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October 4, 2001

STATE FISCAL PROBLEMS COULD WEAKEN FEDERAL STIMULUS EFFORTS: LOW-INCOME HOUSEHOLDS LIKELY TO BE HARDEST HIT BY STATE FISCAL ACTIONS

by Iris J. Lav

Policymakers in Washington are considering a number of actions that could stimulate the economy. Among the options being considered are tax cuts that could spur consumption or investment, and additional federal spending that could directly increase economic activity. In considering these options, however, a key problem often is overlooked. Unless the federal government assists the states with the fiscal problems they are experiencing as a result of the weak economy, many states will be forced by their balanced budget requirements to take contractionary actions — cutting spending and raising taxes — that will counteract and weaken federal stimulus policies.

Moreover, some countercyclical policies the federal government enacts are likely to be aimed at helping people who have lost their jobs or substantial portions of their income as a result of the weak economy and the aftermath of the terrorist attacks. The effectiveness of these federal policies will be dampened if fiscal stress leads states to cut their own low-income assistance programs.

States Pursued Contractionary Policies in Early 1990s

An examination of what happened in the recession of the early 1990s illuminates this matter. In that recession, which was relatively mild by historical standards, states experienced extreme fiscal stress. No fewer than 35 states faced a potential budget deficit at one point from 1990 to 1992, and many faced problems throughout the period. The stress resulted from a weak economy that depressed tax revenues while causing an increase in the number of families in poverty, which heightened the need for government services. In addition, the weakening of the economy came at a time when states already were experiencing difficulties coping with rising health care costs as well as growing prison and school-age populations.

Forty-nine states are required by their constitutions or state law to balance their budgets; in the last recession, many states looked to spending cuts as a way to do so. By state fiscal year 1992, enough states were cutting overall spending that total state spending declined by two percent after adjusting for inflation. At this point, states were not even meeting the normal costs of maintaining services and programs. Since the need and demand for state programs and services increases when economic conditions deteriorate, this spending decline reflected a situation in which many states were cutting the very programs designed to ameliorate the impact of the recession on the well-being of state residents.

Most states, either by law or tradition, must end the year with a balanced budget and so must take remedial actions if their budgets fall out of balance during the year. In addition to the substantial spending reductions states made under their normal budget processes, states made *mid-year* budget cuts of approximately $15 billion in the 1990-1992 period. When states need to make such mid-year budget cuts, the choices for realizing immediate savings are limited. It generally is difficult or impossible for states to reduce education spending or capital investment mid-year in ways that would result in immediate savings. Funds for education, for example, may already have been transferred to school districts, and contracts for capital spending may already have been signed. Additionally, funds for various other purposes may have been fully expended in the early part of the fiscal year, before the crisis developed. Benefits for needy residents, on the other hand, are generally paid monthly — so reductions result in immediate savings. In addition, education expenditures and capital projects tend to have far more powerful constituencies than programs for the poor. This combination of factors led a number of states, both mid-year and during the difficult give-and take at budget time, to adopt spending cuts or freezes in income assistance and health programs that primarily affected poor households.[1]

Brunt of State Budget Balancing Fell on Low-Income Households

The following is a summary of some of the state budget cuts affecting the poor that were enacted in the 1991 and 1992 state legislative sessions.

- Despite sharp increases in poverty and increased need, benefits in the Aid to Families with Dependent Children Program were reduced or frozen in 40 states in 1991and 44 states in 1992. Outright cuts in benefits for 1992 were made in nine states in the 1991 legislative sessions (California, Maryland, Michigan, Tennessee, Maine, Georgia, New Mexico, Vermont, and the District of Columbia). In 1992, six states cut benefits for 1993 (California, Maryland, South Carolina, Nevada, Vermont, and Oklahoma).

- State general assistance benefits, which provide cash assistance to poor individuals not covered by the federal safety net, were the hardest hit of the low-income programs in 1991 and 1992. Of the 28 states with statewide GA programs, 17 lowered benefits or restricted eligibility in either 1991 or 1992 or both years. More than 450,000 low-income households were affected by the 1991 cuts. Another 120,000 were affected by the 1992 cuts.

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[1] During the early 1990s, the Center conducted extensive surveys of the states to assess the ways in which they were responding to the recession. The results were published in two reports entitled *The States and the Poor* (December 1991 and February 1993). In addition, we reviewed the fiscal turmoil of that era in *When It Rains It Pours: A Look at the Adequacy of State Rainy Day Funds and Budget Reserves* (March 1999).

- Twenty-six of the 27 states that provided state supplemental benefits to poor elderly and disabled recipients of federal SSI either froze or cut those benefits in 1991 or 1992.

- Five states restricted eligibility for their Medicaid programs in 1991 by cutting their "Medically Needy" programs (Florida, Kansas, Maine, Montana, and Oregon). In 1992, South Carolina eliminated its Medically Needy program, Florida added further restrictions for elderly and disabled recipients, and Nevada and Arkansas cut back on eligibility for low-income pregnant women and infants.

- Medicaid services were restricted, or coverage for some services eliminated, in 16 states for 1992 and an additional 15 states for 1993. States scaled back prescription drug benefits, limited coverage for physician visits, hospital admissions, or laboratory tests, and/or raised or instituted co-payments for some services.

States also raised taxes in the early 1990s to cope with fiscal stress. Sales and excise tax increases accounted for approximately half of the $27 billion in state tax increases enacted from 1990 to 1992. Sales taxes are highly regressive. As a result, these actions, as well, placed a disproportionate burden on low-income families and individuals.

States Already Are Raising Taxes and Cutting Spending for FY 2002

The circumstances under which states must balance their budgets have changed little since the early 1990s. A substantial number of states already are in fiscal trouble, and have begun the process of cutting back spending and considering tax increases.

- Eight states — Arizona, Indiana, Maine, Nevada, New Hampshire, New Jersey, North Carolina, and West Virginia — raised taxes and fees by at least one percent as they enacted their fiscal year 2002 budgets.

- States such as Mississippi, Ohio, and South Carolina have enacted across-the-board spending cuts, which result in reductions that affect many programs, including those that assist low-income households.

- Indiana and Kentucky have appropriated less money for their Medicaid programs than the programs are projected to require, potentially setting the stage for cuts later in the year.

All of these actions were taken by states prior to September 11, 2001 (with the exception of North Carolina, which enacted its budget after that date). It is likely that further program cuts and tax increases will be made in special sessions later this year or when state legislatures meet in early 2002.

There is every reason to believe that as this new round of state fiscal stress plays out, it could have much the same consequences for low-income families and individuals as it did in the last recession. It is certain that states will have to continue to take fiscal actions that work at cross-purposes to federal stimulus policies unless there is an intervention from the federal level.

Options to Assist States

One obvious solution to this problem would be for the federal government to assist states in meeting their balanced budget requirements. The federal government could provide assistance to the states through some kind of revenue sharing program such as existed in the mid-1970s and 1980s. There is not, however, any current mechanism for providing revenue sharing. It would take a long time to design such a program, to work through inevitable disagreements about a formula for allocating money to each state, enact it, and disburse the funds. Thus, a new revenue sharing program is probably not the best way to respond to the current state fiscal problems, which already have begun to require state budget cuts and tax increases.

More immediate assistance to states could be provided by increasing temporarily the federal matching rate for the federal-state Medicaid program. Since this program already is in place, there would be little start-up time required. An enhanced match could serve two purposes. It could help states shoulder the cost of the increased enrollment in Medicaid that results when people lose their jobs and their employer-based health insurance and, in some cases, become eligible for Medicaid. By so doing, it could help avert cuts in Medicaid that some states otherwise are likely to make. In addition, it could allow states to use less of their own funds for Medicaid, freeing a portion of those funds to help them balance their budgets and thereby avoid counter-productive tax increases or program cuts.

There are a number of advantages to this approach:

- No new bureaucracy or infrastructure would be needed to distribute the funds. Increasing the existing match rate should be relatively simple.
- Much of the funds would likely be used in the near term — during the current fiscal year.
- In many or most cases, states legislatures would not have to act before the funds could be used, since the funds would likely be used for existing programs. These funds could forestall the need for budget reductions in Medicaid and other programs or allow the increasing costs of Medicaid and other programs to be met.

An enhanced Medicaid match is a particularly convenient avenue for aiding states. It is easy to make a temporary change in the funding stream, and there is little start-up time before the funds begin to be expended at the state level because no state legislative action would be required in most cases.

An additional, much smaller amount of assistance to states could be provided through an increase in the federal Social Services Block Grant. The Social Services Block Grant provides a flexible source of funding that enables states to meet the unique needs of their most vulnerable populations, primarily low- and moderate-income children and people who are elderly or disabled. An increase would work much as the increased Medicaid match, allowing states to meet increased need and helping them balance their budgets, except that the program itself is extremely small so any stimulus that could be delivered through it would also be very small.

Various other proposals have been made for assisting states at this time. For example, a set of proposals was released by the National Governors Association on October 4. It is most important to avert at least some of the need for contractionary state policies and help insure that low-income households do not bear the brunt of the fiscal adjustments that are necessary in the wake of the September 11 tragedy.