

Economic Stimulus, State Budget Shortfalls, and State Countercyclical Funding

NGA Proposal

The nation's governors support state countercyclical funding of \$12 billion over one year, made up of \$6 billion in Medicaid assistance and \$6 billion in a flexible block grant. Countercyclical funding should be included in any federal economic stimulus package because it is the most effective means to avoid the budget cuts and tax increases that states will be forced to make to meet their legislative and constitutional balanced budget requirements during the economic downturn.

State Impact Will Worsen Over Time

Despite the fact that it is the beginning of the economic downturn, 18 states already face budget shortfalls totaling \$14 billion in 2008 and 17 states project shortfalls totaling more than \$31 billion in 2009. History tells us that both the number of states facing shortfalls and the severity will grow over time. For example, the recession in the early 1990s ended in 1991, and 28 states cut budgets that year. But states continued to feel the recession's impact and the following year, 1992, 35 states cut budgets. Similarly, in 2001, when the most recent recession ended, 16 states cut budgets. However, 37 states cut budgets in each of the next two years—2002 and 2003. The enclosed chart by NASBO underscores this trend. If the current downturn continues and follows the path of most recessions, between 35 and 40 states will face budget cuts in 2009.

Why the State Impact Lags Behind the Downturn

The state fiscal picture will deteriorate over the next two years. As the economy slows, state sales tax revenues are the first to decline because reductions in personal consumption often lead downturns. Only after the recession hits bottom does unemployment begin to increase, which in turn leads to declines in state personal income tax revenues. The increase in unemployment also often leads to increases in the demand for food stamps, unemployment benefits and particularly Medicaid payments, which is currently about 22 percent of state budgets. The Medicaid growth from women and children coming on the rolls occurs very late in the cycle and constitutes a significant state expense.

Because all but one state has a balanced budget requirement, states will be forced to cut spending or raise taxes to reduce the shortfalls. Both these actions are procyclical, which means they will

make the downturn more severe. The shortfall of \$14 billion in 2008 and \$30 billion in 2009 will have a multiplier effect on the economy in terms of reducing Gross Domestic Product (GDP).

Policy Response

The best policy to counter the procyclical effects of a downturn is to include NGA's proposal for state countercyclical funding in the stimulus package. This policy response is simple, highly targeted, temporary and timely. It also can be done quickly since all formula and other issues were resolved when a similar policy was enacted in 2003.

Medicaid – Including Medicaid assistance is important because states are now expecting higher Medicaid costs for several reasons.

- The economic downturn will increase unemployment, which will drive more people on to the rolls of Medicaid and other poverty-based programs. States will have few sound policy options for dealing with these increases, because they will not want to cut Medicaid optional benefits or eligibility during the downturn.
- The share of the Medicaid program financed by the federal government is based on state per capita income calculations that are several years old. Therefore, robust growth in state economies from 2004-2006 will mean that the federal match for 2008 and 2009 will be significantly reduced, just as state economies witness a downturn.
- Growth in Medicaid rolls historically lags behind economic downturns because it can take several months for children and families to become eligible and apply for health care assistance. Despite this lag, evidence indicates that increases are already occurring in many states.

A major advantage of increasing the Federal Medicaid Assistance Percentage (FMAP) for each state is that this policy can be implemented the day it is signed. There is no need for new rules or regulations, and states could immediately eliminate scheduled budget cuts. Essentially, this action could begin to neutralize the procyclical nature of state spending on day one. Two independent studies have indicated that state assistance would be an effective countercyclical program to help stabilize the economy. (“Options for Responding to Short-Term Economic Weakness,” Congressional Budget Office, January 2008; and “Washington Throws the Economy a Rope,” by Mark Zandi of Moody's Economy.com in *Dismal Scientist*, January 22, 2008.)

Flexible Block Grant – This funding would allow states to set priorities and avoid cuts to critical programs such as elementary, secondary and higher education; non-Medicaid health care and other programs; existing state programs that focus on assisting individuals to avoid defaults on home mortgages; and infrastructure repairs to schools, highways and bridges.

Historical Precedent

During the most recent economic downturn, Medicaid enrollment rose 8.6 percent between 2001 and 2002. This growth was largely attributed to states' increases in unemployment. At the same time, state tax revenues fell 7.5 percent. At the height of the recession, state budget shortfalls reached about \$80 billion and caused states to cut spending on many state programs, raise taxes and fees and enact many one-time revenue sources to balance state budgets.

Following the 2001 recession, Congress approved the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which provided \$10 billion in fiscal relief through a temporary increase in federal Medicaid funding for all states by increasing FMAP, and also provided \$10 billion in general assistance, through time-limited block grants to the states.

Evaluations of the temporary increase found that Medicaid had an important role as a fiscal stabilizer. According to a 2004 report by the National Association of State Budget officers and a 2005 report from the Kaiser Family Foundation, the increased FMAP helped states meet Medicaid spending increases that were driven in part by the economic downturn; it also forestalled additional reductions in Medicaid and preserved Medicaid eligibility. Reports also indicate this fiscal relief achieved its primary objective. The current NGA proposal is essentially the same as its previous one with the exception that it is a \$12 billion, as opposed to \$20 billion, initiative.

NASBO Chart

Source: National Association of State Budget Officers, *December 2007 Fiscal Survey of States*

**Budget Cuts Made After the Budget Passed,
Fiscal 1986-Fiscal 2007 (\$ millions)**

