CENTER ON BUDGET AND POLICY PRIORITIES

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HOW AUTOMATIC CUTS WOULD BE IMPLEMENTED UNDER ENTITLEMENT CAP PROPOSALS THE HOUSE MAY CONSIDER NEXT WEEK

Impact on Veterans Disability Compensation, Student Loans, Social Services, Crop Insurance, Trade Adjustment Assistance, and Medicaid Examined

By Richard Kogan

Two leading bills to alter the federal budget process, H.R. 3800 and H.R. 3925, contain nearly identical entitlement cap proposals. These proposals would set a cap for each year on the total amount that may be spent on entitlement programs other than Social Security, with the cap being set well below the levels that entitlement spending would reach under current law. If Congress and the President failed to enact legislation that cut entitlements deeply enough to fit within the cap, automatic entitlement cuts would be triggered.

The entitlement cap proposals in H.R. 3800 and H.R. 3925 do not prescribe exactly how these automatic cuts would be implemented in each entitlement program but do include "special rules" prescribing how such cuts would be made in some programs. This short paper describes how the automatic cuts would be instituted in a number of programs, based on these special rules, where applicable, and on the basic structure of the entitlement programs in other cases. The programs examined here include: veterans' disability compensation, the Social Services Block Grant (Title XX), the child care entitlement to states, vocational rehabilitation, student loans, crop insurance, Trade Adjustment Assistance, and Medicaid.

Compensation for Disabled Veterans

Automatic cuts made in certain entitlements could not exceed two percent per year. Veterans disability compensation is one of those programs.

The automatic cuts would constitute a permanent reduction in benefits. If automatic cuts were instituted in a number of years, an *additional* two percent would be cut each time the automatic cuts were triggered, with the cuts compounding over time. If automatic cuts were instituted every year, the cut in the veterans disability program would reach 17 percent by 2014.

Under this program, veterans who suffer service-connected disabilities receive monthly payments, the dollar amounts of which are set by statute. If automatic cuts were triggered, the Department of Veterans Affairs would likely reduce the amount of the monthly benefit payments. If automatic cuts were instituted each year, the monthly checks would be cut two percent in 2006 and 17 percent by 2014. In addition, the annual cost-of-living adjustments in veterans disability benefits, which are routinely passed by Congress each year, could be in jeopardy.[1]

Social Services Block Grant (Title XX)

This program is a "capped entitlement" that pays $1.7 billion per year to state social service departments, distributed in proportion to each state's population. The automatic cut would be accomplished by reducing the program cap from $1.7 billion to a lower figure.

This program is *not* one in which the automatic cut would be limited to two percent per year. If the entitlement cap were enforced *solely* through automatic cuts, the automatic cuts in the Social Services Block Grant would reach *100 percent* by 2007 or 2008, and the program would be eliminated.[2]

A number of other "capped entitlement" programs that make payments to states would be reduced in exactly the same manner. Among these are child care payments to states made through the **child care entitlement to states**, **vocational rehabilitation grants, and natural resources receipts** that are shared by formula with states or counties.

Student Loans

Federal loans to college students are made in either of two ways. In one case, banks lend the money, and the federal government guarantees the loans (i.e., it reimburses banks if students default). These are "guaranteed student loans." In the other case, the government lends funds directly to students. These are "direct student loans."

The way in which the automatic entitlement cuts would be applied would differ significantly, depending on the source of the loan. If an automatic cut of *any* size were ordered, two changes would occur in the guaranteed student loan program: the origination fee paid by students would be increased by ½ percentage point, and the "special allowance" payments that the Department of Education pays to banks to induce them to participate would be reduced,

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[1] Veterans Disability Compensation is a unique entitlement in one respect. The amounts of the disability benefits are not indexed for inflation, but Congress invariably enacts an across-the-board increase in disability benefits each year in a percentage equal to the growth of the Consumer Price Index. Because this practice is invariable, official baseline projections incorporate this assumed cost-of-living increase, and the annual increases are not considered by Congress or the Executive Branch to be "entitlement increases" for purpose of various budget enforcement rules. H.R. 3800 and H.R. 3925, however, do not appear to account for the annual cost-of-living increases in Veterans Disability Compensation in setting the overall entitlement cap. This omission could change the political dynamic associated with the increases; annual legislation to provide the cost-of-living increase might be treated as further breaching the overall entitlement cap and thereby forcing deeper reductions in all other entitlement programs. If Congress took this view, enactment of the entitlement cap provisions of H.R. 3800 and H.R. 3925 might impede enactment of these annual cost-of-living increases and result in still larger reductions in benefits for disabled veterans.

[2] For an explanation of why the automatic cuts could eliminate programs like the Social Services Block Grant by 2007 or 2008, see an accompanying Center on Budget and Policy Priorities analysis, "Claims that Proposed Entitlement Cap Would Shield Medicare and Not Cause Massive Cuts Found to be Incorrect," June 9, 2004.

generally by 0.4 percentage points. These are the only ways in which automatic reductions would be applied to guaranteed student loans.

The treatment of direct student loans would be radically different. Direct student loans could be cut by any percentage, up to 100 percent. If the automatic cut in the direct student loan program were, say, 50 percent (as it might be in 2006, the first year the entitlement cap would be in effect), the Department of Education would have choices. It could cut the total amount of new direct loans in half by accepting applications on a first-come, first-serve basis until half of the amount of loans that otherwise would be provided had been issued. More likely, the Department would reduce the amount of money lent to each eligible applicant by enough to cut the direct loan program costs in half.[3]

Federal Crop Insurance

This program enables farmers to purchase insurance at a subsidized rate to protect themselves against losses due to droughts, floods, pests, and other natural disasters. This is another of the entitlement programs for which there would be no limit on the magnitude of the automatic cuts that could be instituted. If the entitlement cap were enforced solely though automatic cuts, the cuts in the crop insurance program would reach 100 percent by 2007 or 2008. After that, the Department of Agriculture would not be able to offer any new crop insurance contracts. If the automatic cuts were, say, 50 percent, the Department would likely reduce the subsidy it provides to help farmers purchase crop insurance, shrinking the subsidy (and thereby raising the price of the insurance) to the degree needed to cut the cost of the program in half.

Trade Adjustment Assistance

This program makes payments to workers who have lost their jobs because of certain circumstances related to international trade. There would be no limit on the size of the automatic cuts that could be made in this program either. Here, too, if the entitlement cap were enforced solely though automatic cuts, the cuts made in the program would reach 100 percent by 2007 or 2008. From then on, the federal government would pay no trade adjustment benefits. If the automatic cuts were, say, 50 percent, the Labor Department would likely cut each worker's benefits in half.

Medicaid

Medicaid is one of the programs that would be subject to automatic cuts of up to two percent per year. Under current law, the federal government reimburses each state for a portion of its annual Medicaid costs, using a formula based on a state's per-capita income. For more affluent states, the federal government pays 50 percent of program costs. For the poorest state, Mississippi, the federal government pays 77 percent of costs. The federal share of a state's Medicaid costs is known as the FMAP (the Federal Medical Assistance Percentage).

[3] It is likely that if the direct student loan program were eliminated or severely scaled back through automatic entitlement cuts, students would instead seek guaranteed student loans in lieu of direct loans, since the guaranteed student loan program would remain open for business.

The Effect of Automatic Entitlement Cuts on Medicaid Financing

	2004	2% cut, 2006	17% cut, 2014
Illinois			
Federal share	50%	49%	42%
State share	50%	51%	58%
Percentage increase in state share		*2%*	*17%*
Texas			
Federal share	60%	59%	50%
State share	40%	41%	50%
Percentage increase in state share		*3%*	*25%*
Mississippi			
Federal share	77%	75%	64%
State share	23%	25%	36%
Percentage increase in state share		*7%*	*56%*

Although the proposed entitlement cap does not specify how the automatic cuts would be instituted in Medicaid, it is likely that the Department of Health and Human Services would simply reduce quarterly reimbursement payments to states below the amounts that HHS otherwise would pay. If the automatic entitlement cut is two percent, the federal government would pay each state 98 percent of what it otherwise would pay. If automatic cuts were instituted every year, by 2014, the federal government would be paying states 83 percent of what they otherwise would receive.

A reduction of this sort in federal payments is the same as a reduction in the federal matching percentage, or the FMAP. Imagine that the total cost of the Medicaid program in Illinois is $20 billion in 2014. Because the federal match for Illinois is 50 percent, the federal government would pick up $10 billion of the total cost, and Illinois would pay $10 billion from its own funds. Now imagine that the entitlement cap, through the imposition of successive automatic cuts, has reduced the federal payments to 83 cents on the dollar by 2014. Instead of paying $10 billion to Illinois, the federal government would pay $8.3 billion, and Illinois would be left with costs of $11.7 billion. In effect, the entitlement cap would have reduced Illinois' federal matching percentage from 50 percent to less than 42 percent.

The budgets of poorer states would be hit the hardest. Consider how Texas would fare. Imagine that, like Illinois, Texas' Medicaid program costs a total of $20 billion in 2014. Under current law, the federal matching rate for Texas is 60.2 percent, so the federal government would pay $12 billion and Texas would pay $8 billion of Medicaid costs. Now imagine that by 2014, successive automatic entitlement cuts have reduced the federal payments to 83 cents on the dollar. The federal payment would drop from $12 billion to $10 billion, and Texas's costs would rise from $8 billion to $10 billion. This would constitute a 17 percent reduction in federal costs and a 25 percent increase in Texas' costs.

The table on page 5 shows the results of a two-percent automatic cut in federal Medicaid payments in 2006, and a 17 percent reduction in Medicaid payments in 2014, for each state and the District of Columbia. The figures cited here reflect the assumption that if federal Medicaid funding is cut, states would provide additional state resources to make up for the lost federal funds, rather than cutting back their Medicaid programs. This is an optimistic view. In the face of lower federal matching payments, it is likely that many states would cut back their Medicaid programs. If that occurred, the beneficiaries most at risk would likely be working-poor families that earn too much to qualify for welfare and elderly and disabled people in nursing homes.

Appendix:
Reduction in FMAP's from the repeated application of "two-percent sequestration"

	Federal Share			State Share			Percentage increase in State Costs	
		2% cut	*17% cut*					
State	**2004**	**2006**	**2014**	**2004**	**2006**	**2014**	**2006**	**2014**
Alabama	70.8	69.3	59.0	29.3	30.7	41.0	4.8%	40.3%
Alaska	58.4	57.2	48.7	41.6	42.8	51.3	2.8%	23.4%
Arizona	67.3	65.9	56.1	32.7	34.1	43.9	4.1%	34.2%
Arkansas	74.7	73.2	62.2	25.3	26.8	37.8	5.9%	49.1%
California	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Colorado	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Connecticut	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Delaware	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Dist Columbia	70.0	68.6	58.3	30.0	31.4	41.7	4.7%	38.9%
Florida	58.9	57.8	49.1	41.1	42.2	50.9	2.9%	23.9%
Georgia	59.6	58.4	49.7	40.4	41.6	50.3	2.9%	24.6%
Hawaii	58.9	57.7	49.1	41.1	42.3	50.9	2.9%	23.9%
Idaho	70.5	69.1	58.7	29.5	30.9	41.3	4.8%	39.7%
Illinois	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Indiana	62.3	61.1	51.9	37.7	38.9	48.1	3.3%	27.6%
Iowa	63.9	62.7	53.3	36.1	37.3	46.7	3.5%	29.5%
Kansas	60.8	59.6	50.7	39.2	40.4	49.3	3.1%	25.9%
Kentucky	70.1	68.7	58.4	29.9	31.3	41.6	4.7%	39.0%
Louisiana	71.6	70.2	59.7	28.4	29.8	40.3	5.0%	42.1%
Maine	66.0	64.7	55.0	34.0	35.3	45.0	3.9%	32.4%
Maryland	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Massachusetts	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Michigan	55.9	54.8	46.6	44.1	45.2	53.4	2.5%	21.1%
Minnesota	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Mississippi	77.1	75.5	64.2	22.9	24.5	35.8	6.7%	56.0%
Missouri	61.5	60.2	51.2	38.5	39.8	48.8	3.2%	26.6%
Montana	72.9	71.4	60.7	27.2	28.6	39.3	5.4%	44.7%
Nebraska	59.9	58.7	49.9	40.1	41.3	50.1	3.0%	24.9%
Nevada	54.9	53.8	45.8	45.1	46.2	54.2	2.4%	20.3%
New Hampshire	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
New Jersey	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
New Mexico	74.9	73.4	62.4	25.2	26.6	37.6	6.0%	49.6%
New York	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
North Carolina	62.9	61.6	52.4	37.2	38.4	47.6	3.4%	28.2%
North Dakota	68.3	66.9	56.9	31.7	33.1	43.1	4.3%	35.9%
Ohio	59.2	58.0	49.4	40.8	42.0	50.6	2.9%	24.2%
Oklahoma	70.2	68.8	58.5	29.8	31.2	41.5	4.7%	39.3%
Oregon	60.8	59.6	50.7	39.2	40.4	49.3	3.1%	25.9%
Pennsylvania	54.8	53.7	45.6	45.2	46.3	54.4	2.4%	20.2%
Rhode Island	56.0	54.9	46.7	44.0	45.1	53.3	2.5%	21.2%
South Carolina	69.9	68.5	58.2	30.1	31.5	41.8	4.6%	38.6%
South Dakota	65.7	64.4	54.7	34.3	35.6	45.3	3.8%	31.9%
Tennessee	64.4	63.1	53.7	35.6	36.9	46.3	3.6%	30.1%
Texas	60.2	59.0	50.2	39.8	41.0	49.8	3.0%	25.2%
Utah	71.7	70.3	59.8	28.3	29.7	40.2	5.1%	42.3%
Vermont	61.3	60.1	51.1	38.7	39.9	48.9	3.2%	26.4%
Virginia	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
Washington	50.0	49.0	41.7	50.0	51.0	58.3	2.0%	16.7%
West Virginia	75.2	73.7	62.7	24.8	26.3	37.3	6.1%	50.5%
Wisconsin	58.4	57.2	48.7	41.6	42.8	51.3	2.8%	23.4%
Wyoming	59.8	58.6	49.8	40.2	41.4	50.2	3.0%	24.8%