Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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IF STATES FAIL TO USE STIMULUS FUNDS AS INTENDED, EFFORTS TO STRENGTHEN ECONOMY COULD BE UNDERCUT

by Iris J. Lav and Nicholas Johnson

A few governors and legislative leaders have suggested that their states might not accept the full amount of fiscal relief in the new recovery legislation or might use the funds to finance tax cuts or build up reserves, rather than spend them as Congress intended.[1] Such actions could weaken the new law's impact, and possibly even prolong the recession, by reducing the amount of stimulus injected into the economy.

Fiscal Relief Helps States Avert Budget Cuts That Would Further Slow Economy

The legislation provides states with roughly $135 billion to $140 billion to help close operating budget shortfalls, most of it in the form of increased Medicaid funding and a "State Fiscal Stabilization Fund" aimed primarily at ongoing education costs. These funds will help the economy recover by averting cuts in state expenditures. The sooner the states use the money, the faster the economy is likely to improve.

When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower 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. As a result, budget cuts directly remove demand from the economy.

Moody's Economy.com estimates that every dollar of federal fiscal relief that is used to avert state budget cuts increases economic activity by $1.38.

A state that refuses the stimulus money, delays the use of the money by putting it into a reserve fund, or uses the stimulus money for purposes other than maintaining programs and services is weakening its economy. It also is undermining federal efforts to turn the economy around.

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[1] For example, Governor Sanford of South Carolina has stated, "I think there are a number of wrinkles that have caused a number of us to say 'Wait a minute, let's take a look — a long look — at whether or not this really makes sense for our state.' " ("Sanford on the stimulus," *Atlanta Journal-Constitution*, February 19, 2009.) Governor Freudenthal of Wyoming has said, "If it is simply money that is available, but it is not money that works with the agenda that works in Wyoming, I'm not going to take it." ("Governor Says He'll Scrutinize Stimulus Funds," *Casper Star-Tribune*, February 19, 2009.) Georgia's legislature has already approved using nearly $500 million in state Medicaid funding freed up by the fiscal relief to continue a program that reduces homeowners' property taxes. In addition, Governors Jindal of Louisiana and Barbour of Mississippi have said they do not plan to accept the new option in the law to reform their states' unemployment insurance systems in order to cover more low-income and part-time workers.

Arguments Against Using Aid As Intended Do Not Withstand Scrutiny

The arguments against using the fiscal relief as Congress intended are based on several myths:

Myth: It is inappropriate to use temporary federal stimulus funds to support ongoing state programs.

✓ **Reality: Supporting ongoing programs is the primary purpose of the funds.**

In normal economic times, government should avoid paying for ongoing spending needs (or permanently cutting taxes) based on a one-time revenue windfall. But these are not normal times. State revenues have plummeted as a result of the recession; the federal stimulus funds are intended to fill in for a portion of the missing revenues, thereby preventing deep budget cuts that would further drag down the state economy.

Myth: States will be stuck with higher caseloads and expanded services to fund from their own resources when the stimulus period ends.

✓ **Reality: States will have flexibility to make necessary choices when federal funds expire.**

While states must meet certain "maintenance-of-effort" requirements to qualify for the Medicaid and education funding in the recovery bill, those requirements will disappear when the stimulus funding runs out. If a state cannot afford to — or simply chooses not to — maintain the level of services it provided during the stimulus period, it will be free to cut back those services when the federal stimulus funding ends.

Also, with their economies and budgets deteriorating, states' top priority should be reversing these damaging trends. This is not the time to worry about what will happen two years from now. If the economy has improved significantly by then, state revenues will have improved as well, helping states cover the cost of providing services. A stronger economy would also mean fewer people needing services. If the economy is significantly worse two years from now, Congress might extend some or all of the federal stimulus provisions — though it would be much less likely to do this if states do not use the initial stimulus funds as it intended.

Myth: States could stimulate their economies more effectively by using the fiscal relief to finance tax cuts than to help cover Medicaid and education costs.

✓ **Reality: Spending is better for the economy than tax cuts.**

Direct state spending on public services — through state-run programs, programs that businesses or nonprofits operate under state contract, or payments to private vendors — creates more of a stimulus than tax cuts. As noted above, every additional stimulus dollar the state spends on programs and services increases economic activity by $1.38.

Tax cuts provide less of an economic stimulus than direct state spending because some of the tax cuts will be saved rather than spent. This is particularly true of tax cuts for higher-income taxpayers, since they save a larger share of their income than less affluent households. But even refundable tax cuts for lower-income families, such as those in the federal stimulus, have less of a positive economic effect than state spending.