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Special Series: **Economic Recovery Watch**

February 10, 2009

SENATE'S CUTS TO "FISCAL STABILIZATION FUND" WEAKEN STIMULUS VALUE OF THE ECONOMIC RECOVERY BILL

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Overview and Summary

The House economic recovery bill includes a $79-billion "State Fiscal Stabilization Fund" to help state and local governments fund education and other key services. However, the Senate — as a result of the Collins-Nelson amendment — has reduced the amount of funding to $39 billion and eliminated *all* flexible funding that states could use to avert budget cuts in areas such as law enforcement, services for the elderly and people with disabilities, and programs to prevent child abuse. By reducing the amount of funding and removing flexibility, the Senate weakens one of the most effective and immediate form of economic stimulus in the bill. Without the funds the Senate cut out of the bill, there will be far more state budget cuts and/or tax increases that create a drag on the economy.

The economic downturn has opened budget deficits in *46 states*, forcing large spending cuts and layoffs, with many more expected. These actions remove demand from the economy, which deepens the downturn. The Stabilization Fund would provide funds to partially close state and local budget shortfalls and allow states to avoid some of the most harmful actions they otherwise would have to take to meet their balanced budget requirements. But the funding in the Senate bill is insufficient.

Even in the House bill, the Fiscal Stabilization Fund and the Medicaid assistance together would fill less than half of projected state deficits over the next 2½ years. In the Senate bill, the federal funding would fill just over one-third of state shortfalls. This diminished funding would increase the extent to which states must take budgetary actions that are likely to undercut efforts to stimulate the economy.

States are Facing Massive Deficits and Cutting Vital Programs

States are facing their worst fiscal crisis since the Second World War. The recession has reduced state revenues, while increasing the need for state services such as Medicaid. Forty-six states face budget deficits in the 2009 and/or 2010 state fiscal year, and state deficits are expected to total $350 billion through state fiscal year 2011.[1]

The state fiscal crisis is a direct result of the economic downturn, not state fiscal mismanagement. Before the downturn, states had amassed reserves totaling 11.5 percent of state spending. Moreover, total state spending, which fell sharply relative to the economy during the 2001 recession, remains below its fiscal year 2001 level as a share of the economy.

Because most states are required to balance their operating budgets, states with deficits are forced to cut spending and/or increase taxes. At least 40 states have enacted or proposed spending reductions.[2]

Some 36 states already have cut funding for elementary, secondary, and/or higher education or proposed such cuts.

- At least 20 states have implemented cuts to K-12 and early education, and another five have proposed such cuts.

- At least 28 states have implemented cuts in funding for public colleges and universities, and another four have proposed such cuts. The result is reductions in faculty and staff and tuition increases of 4 percent to 15 percent.[3] Tuition increases and cutbacks in faculty and enrollment reduce access to higher education for many low- and middle-income students.

When states cut spending, they lay off employees, cancel contracts with vendors, reduce payments to businesses and nonprofits that provide services, and cut benefit payments to individuals. All of these steps remove demand from the economy and compound the economic slowdown, counteracting the effects of the recovery legislation. If states raise taxes to balance their budgets, the effects on demand are similar. An adequate Stabilization Fund would help prevent further cuts to K-12 and higher education, as well as other critical state and local services.

How the Stabilization Fund Would Work

Under both the House and Senate bills, the State Fiscal Stabilization Fund provides funds to support the ongoing costs of education and an incentive fund for states and localities to encourage certain types of education reforms. The House bill also includes a smaller block grant that states could use to support services other than education.

Under the House bill, the larger block grant would provide $38.8 billion, be earmarked for education, and be allocated by each state's population of individuals between the ages of 5 and 24.

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[1] Elizabeth McNichol and Iris J. Lav, "State Budget Troubles Worsen," CBPP, *Updated* Jan. 29, 2009. www.cbpp.org/9-8-08sfp.htm.

[2] Nicholas Johnson, Phil Oliff and Jeremy Koulish, Facing Deficits, "At Least 40 States Are Imposing Or Planning Cuts that Hurt Vulnerable Residents," CBPP, *Updated* Feb. 10, 2000. www.cbpp.org/3-13-08sfp.htm.

[3] Nicholas Johnson, Phil Oliff, and Jeremy Koulish, "Most States Are Cutting Education," CBPP, Revised Jan 29, 2009. www.cbpp.org/12-17-08sfp.htm.

A portion of the funds would be dedicated to helping *states* maintain education funding; the remainder would flow directly to *local* school districts.[4] The smaller of the two block grants would provide $24.8 billion, allocated based on each state's total population, to support other basic state services, such as public safety and law enforcement, services for the elderly and people with disabilities, child care, and the like. In addition, there is a $15 billion incentive fund. Most of this fund is for new education initiatives; it would not be available to support ongoing state obligations to fund education, and at least half of these funds would have to be passed through to local school districts.

Under the Senate bill, about $31.3 billion would be earmarked to help states meet ongoing costs for education. Another $7.5 billion would be devoted to the incentive fund. The Senate does not include *any* additional block grant funding to support other important state services.

Flexible Block Grant Funds Needed to Avert Cuts in Other Key Services

Most of the assistance for states in the recovery legislation is dedicated to either Medicaid or education. The sole piece not so dedicated is the smaller, $25-billion Stabilization block grant in the House bill. States provide a wide range of other vital services that also are threatened by budget deficits, including public safety, corrections, and services for people who are elderly or have disabilities. State budget cuts in these areas, as well, reduce demand and increase unemployment, thereby deepening the recession.

- At least 22 states plus the District of Columbia are cutting, or proposing cuts to, medical, rehabilitative, home care, or other services needed by people with limited incomes who are elderly or have disabilities, or significantly increasing the cost of these services.[5]

- Cuts in other states are reducing funding for law enforcement, programs to prevent child abuse, funding for homeless shelters, and the like.

- Many states are cutting state aid to localities, which will reduce funding for local programs including police and fire protection, meals for the elderly, hospice care, and seniors' services.

- At least 36 states and the District of Columbia have made, or have proposed making, cuts affecting their state workforces, including layoffs.

A flexible block grant can help to reduce the depth of the cuts states and localities will otherwise have to make, preserving essential services and jobs and sustaining economic demand.

Total Fiscal Assistance for States in the Senate Bill Will Cover Little More than One-third of State Deficits

[4] In both the House and Senate versions, to receive the federal funding states would be required to fund both K-12 and higher education at no less than their fiscal year 2006 level.
[5] Johnson, Oliff, and Koulish, "At least 40 States Are Imposing Or Planning Cuts that Hurt Vulnerable Residents."

The direct budget assistance to states in the House bill will cover less than half of the $350 billion in combined deficits that states are likely to face over the next two and a half years.[6] Besides the two Stabilization Fund grants totaling $64 billion, the bill includes an estimated $88 billion in Medicaid funding, which would help pay for Medicaid costs and avert Medicaid cuts. Together, these pieces add up to about $151 billion, or about 43 percent of expected state deficits. In the Senate Bill, there is $87 billion in Medicaid funding and $31 billion in the stabilization fund, for a total of $118 billion or about 34 percent of projected state deficits.

As noted above, both bills include an incentive fund. In the House, the $15 billion incentive fund brings the Stabilization Fund total to $79 billion, while in the Senate the $7.5 billion incentive fund brings the total to $39 billion. The incentive funds do not provide fiscal relief to states, however, because most of the funds must be used for new initiatives and half of the funds must be passed through to local governments.

States will also receive funding for infrastructure, but that is not fiscal relief that helps close holes in state *operating* budgets, which are the budgets that states must balance each year. States fund most infrastructure projects out of their *capital* budgets, which are separate.

States would be required to spend the funds quickly.

Both bills require states that fail to spend any portion of a Stabilization grant *within one year* of receipt to return the unspent portion, which would then be redistributed to the other states. The Senate bill allows grants to start sooner than the House bill does, with funding available to close gaps in the current state fiscal year. Since some 43 states face mid-year deficits in the current fiscal year, which ends June 30, 2009 in most states, and a comparable number of states face deficits for the next fiscal year, which generally runs from July 1, 2009 to June 30, 2010, this aspect of the Senate bill represents the sounder design. Funding under either bill is likely to be spent within a year and a half to two years of the legislation's passage.

[6] See Iris J. Lav and Nicholas Johnson, "Funding for States in Senate Economic Recovery Package Would Close Less Than Half of Projected State Deficits," CBPP, Jan. 29., 2008. www.cbpp.org/1-29-09sfp.htm.