ECONOMIC STIMULUS: A STATE PERSPECTIVE

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Economic Stimulus: A State Perspective

Summary – The purpose of this background paper is to provide Congress and the Administration with information regarding the fiscal condition of the states, guidance on the potential state role in economic stimulus and specific policy options.

Economists are increasingly concerned the U.S. economy is slipping into recession. While this is a national problem, states face particular challenges during a recession. Namely state balanced budget restrictions require states facing declining revenues to either cut spending or increase taxes to maintain balance. Both of these actions are "pro-cyclical" and make recessions more severe.

Although the nation is at the beginning of a downturn, 17 states already face shortfalls totaling $14 billion in 2008 and 15 states project shortfalls of $30 billion for 2009. History suggests both the number of states facing shortfalls and the severity will grow even after the downturn ends. For example, the same year the recession of the early 1990's ended, 28 states cut budgets. The following year, as the economy began to recover, 35 states had to make cuts. Similarly in 2001, the year the last recession ended, 16 states were forced to cut their budgets and in each of the next two years 37 states made reductions to meet shortfalls (see NASBO chart). If the current downturn follows the path of previous recessions, 35 to 40 states could face budget cuts in 2009.

There is a strong consensus among economists that any stimulus package should adhere to the criteria of being timely, temporary and targeted. From a state perspective, stimulus policies also should aim to do no harm by avoiding policies that would exacerbate the fiscal condition of states by diminishing state revenues, shifting costs from federal to state programs or imposing new unfunded mandates. Federal lawmakers considering a federal stimulus package should consider policies that meet the criteria and conform to one of the following broad categories:

- General revenue sharing – Similar to a portion of the relief provided in 2002, revenue sharing provisions provide states with unrestricted funds to prevent states from having to raise taxes or cut services to meet balanced budget requirements.
- Targeted state-federal programs for high-risk populations – Increased spending in state-federal programs can quickly reach targeted populations and lessen the effects of an economic downturn. Programs in this category may include investments in LIHEAP, Food Stamps, Medicaid and Unemployment Insurance.
- Job creation – Changes to infrastructure programs can quickly create new jobs during times of increased unemployment.
- Mortgage default assistance – Mitigating the effects of the housing downturn and subprime mortgage crisis will help individuals avoid expensive foreclosures.
- Existing regulations – Adopting or extending moratoriums on regulations that increase state expenditures without corresponding savings for states can limit further pro-cyclical actions.
- Individual income tax and business tax reductions – Although individual income tax reductions and business tax incentives have proven to be an efficient means of stimulating the economy, federal policymakers must minimize the impact of federal tax changes on state revenues.

The Problem – Economists increasingly are concerned that the U.S. economy is slipping into recession. These concerns are fueled by a confluence of factors that are limiting the availability of credit and dampening consumer spending. First, while the price of oil has increased dramatically, its full impact on the price of gasoline will not be felt until summer, when the average cost per gallon could approach $4.00 per gallon. This increase will act as a tax on American consumers and depress expenditures on other goods and services. It is worth noting that since World War II major increases in the price of oil price have preceded most U.S. recessions.

Second, decreasing home values are dampening consumer demand for goods and services. As home prices rose over the last five years, consumers increased spending by tapping into their home's equity to pay for renovations and support spending on other consumer goods and home improvements. A decrease in housing prices has the opposite effect. Consumers lose equity in their homes, feel less wealthy and make fewer purchases of goods and services.

Third, experts are increasingly concerned that significant portions of securitized mortgage debt are worthless and must be written off by financial institutions. Some analysts believe that recent write-downs of securitized subprime mortgage debt by major banks represent only one-third of the total losses that banks will have to absorb this year. These losses could eventually exceed $250 billion, dramatically reducing the liquidity of the U.S. banking system and consequently decreasing the availability of loans for individuals and businesses. The projected size of the loss also may reduce the effectiveness of the Federal Reserve's efforts to lower interest rates and increase liquidity.

Most states and local governments are experiencing the negative effects of these national trends. Downturns in the national economy show up first in fewer purchases by businesses and consumers, followed by falling sales tax revenues, reductions in employment growth and increases in unemployment. Slowing employment likewise affects state revenues in the form of dropping income tax revenues, and rising state expenditures to meet demand for services like Medicaid and unemployment benefits targeting low-income individuals. Declining home values and increased foreclosures also have a profound effect on local finances which depend on property taxes. Losses at the local level often translate into increased expenditures by the state to stabilize local economies.

Although recessions are national in scope, not all states experience similar hardships during a national economic decline. For example, at this time a few small states, particularly those with economies based on oil and natural gas production, have benefited from high energy prices and are faring better than others. This is also true of some farm states who are witnessing an increase in the demand for grains due to the falling dollar.

Unfortunately during a recession, state balanced budget requirements force states with declining revenues to either cut spending or increase taxes to maintain balance. Both actions are pro-cyclical in that they make recessions more severe. During the last national recession in 2002, the federal government provided $20 billion in fiscal assistance to states to mitigate pro-cyclical effects and help stabilize the economy. Specifically, $10 billion was used to enhance the federal matching rate for Medicaid to forestall cuts to healthcare services, while another $10 billion was distributed as a flexible block grant to states to fill gaps in revenue. This federal intervention was very helpful in that it prevented some spending cuts and tax increases, but because it was delivered toward the end of the recession as states were beginning to recover, it was not as helpful in preventing pro-cyclical state actions as it might have been.

<u>The State Fiscal Outlook</u> – The state fiscal outlook has deteriorated over the last several months. In the latest fiscal survey released by NGA and the National Association of State Budget Officers in December 2007, states projected increases in state expenditures of only 4.7 percent in fiscal year (FY) 2008, far below the historic average of 6.5 percent. Revenue growth also is trending downward. Third quarter calendar year (CY) revenue growth from 2007 dropped to 4.4 percent and fourth quarter CY 2007 growth fell to 3.0 percent. At the same time, end-of-year balances, which include rainy day funds, were projected at $46 billion, or 6.7 percent of expenditures, for FY 2008. By comparison, before the 2002 recession states had end-of-year balances of 10.4 percent in 2000 and 9.1 percent in 2001. During the last recession, these reserve funds quickly eroded as the economy declined and states were forced to fill budget gaps to meet balanced budget requirements.

During the week of January 14, NGA surveyed states to update their fiscal information. Seventeen states now expect to have deficits in 2008 totaling more than $14 billion and 15 states are projected to have deficits of $30 billion in FY 2009. If Congress and the Administration determine a federal stimulus package is warranted, they should consider supporting state programs to ward off the pro-cyclical effects of state budget adjustments.

<u>Criteria for Federal Stimulus Policy Initiatives</u> – There is a strong consensus among economists that any stimulus package must meet three primary criteria:

- **Timely –** It is critical that any stimulus package be enacted early in an economic downturn to maximize its effectiveness and minimize its cost. Stimulus policies enacted as a downturn progresses are generally less effective and require more funds to stabilize the economy. In fact, if a stimulus package is enacted too late, it can hurt the economy by contributing to a higher rate of inflation during the recovery phase.
- **Temporary –** The stimulus should be temporary. Although a federal stimulus package may increase the federal deficit in the short-run, it should not increase the long-run deficit. Also, it should last no longer than one year to 18 months.
- **Targeted –** Stimulus policies should be targeted on programs that can spend funds quickly and get cash into the hands of citizens as soon as possible. Some of the most efficient means of distributing funds include personal income tax or payroll tax reductions, personal income tax rebates or additional funding for existing state programs. The primary objective of delivering cash into the economy quickly argues for using existing programs to distribute funds and avoiding programs that payout over several years.

From a state and local government perspective, federal stimulus proposals should aim to avoid policies that hinder the ability of these governments to respond to economic downturns. This principle of **"Do no harm"** requires that any federal stimulus package avoid policies that would exacerbate the fiscal condition of states by diminishing state revenues, shifting costs from federal to state programs or imposing new unfunded mandates.

<u>State Role in Economic Stimulus</u> – As mentioned above, states play a critical role during economic downturns because their ability to maintain services while balancing state budgets is essential to avoiding further erosions in the national economy. More important, however, is the fact that states administer most federal programs, including those designed to assist low-income populations and transportation, economic development, and education programs.

1. <u>Flexible Block Grants</u> – One of the most basic means of countering state pro-cyclical actions is through the provision of funds directly to states on an unrestricted basis. The goal is to temporarily stabilize state budgets and prevent tax increases or benefit or other reductions. During the last downturn in 2002, the federal government provided $20 billion in fiscal assistance to states to help stabilize the economy. Ten billion dollars went towards an enhanced federal match for Medicaid, while the other $10 billion was a block grant to states. The grants are generally unrestricted to allow each state to use the funds in a manner that best met its fiscal needs.

2. <u>Targeted State-Federal Programs for High-Risk Populations</u> – As unemployment increases, the case loads of state low-income programs also increase. Federal investments in targeted state-federal programs can quickly distribute funds to the most needy individuals and help avoid cuts to basic services. Programs falling into this broad category include:

- <u>Medicaid</u>

  The Federal Medical Assistance Percentage (FMAP) is the share of the state Medicaid benefit costs paid for by the federal government. FMAPs are recalculated each year and the new FMAP is applied at the start of the federal fiscal year. The current FMAP formula reflects economic conditions from several years ago, thereby creating a lag that could exacerbate problems states have financing Medicaid during a period of fiscal downturn. In federal FY 2008, 20 states experienced FMAP declines over their federal FY 2007 FMAP. Seventeen states are projected to have FMAP decreases in federal FY 2009, beginning October 1, 2008. At the same time, anecdotal evidence is emerging of increasing state Medicaid program enrollments.

  During the last economic downturn, Congress approved $10 billion to temporarily enhance FMAP percentages for every state by 2.95 percent for five quarters. In addition, a hold harmless provision preventing scheduled FMAP decreases was implemented for periods in 2003 and 2004. Both preventing scheduled decreases and temporarily increasing all states' FMAPs would provide immediate fiscal relief to states by alleviating Medicaid obligations and preventing cuts to programs important to residents during fiscal downturns.

- Food Stamps
  The Food Stamp Program (FSP) is a federally funded, state-administered entitlement program that provides cash benefits to individuals and families to enhance their food purchasing power. Benefits are provided to low-income households through electronic benefits that can be used at most grocery stores. The FSP serves dual purposes: it provides nutritional assistance and supplements the income of low-income individuals and families. In addition to alleviating hunger, the FSP is a critical component in helping states guide individuals and families through the transition to greater self-sufficiency.

  Infusing new money into the FSP to provide assistance to low-income individuals and stimulate the economy. In addition to increasing the food purchasing power of low-income individuals and families, a targeted and temporary increase to the FSP will free up additional income for consumers.

- School Meals
  Another means of supporting the nutritional needs of low-income families is through our nation's schools. An expansion of eligibility for the school meals programs, including the National School Lunch Program, School Breakfast Program, Summer Food Service Program, Child and Adult Care Food Program, and After School Snack Program will help ensure that low-income children have healthy, consistent meals at a primary location outside the home. Currently, children in families at or below 130 percent of poverty ($26,845 for a family of four) are eligible for free school lunch and breakfast. Children in families between 130 percent and 185 percent of poverty (up to $38,203 for a family of four) are eligible to receive a reduced-price meal.

  In FY 2006, more than 30.1 million children participated in the National School Lunch Program, and 7.9 million children received free or reduced-price school breakfast. Considering the economic impact of a recession on low-income families, schools may see an increase in both the participation of and need for meals as more families struggle with daily financial concerns. Additionally, even at a reduced price, families currently still struggle to pay the adjusted price of a meal and may forgo the benefit.

  Congress could temporarily expand the eligibility for free school meals to a higher level of poverty and set a new threshold for reduced-price meals, thereby allowing more children to be eligible for federally subsidized healthy meals.

- Expanding Unemployment Insurance
  The Unemployment Insurance (UI) Program is a federal-state program that serves a core stabilizing function during economic downturns and periods of increased unemployment. Benefits under the program typically run for 26 weeks. Temporary expansions of UI benefits have proven particularly effective in targeting needy populations and putting cash into the economy because families on UI tend to spend benefits quickly to meet day-to-day expenses.

- Transfer Surplus Federal Unemployment Trust Funds to States for Economic Stimulus
  Congress could immediately transfer excess federal funds to state accounts through a Reed Act distribution. These funds would stimulate the economy by supporting weekly unemployment benefits, employment services, and administration of unemployment insurance claims and by reducing the prospect of increases in unemployment payroll taxes as a result of growing lay-off experiences. The added funds bolster state unemployment trust funds at a critical time.

- LIHEAP
  The Low Income Home Energy Assistance Program (LIHEAP) provides funds to states so that they may help low-income households pay home energy expenses. States may use LIHEAP funds to assist families with heating and cooling costs, provide crisis assistance, and pay for weatherization projects. While the Energy Policy Act of 2005 authorized funding for LIHEAP at $5.1 billion, FY 2008 funding was $2.57 billion. Inadequate program funding, coupled with the rising cost of energy and a growing need for financial assistance among low-income families, has resulted in fewer eligible households receiving aid at lower benefit levels; a smaller portion of families' energy expenses being covered by LIHEAP assistance; and a growing number of households having to spend a greater portion of their income on heating and cooling expenses.

  Infusing new money into this program would help stimulate economic growth by increasing the purchasing power of low-income families who traditionally engage in more immediate consumption; providing an avenue for quickly recycling revenue between consumer and provider; and freeing up additional household income for increased low-income household consumption.

3. Job Creation – States manage several programs that could expand rapidly to provide employment opportunities during a recession. The challenge for these programs is meeting the objective of distributing federal funds quickly to maximize the effectiveness of federal investments.

- Expand Obligation Limits for Core Transportation Programs
  Congress could temporarily raise the obligation limitation on core transportation programs such as bridge maintenance, Interstate maintenance, the National Highway System, and the Surface Transportation Program for fiscal year 2008. Every $1 billion in new transportation spending generates approximately 50,000 jobs and $5.7 billion in additional economic activity. Raising the obligation limit would be timely because the 2008 transportation construction season remains several months away. This could provide states enough lead time to execute new or modify existing construction and maintenance contracts for projects ready to go. However, an infusion of additional federal money may not help states that either do not have or cannot reallocate sufficient revenue to meet the state match requirement unless Congress temporarily changes the match as applied to those additional funds.

- School Repair, Modernization, and Construction Projects
  A one-time targeted investment into much-needed and immediate school construction, repairs, renovations, and technological modernization would also help spur job creation. The American Society of Civil Engineers' 2005 Report Card on America's Infrastructure gave our schools' infrastructure a "D". A 2000 study by the National Education Association estimated a need of $321 billion in unmet infrastructure and technology needs and the most recent federal study, performed in 1999 by the National Center for Education Statistics, calculated $127 billion for repairs and renovation of existing facilities. Proper building maintenance, school expansion, or modernization is essential for student and staff health, safety and learning, and in some instances, these improvements help to decrease energy costs. Congress could support a one-time investment for school construction, repairs, renovation and technological modernization.

  In addition, Congress could extend the authority to issue "qualified zone academy bonds" (QZABs) whose proceeds can be used for school infrastructure, such as public school rehabilitation and repair. Currently, the QZAB program provides about $400 million in bond authority to the states for school repair and modernization purposes. However, the QZAB program does not cover other needs including new construction.

4. Mortgage Default Assistance – This economic downturn is unique in that declining home values and the pending mortgage crises are contributing to the economic decline. Foreclosures are expected to continue to grow as subprime mortgages adjust to higher rates over the next year. Supporting programs to prevent foreclosures and promote continued home ownership could help mitigate the effect of declining property values, especially in hard hit states and regions. States already have developed programs working with residential communities and neighborhoods to assist individual mortgage holders so they do not default. This is done by consolidating and convening private sector holders of mortgages. (See *States Take Action to Address Foreclosures in Subprime Mortgage Market* at www.nga.org/center/homeownership.)

- Federal Funding for Homeowner Assistance Programs
  Approximately 20 percent of the states now operate some type of assistance program tailored to homeowners, primarily low- and moderate-income persons, at risk of foreclosure because of the growing subprime mortgage crisis. Currently, eight states run programs that help qualifying homeowners with adjustable rate subprime mortgages refinance into lower fixed-rate mortgages to avoid foreclosure. Congress could channel additional federal money through the existing HOME Investment Partnership Program administered by HUD to help capitalize state-run refinance funds and homeowner assistance programs. HOME provides formula-grant funding to states and localities, including through its American Dream Down Payment Initiative program (ADDI), which assists low-income, first-time homebuyers in purchasing single-family homes.

- Federal Funding for Neighborhood Stabilization Programs
  The economic impact from the subprime mortgage crisis affects not only individuals and families, but also communities in the states where they live. State and local stabilization programs would help preserve the social and economic health of communities that face a concentrated percentage of subprime residential mortgage foreclosures. Through the Community Development Block Grant (CDBG) program, Congress could deliver targeted new funding to help states and local governments capitalize neighborhood stabilization efforts. States and local governments may use CDBG funding to benefit low- and moderate-income families, aid in the prevention or elimination of blight or slums, and to help meet other urgent community development needs that pose a serious and immediate threat to the economic health and welfare of a neighborhood.

5. Existing Regulations – There may be areas where the federal government can merely freeze or waive a regulation that would allow states to avoid expenditures that hinder their ability to fund current programs and provide existing benefits.

- Medicaid Regulations
  Currently, six proposed or final Medicaid regulations are scheduled to take effect at various points in 2008. These regulations would make significant changes to state Medicaid programs resulting in an aggregate cost shift to states of approximately $1.3 billion in the first year and $11.5 billion over five years. Congress approved temporary moratoriums on four of the six pending regulations, two of which expire on May 25, 2008, and two on June 30, 2008. Extending the moratoriums on all of the pending Medicaid regulations would alleviate fiscal pressure from using state-only dollars to maintain critical services and/or avert reductions in essential services or programs used by low-income individuals.

6. State Issues Related to Federal Tax Proposals – Changes to federal tax policy are generally aimed at providing additional cash for individuals to spend or to encourage business to make investments they would otherwise delay during an economic downturn. When properly structured, tax changes can be very effective at getting cash into the economy quickly and nationwide.

State and federal tax systems are closely linked, meaning that changes in federal tax policy that reduce the federal tax base generally have the same effect at the state level. Any policy that would reduce both federal and state tax revenues violates the criteria of do no harm because losses at the state level have to be offset to meet balanced budget requirements. When considering tax changes for individuals or businesses to spur economic growth, Congress and the Administration should take into account the degree to which states conform their income tax base to the federal base and whether the stimulus provided by federal tax changes will be undermined by corresponding revenue losses for states.

- Changes to Personal Income Tax

  A review of past stimulus packages demonstrates that tax changes focused on individuals can generate immediate positive results for the economy. In particular, tax benefits aimed at putting cash in the hands of lower income households are most effective because such individuals tend to spend extra cash more rapidly than high-income individuals. Currently, 36 states, plus the District of Columbia, conform their individual income tax base to the federal individual income tax base. Refundable tax credits distributed directly to individuals through checks would not affect the federal or state tax base; that is, they will not reduce state revenues, yet put additional cash in the hands of individuals and benefit all income levels. Likewise, nonrefundable tax rebates would not reduce state revenues, but would exclude those portions of the populations that have no income tax liability, thus diminishing their stimulus effect. Furthermore, they will not reduce state revenues.

- Changes to Business Taxes

  Tax changes designed as incentives to encourage business to invest in equipment and structures are another popular form of tax stimulus. Studies of bonus depreciation policies enacted in 2002, however, indicate that such incentives are not as effective as measures aimed at individuals. They also reduce state revenues, thereby exacerbating economic conditions in states, undermining the effect of the federal stimulus and violating the criteria of do no harm.

  Because most states conform to federal rules on depreciation in the calculation of their business income taxes, changes to federal depreciation calculations also affect state taxable income. In 2002, federal bonus depreciation provisions were projected to reduce revenues in 47 states by more than $14.7 billion over three years. To counter these revenue losses, all but 13 states decoupled from the federal depreciation rules. Decoupling prevents immediate revenue losses at the state level, but it also increases complexity for states and taxpayers as businesses must conform to different depreciation schedules in different tax jurisdictions. Most states have once again coupled their depreciation rules with federal guidelines. If federal officials adopt temporary accelerated depreciation provisions as part of a stimulus package, states will either once again decouple from the federal system, or be forced to raise revenues or cut spending to counter the loss in business income tax revenues.

  Alternatively, investment tax credits can have the same stimulus effect on business investment without undermining state revenues. Tax credits are preferable for states because they do not reduce federal taxable income upon which state business taxable income is based. The credit still encourages business to make investments in equipment and structures in the near term, but does not require states to undertake countervailing measures to protect revenues.

NASBO Chart

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