sizeable shortfalls. For example, states began this decade with reserves equaling 10.4 percent of annual expenditures, a quite substantial amount. But these reserves closed only about one-quarter of the state budget gaps that opened up through state fiscal year 2003. Rainy day fund and other reserve balances in the current economic crisis are no where near enough to plug the deficits.

Form of Stimulus

The majority of the fiscal relief would be most effective as an increase in the federal share of the Medicaid program (FMAP), together with a ban on states from reducing eligibility in that program.

Cuts in Medicaid not only hurt people who become uninsured, but also generally result in reductions in payments to providers — which in turn can lead to reduced staffing and reductions in

demand for goods and services in the state. An increase in the FMAP tied to maintenance of effort provision can avert the most damaging of such cuts.

An increase in the FMAP also provides particularly timely and effective stimulus. States, most of which will have rising Medicaid costs as people losing jobs and income come onto the rolls, can immediately use the funds from an increased FMAP to pay those costs. There is no need to develop projects, go through an appropriation process, or even have the legislature in session. This makes the FMAP a particularly good vehicle for stimulus.

Going forward, states could probably absorb \$30 billion to \$35 billion in enhanced FMAP. \$30 billion would represent approximately 20 percent of state Medicaid spending.⁵ In the last recession, Medicaid enrollment increased by 17 percent and arguably would have increased by about 20 percent if states had not drastically cut enrollment prior to receiving federal fiscal assistance.⁶ Since this recession is likely to be deeper and more prolonged than the one at the beginning of the decade, \$30 billion to \$35 billion seems like a reasonable number to assist states in handling increased caseloads and costs, to prevent large-scale increases in the number of uninsured, and to avoid the fiscal drag on the economy.⁷

The other \$20 billion (or \$15 billion) should be provided as a flexible block grant. This could prevent cuts in education and social services — which lead to reductions in employment in the government and nonprofit sectors and create a drag on the economy. It also could lessen the tendency of states to cut their aid to local governments in recession. A number of local governments also have revenue problems or soon will because of declining housing values and property taxes and are likely to impose cuts on public services.

Earlier this year, when fewer states were facing fiscal stress, the Center has released reports suggesting that fiscal relief might be targeted on states that are experiencing the most economic stress, as measured by changes in employment, foreclosures, and food stamp rolls (as a proxy for changes in poverty).⁸ In particular, it was clear that energy- and commodity-rich states were benefiting from extraordinarily high prices for those goods and were not experiencing fiscal problems. These states included West Virginia, Louisiana, Texas, New Mexico, North Dakota, Montana, Wyoming, and Alaska. As U.S. and world demand has weakened in the last month, however, it appears that those high prices will be declining; the price of oil has already dropped from a peak of \$145 a barrel to the \$70 range. As a result, it is likely that fiscal distress will ultimately

⁵ State Medicaid spending in federal fiscal year 2008 is estimated to be roughly \$156 billion in fiscal year 2008. \$30 billion is just under 20 percent of state spending. CBPP calculations based on CBO March 2008 Medicaid baseline.

⁶ Enrollment was 35.7 million in December 2001 and 41.8 million in December 2004 – a 17 percent increase. If one adds back the approximately 1 million people who lost eligibility for Medicaid prior to enactment of the fiscal relief, the increase would be 20 percent. Data from Kaiser State Health Facts.

⁷ Two factors cause Medicaid to increase during a downturn. As unemployment rises, more people need Medicaid. The Urban Institute estimates 1 percent point increase in the unemployment rate equals 1 million additional Medicaid enrollees. Jon Gruber estimates it at 1.2 million enrollees. In addition, the increase in health care costs continues to erode employer-based insurance, especially when businesses have low profitability or losses, which adds to the Medicaid rolls.

⁸ See, for example, Iris Lav, Jason Levitis, and Edwin Park, *House Stimulus Plan Effectively Targets Fiscal Relief to States*, Center on Budget and Policy Priorities, September 26, 2008. <http://www.cbpp.org/9-26-08sfp.htm>

reach most states if present trends continue. It may no longer be necessary to use the type of targeting we had earlier suggested, or it may make sense to target one type of the assistance but not the other.

Timing

In the last recession, federal fiscal relief for states was enacted at the end of May, 2003, just before the beginning of state fiscal year 2004. As the year-by-year deficit chart shows, states had already been coping with deficits and enacting budget cuts for two years before the federal fiscal relief was enacted. By the time federal relief was enacted, for example, 1 million people had already lost eligibility for public health insurance programs. The relief specified that no further eligibility reductions could be made, so it undoubtedly prevented additional deterioration.

It would be far better to enact fiscal relief now, before states make the deep cuts that otherwise will be inevitable as they enact cope with mid-year deficits and particularly as they enact their state fiscal year 2010 budgets (for the year beginning July 1, 2009 in most states) in the first part of 2009.