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

*Special Series:* **Economic Recovery Watch**

Updated March 1, 2010

# ADDITIONAL FEDERAL FISCAL RELIEF NEEDED TO HELP STATES ADDRESS RECESSION'S IMPACT

## Without It, States' Steps to Balance Their Budgets Could Cost Economy 900,000 Jobs Next Year

By Iris J. Lav, Nicholas Johnson, and Elizabeth McNichol

### Summary

States face a serious fiscal problem that could force them to institute additional deep budget cuts and tax increases in 2010, weakening the fragile economic recovery and harming vulnerable children, seniors, and people with disabilities, among others. The federal assistance that states received for their Medicaid programs under this year's economic recovery legislation is scheduled to end with a "cliff" on December 31, 2010, and the assistance states received for education and other services also will be largely exhausted by then. Although that date is more than a year away, the problem is coming to a head now.

That's because states — which continue to face huge budget shortfalls that they must close — are taking steps now to plan their budgets for state fiscal year 2011, which starts on July 1, 2010 in most states. Governors will send their budget proposals to their legislatures between next month and February 2010 in almost all states. The legislatures will have to pass budgets as early as March or April in some states and by the end of June in almost all states. If states do not know they will receive additional federal fiscal relief, they will begin implementing new budget cuts and tax increases by this summer, at the latest.

Presuming they will get no more fiscal relief, states will have to take steps to eliminate deficits for state fiscal year 2011 that will likely take nearly a full percentage point off the Gross Domestic Product. That, in turn, could cost the economy 900,000 jobs next year.[1] Mark Zandi, Chief Economist of Moody's Economy.com, recently warned that these state budgetary actions "will be a serious drag on the economy at just the wrong time."

[1] This estimate relies on the rule of thumb used by the President's Council of Economic Advisers that each percentage point of GDP translates roughly into 1 million jobs.

For economic and other reasons, federal policymakers should provide some additional fiscal relief, so that such relief is extended or phased down after 2010 rather than ending abruptly. That would constitute one of the most effective uses of additional federal dollars to boost the weak economy and preserve or create jobs.

States are continuing to grapple with record steep declines in tax receipts. Large job losses and declining incomes have caused state and local tax revenues to fall steeply, and this is occurring at the same time that high unemployment and rising poverty are increasing the need for state services such as Medicaid. The result has been large, widespread, and persistent state budget gaps of stunning magnitude. Deficits for the current state fiscal year, not all of which states have closed, total more than 25 percent of state general fund budgets, making these the largest shortfalls on record.

Deficits pose a particularly difficult problem for states during recessions because nearly all states are required to balance their operating budgets, no matter how bad the state of the economy. And many of the actions that states must take to achieve budget balance in the face of sharply falling revenues — cutting services, laying off workers, and raising taxes — further weaken the economy. Given the importance of encouraging job growth and bolstering the economy in the months ahead, federal policymakers have cause for serious concern that the actions which state policymakers will be compelled to take in the next two years will impede recovery and cause significant economic damage.

Some private forecasters have begun to ask whether the state budget cuts and tax increases that lie ahead will stall the economy. Goldman Sachs estimated last July that the fiscal drag from state budget cuts and tax increases could reduce GDP by 0.6% to 0.7% over the coming year as states move to close their deficits.[2] The outlook for state fiscal year 2011 is even grimmer; as noted, actions states will have to take to eliminate deficits for that year are likely to drag down GDP by more than 0.9% and could cost 900,000 jobs.

Zandi recently told the Congressional Joint Economic Committee, "Fiscal 2011 budgets are likely to be more troubled than those for the current year. . . . [States] will be under intense pressure to cut jobs and programs and to raise taxes and fees. . . . For state and local governments to turn into a weight on growth will be a meaningful impediment to the broader recovery's prospects."

He recommended that "To avoid this, more federal aid to states for their FMAP and educational obligations may be necessary." Zandi rates federal assistance to state and local governments as highly efficient stimulus; he estimates that every dollar the federal government spends on this assistance in a year translates into a $1.41 increase in GDP that year.

There is also the issue of hardship. To close budget gaps during the recession, many states already have implemented deep and broad cutbacks in education, health care, and most other areas of state expenditures. The cuts have affected vulnerable children, seniors, and people with disabilities, among others. Additional, deeper cutbacks will intensify the problems that these cutbacks already are causing. More than 30 states have raised taxes as well.

---

[2] Goldman-Sachs US Economic Analyst, "The State and Local Sector: What a (Fiscal) Drag!," July 10, 2009.

## The Role of the Federal Economic Recovery Legislation

The state fiscal assistance from the American Recovery and Reinvestment Act (ARRA) has helped substantially. Without it, both state budget cuts and state tax increases would be much larger. The best estimates suggest that the fiscal relief in ARRA — provided mainly for health care and education — has allowed states to close 30 percent to 40 percent of their budget gaps this year. (See the box on page 6 for a description of the fiscal relief provisions.) Without this aid, states would have been forced to institute even more severe actions that would have placed a greater drag on the economy.

The ARRA funding for state fiscal relief is creating and preserving jobs. The Department of Education found that more than 240,000 education jobs and nearly 44,000 jobs in other areas were being funded in the fourth quarter of 2009 by the Fiscal Stabilization Fund in the Recovery Act. That's a total of about 284,000 jobs funded by the Fiscal Stabilization Fund during the fourth quarter of 2009.[3]

No official reports are available on the jobs impact of the fiscal relief funding provided through Medicaid. It is reasonable to assume, however, that the Medicaid funding has resulted in the retention or creation of both public and private sector jobs for health providers, in large part because more people remain insured than would have been the case without the funding. The President's Council of Economic Advisers looked at the first six months of ARRA Medicaid funding and found a strong relationship between that funding and jobs.[4]

Unfortunately, however, a serious problem now is looming. The Medicaid fiscal relief that ARRA provides will end with a "cliff" on December 31, 2010. States also will have drawn down most of their education fiscal relief funds by that time.

The December 31, 2010 date falls in the middle of the next state fiscal year, and that fiscal year is a period for which state deficits are projected to be at least as large as the deficits were for the current fiscal year (before state actions to close them). This means that states will have to institute rather massive new budget cuts and tax increases on July 1, 2010, a matter of great concern because the unemployment rate is expected to still be close to double-digit levels at that time and the economy is likely still to be fragile.

Moreover, state deficits of a very large magnitude are likely to persist for another two or three years. Despite some improvements in the economy as a whole, state fiscal conditions for state fiscal years 2011 and even 2012 look as bad, or nearly as bad, as those for 2009 and 2010.

- Budget projections suggest that states will face total deficits for state fiscal years 2011 and 2012 of as much as *$260 billion* beyond what can be covered by the limited ARRA funding that will

---

[3] Total education funding through ARRA, including both fiscal relief and programmatic funding, was found to befunding 326,593 education jobs. US Department of Education, "American Recovery and Reinvestment Act :Section 1512 Quarterly Reporting Through December 31, 2009," http://www2.ed.gov/policy/gen/leg/recovery/spending/arra-program-summary-2-program.xls,.

[4] Executive Office of the President, Council of Economic Advisers, "The Economic Impact of the American Recovery and Reinvestment Act 2009," September 10, 2009.

remain available. (See the chart on page 5.) State budget-balancing actions thus could reduce demand in the U.S. economy by as much as $260 billion in those years.[5]

- Furthermore, these figures reflect only budget cuts and tax increases at the *state* level. *Local* governments will institute their own budget cuts and tax increases — to close their own deficits — on top of these.

State deficit projections remain this large because, as discussed below, state and local fiscal recovery typically lags behind the resumption of economic growth and other economic indicators by two to three years. In both of the past two recessions, state budget deficits remained very large for several years after the recession officially ended. The current recession, in which there have been unprecedented drops in state revenue, could have an even longer recovery period.

As a result, allowing federal fiscal assistance to states to terminate in 2010 would pose dangers for the economy. The surge of state budget cuts and tax increases that would follow could place a significant drag on the economy and compromise the recovery. An extension or gradual phase-down of the current federal fiscal relief to states would represent sounder and more prudent economic policy.

In addition to bolstering the economy and adding protection against the recovery stalling out, additional fiscal relief also would help the nation's most vulnerable households, which face potential steep cutbacks under the vast budget cuts that otherwise will occur. As one example, ARRA requires states to maintain — through December 31, 2010 — the Medicaid eligibility levels they had in place before the recession started, as well as to maintain at least their 2008 levels of spending for education. These are conditions for state receipt of the federal fiscal relief under ARRA. If federal fiscal relief ends while states continue to face crushing deficits, these requirements will lapse and health care and education will be cut, likely by large amounts in many states. The health agency in one state already has provided the governor with a proposal to terminate Medicaid eligibility for 80,000 low-income people on January 1, 2011.[6] Other states are likely to follow suit.

## State Deficits, the Economy, and Jobs

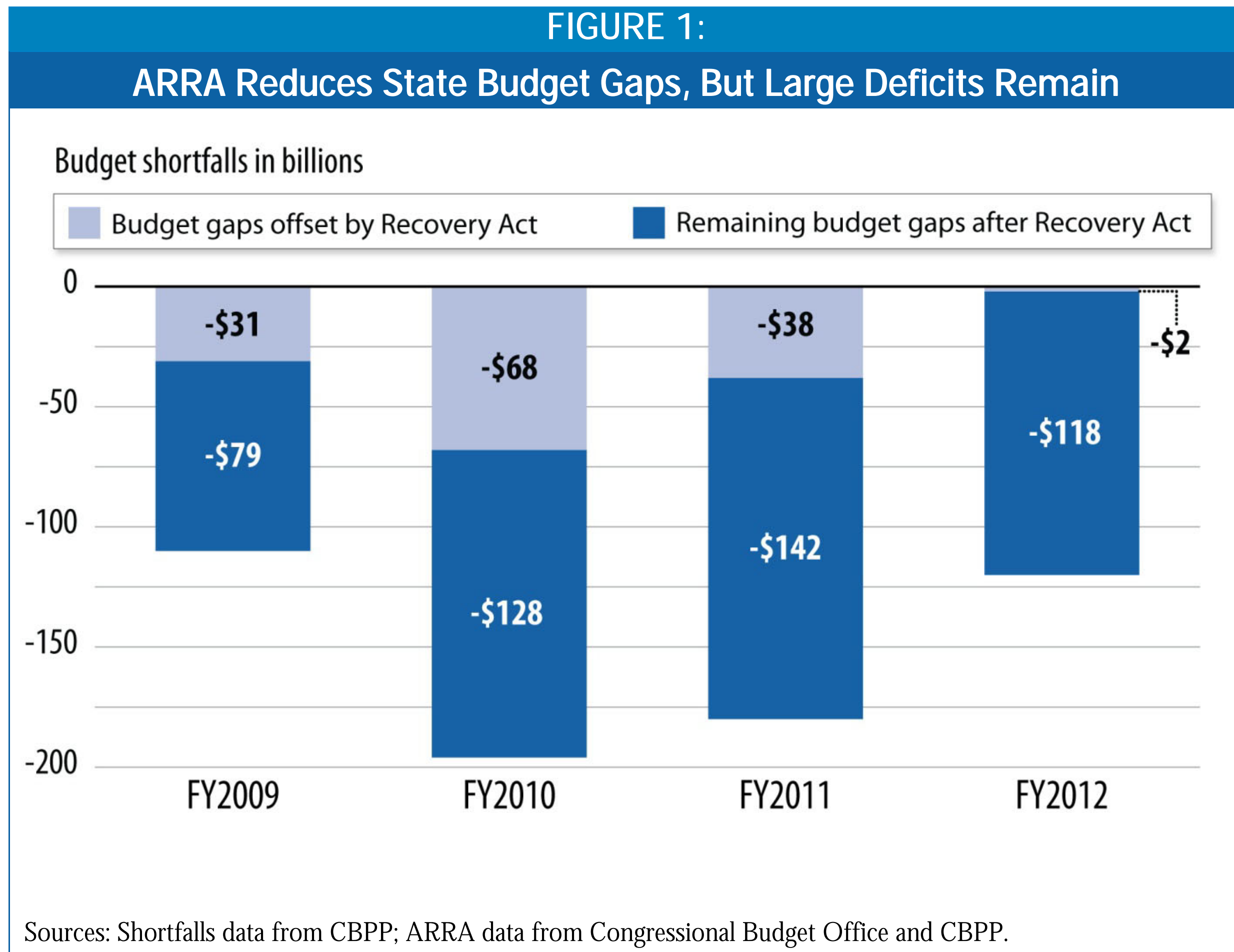
State and local spending plays an important role in the economy. The state and local sector is responsible for about one-eighth of GDP, so when states cut expenditures and raise taxes in an economic downturn, the overall economy feels the effect.

The revenue decline in this recession is unprecedented; it is the largest on record in the post-World War II period. State tax revenues have been declining since the fourth quarter of 2008. In the critical April-June quarter, when a major portion of state tax revenues are collected, revenues

[5] This figure equals $180 billion in fiscal year 2011 deficits, minus $40 billion in ARRA funding estimated to be remaining for use that year, plus $120 billion in fiscal year 2012 deficits.

[6] Submission of the Florida Agency for Health Care Administration to Governor Crist.

dropped 16.6 percent in 2009 compared to the previous year. The income tax was down 27.5 percent, and the sales tax was down 9.5 percent.[7]



Sources: Shortfalls data from CBPP; ARRA data from Congressional Budget Office and CBPP.

As a result, in the current state fiscal year (state fiscal year 2010, which runs from July 1, 2009 through June 30, 2010 in most states), 48 states have experienced budget shortfalls. These deficits were closed through a combination of budget cuts, tax increases, use of available reserves, and use of federal ARRA funds. Since states' 2010 budgets were enacted, however, revenue collections have been much weaker than even the tepid projections on which those budgets were based. As a result, mid-year budget shortfalls totaling $38 billion have opened up in 41 states, requiring states to embark on a new round of mid-year budget cuts. Considered together, the initial and mid-year deficits total $196 billion, or 29 percent of state budgets. These are the largest state budget shortfalls on record.

Estimates based on economic projections, state data, and past history suggest that deficits in state fiscal year *2011* will total at least $180 billion, followed by deficits in state fiscal year 2012 of about $120 billion. Fiscal conditions are likely to stabilize in most states by 2013.

---

[7] Lucy Dadayan and Donald J. Boyd, "State Tax Revenues Show Record Drop, For Second Consecutive Quarter," Rockefeller Institute, October 2009.

### Fiscal Relief Is Being Provided through Medicaid and Fiscal Stabilization Fund

The economic recovery act (ARRA) includes a temporary increase in the share of the Medicaid program paid by the federal government (known as the Federal Medical Assistance Percentage or "FMAP"). It provides states with approximately $87 billion in assistance over nine calendar quarters (October 1, 2008 through December 31, 2010).

The ARRA formula for increased federal support for state Medicaid costs has two parts: a base amount of additional federal assistance that is provided to each state, and additional amounts of federal assistance that go to states in which the unemployment rate is substantially higher than it was before the recession started. (It also includes a "hold harmless" provision that prevents a state's FMAP from dropping due to the annual recalculation of the formula.)

To receive an increased FMAP under ARRA, a state may not have Medicaid eligibility levels that are more restrictive than those in effect on July 1, 2008. While the ARRA provisions are in effect, a state may not cut eligibility or introduce procedures that can be a barrier to Medicaid enrollment or retention.

ARRA also includes a "State Fiscal Stabilization Fund." The Stabilization Fund provides two block grants for states — a $39.5-billion grant earmarked for education and an $8.8-billion grant to help fund other key services. Together, these provisions provide about $48.3 billion in fiscal relief for state and local governments.

The $48 billion in block grants is allocated among states through a combination of two population measures. Sixty-one percent of the funds are allocated by each state's population aged 5 to 24. The remaining 39 percent of these funds are allocated based on total state population. Out of each state's allocation based on these measures, 81.8 percent is reserved for the education block grant, and 18.2 percent is considered the "flexible" grant.

The $39.5 billion in education grants can support K-12 and higher education during state fiscal years 2009, 2010, and 2011. A portion of the funds is dedicated to helping states maintain K-12 and higher education funding; the remainder flows directly to local school districts. The funds must first be used to restore state education funding up to the greater of the state fiscal year 2008 or fiscal year 2009 level, or, if higher, up to existing state formula levels. These funds can also be used to allow the phase-in of previously enacted equity and adequacy adjustments. Any funds remaining after these uses must be sent to local school districts.

States can use the $8.8 billion in flexible block grants to avert budget cuts in education or other basic state services, such as public safety and law enforcement, services for the elderly and people with disabilities, and child care. These funds can also be used for school modernization, renovation, or repair.

To receive the block grants, states are required to fund both K-12 and higher education at no less than the fiscal year 2006 level in fiscal years 2009, 2010, and 2011.

Stabilization funds can be obligated through September 30, 2011 (and can be available for expenditure in the subsequent year). But because states are facing massive deficits and have such a strong need for these funds, states have reported to the Department of Education that they plan to use more than 86 percent of these funds by the end of state fiscal year 2010 (i.e., by the end of June 2010 in most states). The ARRA funds that are helping states lessen the severity of cutbacks and job losses in education thus are likely to run out at around the same time as the enhanced Medicaid funding.

Some $40 billion of ARRA funding is likely to be available to help states close the $180 billion in state deficits expected in state fiscal year 2011. State actions to close the remaining deficits could reduce aggregate demand in the economy as states raise taxes and cut expenditures to balance their budgets.[8]

The $140 billion fiscal year 2011 deficit ($180 billion less $40 billion in ARRA funds) equals about 0.9 percent of GDP. Assuming that economic activity declines by one dollar for every dollar that states cut spending or raise taxes, state deficits could cost the economy 900,000 jobs next year.[9]

It is worth noting that the problems states currently are facing are overwhelmingly a result of declining revenues and not, as some have assumed or claimed, of excessive spending or mismanagement. State spending increases since the last recession were very modest. State spending fell sharply relative to the economy during the 2001 recession. And for states in the aggregate, it remained below the fiscal year 2001 level in state fiscal year 2008, before the current recession started. State spending as a share of the economy has declined since then and taken a particularly large dip in the current fiscal year (2010).

States also acted prudently between the last recession and the current one to build up rainy day funds and other reserves. At the end of fiscal year 2006, state reserves — general fund balances and rainy day funds — totaled 11.5 percent of annual state spending, making them the largest reserves on record. Reserves can be particularly important to help states adjust in the early months of a fiscal crisis or to weather a mild recession. But the reserves have proved inadequate in this unusually long and deep recession.

## State Fiscal Recovery Typically Lags Economic Recovery

Improvement in state fiscal conditions, like the decline in the unemployment rate, typically lags an economic recovery. In both the recession of the early 1990s and the 2001 recession, states experienced large deficits and were forced to make budget cuts or raise taxes well *after* the recessions had officially ended.

- The recession of the early 1990s ended in March 1991, before the end of state fiscal year 1991. Yet the largest deficits that states experienced during that recession (deficits equaling 6.5 percent of state general fund budgets) came in state fiscal year 1992. Some 35 states cut their budgets in 1992, and 22 states did so in 1993 as recession-induced problems continued to be worked out of budgets.[10]

---

[8] A number of prominent economists have pointed out that tax increases on higher-income residents reduce demand less than budget cuts, because some of the additional taxes are paid from savings or other funds that otherwise would not be spent in the state. See, for example, http://www.cbpp.org/cms/?fa=view&id=1032.

[9] The assumption that a dollar of state budget cuts only reduces economic activity by a dollar may be conservative, given the Zandi estimate that every dollar the federal government spends on preventing such cuts leads to $1.41 of economic activity. As noted in footnote 1, the potential loss of 900,000 jobs relies on a Council of Economic Advisers rule of thumb that each percentage point of GDP equates to roughly 1 million jobs.

[10] National Association of State Budget Officers, "Fact Sheet: Quick Rebound?," March 12, 2002.

- The recession in the early part of the current decade ended in November 2001. Yet state fiscal distress continued through state fiscal year 2005. Deficits in state fiscal year 2004 equaled more than 15 percent of state budgets, while fiscal year 2005 deficits exceeded 8 percent of budgets.

There are a number of reasons for these lags in state fiscal recovery.

- In the last two recessions, the unemployment rate continued climbing for 15 to 19 months after the recession ended and then remained high for a considerable period of time after that. That hampers the ability of state revenues to recover strongly; high unemployment reduces both income tax and consumption tax revenues. In the current economic downturn, unemployment is projected to continue rising in calendar year 2010 and to remain relatively high through 2012 or 2013. Mark Zandi forecasts that the unemployment rate will peak at 10.5 percent in the late spring of 2010 and not fall back to a rate consistent with full employment until 2013. Goldman-Sachs forecasts the unemployment rate to continue to rise throughout calendar year 2010, reaching 10.5 percent in the fourth quarter.[11]

- High unemployment also affects state expenditures, as Medicaid rolls remain swollen with residents who have lost their jobs, income, and health insurance.

- As states strive to balance their budgets while doing the least harm to their economies and their residents, they initially draw down rainy day funds and other reserves, sell assets, and postpone payments. The use of these strategies, however, creates holes in future-year budgets that have to be filled. When unemployment remains high in the years immediately after a recession ends, state revenue growth generally is not strong enough to fill these gaps.

- The tax increases that states enact during recessions often are temporary and expire before fiscal conditions have fully recovered.

## Timing of Action

Because of state budget calendars, it would not be effective for the Administration and Congress to wait until the fall of 2010 to consider additional aid to the states for state fiscal year 2011.

In most states, the governor's proposed budget for fiscal year 2011[12] is being developed this fall. At the end of calendar 2009 or the beginning of calendar 2010, governors will submit their budgets to their legislatures, to be considered between January and June 2010. Final budgets for fiscal year 2011 will be adopted at some point during that period. Some states, particularly those with short legislative sessions, require the adoption of budgets by March or April.

States budget for their fiscal years as a whole, not for six-month periods. The spending cuts and tax increases that states will institute in order to balance their 2011 budgets will be determined based on the state's budget projections for *all* of fiscal year 2011. Those projections will include a

---

[11] Zandi testimony at Joint Economic Committee, and Goldman-Sachs, US Economics Analyst, October 30, 2009.

[12] Fiscal year 2011 begins on July 1, 2010 in all but four states. It starts on April 1, 2010 in New York and on September 1 or October 1 in Alabama, Michigan, and Texas.

significant drop-off in ARRA funds for the final half of the state fiscal year (i.e., after December 2010).

Accordingly, many of the actions that states will take to balance their 2011 budgets will be implemented next summer (or in some cases even earlier if budget gaps have reopened for the current fiscal year). To gain maximum revenue, states that plan to adopt tax increases to help address their looming fiscal year 2011 shortfalls may want to put them in place as quickly as possible. The same applies to spending reductions; for example, many cuts in education spending are likely to take effect next summer, at the start of the 2010-2011 school year.

The bottom line is that unless states know that additional aid is coming — even if they do not actually receive the dollars until calendar year 2011 — they will institute large new budget cuts and/or tax increases by next summer to close the shortfalls in their fiscal 2011 budgets.

## Conclusion

State fiscal assistance under ARRA will end or largely be exhausted by the end of calendar year 2010. Unfortunately, big state deficits are expected to continue through state fiscal year 2012 — that is, for another 18 months or so after 2010 ends. If states do not receive additional federal assistance beyond the scheduled expiration of such aid, they will be forced to institute further deep budget cuts and/or substantial tax increases. Such actions would place a drag on the U.S. economy, impeding the recovery and costing many jobs. Such measures also could cause serious hardship for many families and individuals that have lost their jobs and are relying on Medicaid and other key state services to make it through this unusually painful economic downturn.

For both economic and other reasons, the provision of some additional fiscal relief, so that such relief is extended or phased down after 2010 rather than ending abruptly at that point, would be highly desirable. It would constitute one of the most effective uses of additional dollars to boost the weak economy and preserve or create jobs.