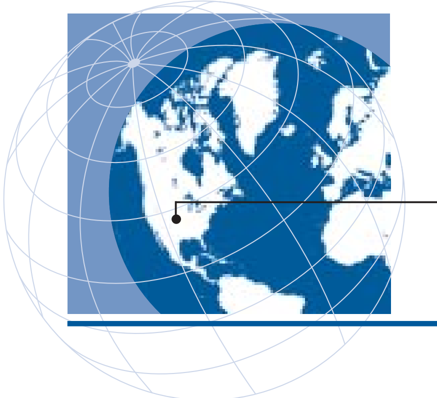

Fiscal policies and a weak economy fray U.S. federal fabric

When the federal government tries to both cut taxes and wage war it squeezes the states.

BY *ROBERT AGRANOFF*

The war with Iraq and the "war" against terrorism internationally have lowered the visibility of a domestic economic situation that cuts at the very core of the United States federal system.

At the federal level, the Bush Administration has proposed large tax cuts to stimulate the economy, a return to deficit spending and revamping of health care programs. The states are facing a combined $30 billion shortfall this fiscal year, and an anticipated combined deficit of $82 billion in the fiscal year that begins in July. Since virtually all states are constitutionally prohibited from running non-capital fund deficits, their only recourse is to reduce services and raise taxes.

State fiscal policies are closely tied to federal actions in taxing and spending and state governments have to meet the costs of federal program requirements. And so state governors have sought federal help.

Governor Paul Patton (D-Kentucky) makes a point as Gov. Dirk Kempthorn (R-Idaho) and Mike Johanns (R-Nebraska) listen at the governors' conference. (Evan Vucci – AP)

To date, the Bush administration has chosen a different route.

> ***"The Bush administration is hoping that the combination of low interest rates and large budget deficits will provide a huge boost to a slow economy."***

The basics of President Bush's economic stimulus plan involve a ten-year $695 billion tax cut, which includes eliminating taxes on dividend earnings, accelerating already enacted tax rate reductions, and making the "temporary" 2001 tax cuts permanent. The administration estimates that federal revenue would shrink about $1.8 trillion through the year 2013. Historically about one-third of the federal budget pays for all domestic discretionary programs (education, disability services, housing, transportation); one-third so-called "entitlement" programs (social security, Medicare, Medicaid) and one-third is allocated for defense spending. Given the current international situation defense spending cuts are unlikely so the federal government is seeking reductions in other areas, along with deficit spending. The Bush administration is hoping that the combination of low interest rates and large budget deficits will provide a huge boost to a slow economy.

Michigan Governor Jennifer Granholm: tough times, hard choices.

Federal tax changes hit states

Among recent federal actions that have had a big fiscal impact on the states was the repeal of the federal estate tax. About 35 states have been using a "pick-up" provision where their tax on estates or inheritance is a payment taken as a credit against the federal payment, a revenue source for the states of about $6 billion in 2000. Federal repeal means that states must

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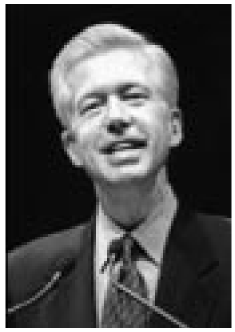
"decouple" their receipts and pass new tax laws or these receipts will disappear by 2004.

Most states with an income tax use the federal definition of adjusted gross income for purposes of simplification. The proposed elimination of federal taxes on capital gains would automatically eliminate state taxes in that arena. State and local bonds are exempt from federal taxation, which allows the states to borrow for capital programs at low rates. If corporate capital gains income taxes are eliminated, there will be less advantage in investing in state bonds, and state borrowing rates will increase. The well-respected Center on Budget and Policy Priorities estimates that 11 of the administration's tax cut proposals will cost the states up to $64 billion in revenues over the next 10 years.



Governor Gray Davis (California): "Recession has forced us into the red."

The Medicaid Monster

Medicaid, the program that funds health care for the poor, has been referred to as "the PAC-MAN of state budgets," taking up increased portions of spending, now at an average of around 20 per cent of all state spending, and up to one-third of all expenditures in some states. As a federal-state program, the federal government sets minimum requirements for benefits, eligibility, and reimbursement of health care providers, and establishes administrative rules that states must follow. States can expand those eligible to include the "medically needy," i.e. those just over the poverty line. Elderly people comprise just 15 per cent of the recipients but use up nearly 60 per cent of expenditures, primarily in nursing home and hospital care. States can also offer a number of additional services from a federally provided list of optional services. While Medicaid costs increased by about 5 per cent per year in the early 1990s, cost increases in fiscal year 2002 were at 13 per cent. In fiscal year 2004, Medicaid will approach $230 billion in federal and state spending.

In early 2003 the Bush administration proposed a basic change to the Medicaid program. States would have the option to enter into a new flexibility agreement. Although mandatory recipient coverage would remain, states would have broader powers to expand, reduce, or eliminate benefits for the other recipients. States would be given flexibility to design private health plan "buy-ins" for Medicaid eligible recipients. Funding for those states that opt in to the reform would be increased by a total of $3.25 billion for fiscal year 2004, and a total of $12.7 billion over seven years. These amounts would be tied to a fixed state allocation. If costs go down, the states would benefit from the added payments. However, states would have to give up the existing open-ended funding allocations to meet their spending.

At the National Governors Association Winter Meeting in Washington, D.C. in February 2003 there was not great enthusiasm for the Bush proposal. Governors estimated that the long sought after flexibility to reduce costs would only affect about 15 million of 45 million Medicaid recipients. They expressed concern that the proposal would eventually cap federal Medicaid contributions.

Medicaid costs, it was pointed out, are unlikely to go down, because of the rising costs of prescription drugs, medical technology and increasing costs of elderly and disabled care. It could also lead to large financial burdens for the states at the end of the seven-year period. Republican governors argued that more recognition should be given to the fact that every dollar in state cuts will save the federal treasury one to two dollars and as a result, flexibility should be handed over now. A Republican governor suggested that the federal government should allow the states to keep the federal money they save, and that Medicare, a social insurance program primarily for the elderly, should assume the entire cost of health care for those elderly that are on Medicaid (about six million people). Some Democratic governors, and members of the Congress and Senate, have called for temporary increases in the federal share of Medicaid. On the other hand, the House majority is working on a $92 billion, ten-year *reduction* in Medicaid spending.

The governors could not agree on a Medicaid reform position at the meeting, so they established a committee of eight governors – with both Democrats and Republicans - to negotiate with the administration and Congress on Medicaid revisions.

Between 1990 and 2001, a booming economy led to annual state general fund spending increases of over 5 per cent, twice the rate of inflation and faster than federal spending. States expanded big-ticket programs such as education and Medicaid options, and broadened eligibility for many social programs while enacting tax cuts. The current deficit situation is triggered not only by the economic slowdown, but by the collapse of the stock-market peak and rising health care costs. State tax revenues in the fiscal year ending June 30, 2002, proved to be far lower than estimates: sales tax, $147.6 billion, 3.2 per cent lower than projections; personal income tax, $187.7 billion, down 12.8 per cent and corporate income tax $21.6 billion, at 21.5 per cent lower than expected.

The first round of relatively easy one-time spending cuts and funding shifts have already been made, and the "rainy day" reserve and tobacco settlement trust funds are virtually depleted. As is the situation with most states, after California meets its obligations to school districts, colleges and universities, local governments, and health care providers, it has committed about three-quarters of its budgets. In its fiscal year 2003 budget of $79 billion, California has only $18 billion to fund state agencies and programs other than its obligated funds according to Governor Gray Davis. The state is facing a $35 billion deficit, which obviously cannot be met by marginal cuts here and there. In fact, only three states – New Mexico, Arkansas and Wyoming – expect their fiscal ledgers to balance next year.

Kids with disabilities and defending the homeland

State responses have mainly come in the form of across-the-board spending reductions. Some 30 states have cut spending, targeting health care, education and prisons. Kentucky has released lesser-offense prisoners up to one year early. Oregon cut their school year by one month. Forty-nine states

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and the District of Columbia have reduced Medicaid benefits, including restricting or eliminating dental coverage, occupational or physical therapy, and decreasing spending on long-term care services. About half of the states are considering higher taxes, particularly on cigarettes and alcohol.

"Economic and job growth will come when consumers buy more goods and services from businesses such as your own. And the best and fairest way to make sure Americans can do that is to grant them immediate tax relief so they have more of their own money to spend or save.

"In 2001, the Congress passed broad tax reductions in income taxes. And promised much of this tax relief for future years. With the economy as it is, the American people need that relief right away. The tax cuts are good enough for the American taxpayers three or five or seven years from now, they are even better today."

U.S. President George W. Bush, addressing small business people at the White House, April 2003

"Much of what we've built is being threatened by a struggling national economy and declining stock market. Personal income is down. Employment is down. Retail sales and manufacturing are down. This national recession has forced nearly every state in America into the red. These are tough times. On Friday, I will send you one of the toughest budgets ever presented. It will make significant cuts in nearly every program. My budget will erase the $35-billion shortfall and eliminate the structural deficit. Already, my Administration has begun the hard work. We've frozen hiring and spending. Eliminated more than 10,000 positions. Identified more than $10 billion in reductions."

From State budget presentation by California Governor Gray Davis

"The problem we face in Michigan today is one that any family in our state can understand. You simply can't spend more than you make, month after month, year after year, without digging yourself into a deep hole. But, that is exactly what we've done in Michigan, and together we must fix it.

"The days of spending beyond our means are over. As long as I am your Governor, this state will live within its means."

From State budget presentation by Michigan Governor Jennifer Granholm

Medicaid was not the only federal concern on the governors' minds at their midwinter meeting. They focused on three additional federally mandated programs that they say present significant underfunding challenges. First is the cost of homeland security programs, for which state and local governments bear the bulk of implementation costs. The $3.5 billion proposed by the administration will cover only a small fraction of the actual costs. Second are special education requirements for children with disabilities. The federal government has committed itself to paying 40 per cent of the cost of these programs, but have actually provided only 17 per cent. Third is the "No Child Left Behind" education law, for which the governors claim that only half the promised amount of money is budgeted. The states report great frustration with federal rules for testing and accountability, which have constrained state policies along with driving up costs. Combined, the cost of these three program requests is $21 billion. The governors hope the federal Congress will agree to fund at least half of that amount.

Do the states get relief?

Several proposals to provide tax relief to the states are on the congressional agenda. Democrats in both houses have introduced around $140 billion in tax cuts and aid to state and local governments for the current fiscal year and $112 billion more over the next ten years. A "State and Local Aid and Economic Stimulus Act of 2003," introduced in the Senate provides $40 billion in direct, no-strings-attached federal aid to the states and local government. Both Democrat and Republican sponsors are pushing a "State Budget Relief Act of 2003" in both houses that provides temporary boosts of money for Medicaid and the Social Service Block Grant program. The Bush economic plan proposes no funds for state relief. After an unusual two-hour working meeting with President Bush at their Winter National Governors Association Conference (normally presidents only speak before the group and answer questions), the president asked for support for his tax cut proposals and pledged cooperation but not more money. Tax cuts, Bush said, will help restore economic growth, which is the best long-term financial help the federal government can provide to the states.

Getting on Bush's agenda

Federally-mandated and program-generated costs, particularly the Medicaid behemoth and the impact of federal fiscal policies, increasingly bring the governors and other associations of state and local officials to the president and Congress for redress. Normally the governors do not meet in formal negotiation sessions with the president, like the first ministers conferences in Canada and Australia. Also, unlike Spain, where the regional presidents periodically testify before

The Bush tax and spending cuts, which are sure to be somewhat modified by congressional action, once again raise the issue that governments may be in different boats, but are subject to the same tides.

the Cortes on matters of autonomous community concern, and have powers of legislative introduction, United States governors rely on the National Governors Association, other associations of state officials, and staff members and lobbyists.

There have been two attempts at "Federalism Summits" of governors and state legislative associations. The first, in 1995, focused on ways for states to control and even block federal actions and to enforce the Tenth Amendment to the Constitution, which reserves powers to the states. The second, held in 1997, focused on federal mandates and preemptions. An eleven-point plan, designed to enhance the idea of federal-state partnership, included recommendations calling for Congress to justify its constitutional authority to enact a given bill, limit and clarify federal preemption of state law and federal regulations, streamline block-grant funding, and prohibit conditions of federal aid not tied to the aid purposes.

The states may have created some of their own problems by their tax cutting and spending decisions of the 1990s, but the federal government bears a large share of the culpability, for which the states want fiscal redress.

This intergovernmental agenda calls attention to the grievances that the states feel, and forms the strategic backdrop for their national meetings and lobbying. The Bush tax and spending cuts, which are sure to be somewhat modified by congressional action, once again raise the issue that governments may be in different boats, but are subject to the same tides. The states want recognition and relief regarding the increasing number of national actions that impact them in financing and in programs, many of which were originally parachuted on them by Washington.

Underfunded federal programs

As is the case with many federal countries, the United States has a highly "intergovernmentalized" system of programs that are joined despite constitutional and legal divisions of responsibilities. These ties are often woefully financed, as the case with services for the disabled, homeland security, and education, all of which partially preempt preexisting state or state-local programs and regulations. Education is a prime example where the federal government funds under 10 per cent of all costs, but influences state-local programs with its equality of opportunity and disadvantaged population requirements. Often program mandates go underfunded or completely unfunded. For example, the 1996 Congress enacted what is popularly known as "Megan's Law" which requires states to keep records of the location of freed rapists and child molesters, and to make those lists available to the public. With this unfunded mandate, failure to comply means federal crime funds to the states can be reduced. The United States Conference of Mayors estimates that cities are spending $2.6 billion on new security measures without receiving any federal assistance. Congress passed legislation in January 2003 to upgrade equipment and train election poll workers. These new federal voting standards are superimposed on election procedures that are constitutionally state administered. Only $1.5 billion of the $4 billion authorized for the states to comply with the election law has been appropriated.

Hard times plus underfunding and nonfunding

These conditions hardly threaten the existence of the United States as a federation, but they shake at its core. As is the case for the majority of the world's federations, the combined forces of communication, industrialization, welfare state programs, and global and international connections have brought state and local governments closer together with the United States government.

It is also true that like most federations, degrees of centralization in the general government are coupled with forms of decentralization throughout the system. However, when times are difficult, such as with the current threats to internal security and economic downturn, along with the need to finance war efforts, their attendant costs put inevitable strains on multi-level systems. The states may have created some of their own problems by their tax cutting and spending decisions of the 1990s, but the federal government bears a large share of the culpability, for which the states want fiscal redress.

The situation of underfunding and nonfunding in hard economic times poses a real test of the federal-state relationship, weakens the "bargain" related to federal movement into state policy arenas, and threatens the states' ability to meet their requirements and produce constitutionally required balanced budgets. If these conditions continue for some time, it is possible that some federal "reweaving" will occur through changes that reposition the states in the American federal system.