CENTER ON BUDGET AND POLICY PRIORITIES

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DEEP CUTS IN FEDERAL GRANTS IN FY 2006 BUDGET WILL SQUEEZE STATES AND LOCALITIES

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Some of the spending austerity in the President's budget is accomplished by passing down costs to other levels of government. This leaves states and localities the option of either curtailing services or increasing their own taxes to compensate for declining federal funds.

- Under the President's budget, grants to state and local governments for all programs other than Medicaid would ***decline*** **by $10.7 billion or 4.5 percent** from fiscal year 2005 to 2006, after adjusting for inflation. (Medicaid is excluded because changes in Medicaid grants largely reflect inflation in health-care costs in the public and private sectors alike. Considering grants other than Medicaid gives a more accurate picture of the relative level of federal funding for state and local services.)

- Grants for all programs other than Medicaid would be lower in 2006 as a percent of the economy than they were in 2001. For 2006, the budget proposes grants for programs other than Medicaid that total just 1.75 percent of GDP. In 2001, such grants were 1.99 percent of GDP. Considering grant levels relative to the economy provides a somewhat better measure of whether the grants would be adequate to maintain the current level of state and local services they support, because the cost of providing services tends to grow in tandem with the economy. **If grants for all programs other than Medicaid for 2006 were at their 2001 level relative to the economy, they would be $31 billion higher than their proposed 2006 level.**

- Even if Medicaid is included, total grants relative to the economy would be lower in 2006 than in prior years. Total grants in 2006 would amount to 3.42 percent of GDP, as compared to levels of 3.5 to 3.6 percent of GDP in 2002 through 2004. (Note that fiscal relief payments are excluded from this analysis as a one-time phenomenon; they are not the reason for the higher levels in earlier years.)

- These shortfalls would be extremely difficult for states and localities to handle as they slowly emerge from the fiscal crisis. Even though revenue growth has resumed, at least 24 states face fiscal year 2006 budget deficits totaling some $35 billion, averaging about eight percent of general fund spending in the states with deficits. Cuts in federal grants will enlarge these deficit gaps, and will force states and localities to institute additional budget cuts and tax increases.

Table 1
Grants-In-Aid to State and Local Governments in the FY 2006 Budget, *excluding Medicaid*
Budget Authority (funding) in billions of dollars

	FY 2004	FY 2005	FY 2006
Discretionary Funding	$126.6	$130.7	$127.1
Mandatory Funding	105.3	102.5	99.4
Total Funding	231.9	233.2	226.4
Total Funding adjusted for technical anomalies*	229.6	232.3	225.4
In 2006 dollars (i.e., adjusted for inflation)	238.0	236.1	225.4
Percent change after adjusting for inflation		**-3.0%**	**-4.5%**
Funding as a percent of GDP	**1.99%**	**1.90%**	**1.75%**

* Adjustments were made to exclude disaster relief funding in all years and fiscal relief in 2004, to reflect funding for highways and mass transit as the level of obligations for those programs rather than the level of "contract authority," to remove distortions that can occur when the level of "advance" appropriations changes from year to year.

Discretionary and Mandatory Grants

The President's 2005 budget proposes cuts in both discretionary grants that are appropriated annually and in entitlement programs.

- Discretionary grants to state and local governments would decline by $3.7 billion. The decline would be $6.4 billion, or 3.8 percent from 2005 to 2006, after adjusting for inflation.
- On the entitlement or "mandatory" side of the budget, grants to state and local governments other than for Medicaid would *decline* by $3.2 billion. The decline would be $4.3 billion, or 6.5 percent, after adjustment for inflation.
- Total discretionary and mandatory grants combined, other than Medicaid, would decline by $6.9 billion. After adjustment for inflation, the decline would be $10.7 billion or 4.5 percent.

Reductions by State

Table 2 provides an illustration of what cuts of this magnitude would mean for each state. It distributes the reduction in grants other than Medicaid by the percentage of grants (other than Medicaid) that each state is expected to receive in 2006. This analysis does not take into account the distribution by state of the specific program cuts proposed in the budget. It does, nevertheless, provide a reasonable approximation of the amount by which each state might have to reduce services or raise revenues in order to achieve the level of federal deficit reduction the President seeks from cutting grants-in-aid.

Future Years

Much deeper losses of federal grants would be in the offing in years after 2005 under proposals included in the President's budget. This would occur because the budget proposes a cap on discretionary spending. A single cap would cover most discretionary spending, including defense, international, and most domestic discretionary spending. This would put domestic and defense spending in competition for funding.

If defense, homeland security, and international affairs are funded at the levels the President proposes, then by 2010, funding for the remaining discretionary programs would have to be cut about $66 billion, or 16 percent, below the 2005 levels, adjusted for inflation. This means funding would be substantially below the level necessary to maintain current levels of programs and services. Grants-in-aid represent about one-third of domestic discretionary programs, and would be substantially affected by these reductions.

Within domestic discretionary spending, grants to states and localities account for nearly one-third of the total. Grants to states and localities would be likely to sustain at least a proportionate cut in funding if the proposed cap were to become law, and might be cut disproportionately if spending in other areas were protected.

Moreover, the Medicaid program is cut by a net of $45 billion over the next 10 years. While various of the Medicaid proposals appear to warrant consideration (although more detail is required to evaluate them), reducing the federal funding provided to states for Medicaid when the number of the uninsured is rising and states are encountering increasing difficultly paying their share of Medicaid costs would be problematic. If total Medicaid funding to states is reduced, states will have to choose between reducing health care for some their residents or increasing the number of uninsured children, parents, elderly and people with disabilities, or raising their own taxes to compensate for a reduction of that magnitude. There also are deep cuts in child care subsidies over the next five years, which will frustrate the efforts of states to help families join and remain in the workforce.

Other Impacts of Budget on States

In addition to the loss of federal grants for programs, states would face the loss of significant amounts of revenue as a result of the federal tax changes proposed in the Bush budget. Federal tax changes often affect state revenues, because most states use federal definitions of income, federal depreciation allowances, and other features of the federal tax code as the basis for their own taxation. The 2006 budget includes a number of tax initiatives that could result in the loss of significant amounts of state revenue, including making permanent the estate tax repeal, providing an above-the-line deduction for high-deductible insurance premiums, new savings incentive, and certain incentives for charitable giving, among others.

Table 2
Illustration of Potential Loss of Grants-in Aid by State
Grants Other than Medicaid in Millions of Dollars
FY 2006 Compared to FY 2005 in President's Budget

State or Territory	FY 2006 Percentage of Grants Other than Medicaid	Nominal Budget Cut	Budget Cut after Adjustment for Inflation
All States		6,891	10,702
Alabama	1.5%	101.1	157.0
Alaska	0.5%	37.8	58.7
Arizona	1.6%	109.9	170.7
Arkansas	0.9%	63.3	98.3
California	14.3%	986.4	1,531.9
Colorado	1.2%	81.0	125.8
Connecticut	1.2%	83.7	130.1
Delaware	0.3%	19.2	29.8
District of Columbia	0.5%	33.0	51.3
Florida	4.5%	313.3	486.6
Georgia	2.9%	201.6	313.1
Hawaii	0.5%	34.3	53.2
Idaho	0.4%	29.1	45.1
Illinois	4.2%	288.0	447.3
Indiana	1.7%	116.7	181.2
Iowa	0.8%	56.0	86.9
Kansas	0.8%	54.6	84.8
Kentucky	1.4%	95.2	147.8
Louisiana	1.6%	113.4	176.1
Maine	0.4%	28.4	44.0
Maryland	1.6%	112.5	174.8
Massachusetts	2.4%	163.3	253.7
Michigan	3.1%	213.6	331.7
Minnesota	1.4%	96.9	150.5
Mississippi	1.1%	73.4	114.0
Missouri	1.7%	118.7	184.3
Montana	0.4%	27.5	42.8
Nebraska	0.5%	37.7	58.5
Nevada	0.6%	40.7	63.2
New Hampshire	0.4%	24.2	37.5
New Jersey	2.8%	192.4	298.9
New Mexico	0.8%	52.9	82.2
New York	8.8%	609.3	946.3
North Carolina	2.4%	166.9	259.2
North Dakota	0.3%	22.3	34.7
Ohio	3.6%	248.2	385.4
Oklahoma	1.2%	81.2	126.2
Oregon	1.1%	75.5	117.2
Pennsylvania	4.3%	293.2	455.3
Rhode Island	0.4%	29.1	45.1
South Carolina	1.2%	81.3	126.3
South Dakota	0.3%	23.8	37.0
Tennessee	1.8%	122.2	189.7
Texas	7.1%	487.1	756.5
Utah	0.7%	45.7	71.0
Vermont	0.3%	19.4	30.2
Virginia	1.9%	133.2	206.8
Washington	1.9%	129.3	200.8
West Virginia	0.7%	49.1	76.2
Wisconsin	1.5%	105.9	164.5
Wyoming	0.3%	19.4	30.1

Notes:
Percentage of grants per state from Analytic Perspectives, Tables 8-6 and 8-16
Analysis is illustrative of cuts states would experience if the amount of grant reductions in the budget were distributed over all non-Medicaid grants.