Laboratories of Underfunding?
State Financing for Antipoverty Efforts after the Recession

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Paper Prepared for
The Georgetown University and Urban Institute
Conference on Reducing Poverty and Economic Distress after ARRA
January 15, 2010

April, 2010
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Introduction

State governments help finance most U.S. antipoverty programs. The Great Recession has documented, as never before, the major flaw in this approach: the need for these programs is higher than ever, at exactly the moment that the ability of state governments to pay for them is at a low point. The resulting budget gaps have led states to enact significant cutbacks to programs, including cuts to antipoverty programs, and additional such cutbacks are likely. However, these cutbacks would have been far worse if the federal government had not provided assistance directly to states to help them meet the increased demand for assistance in the midst of declining revenues. The federal government responded with a mix of general aid to state and local governments, direct support to families in need, and targeted support to meet the increased demand for select antipoverty programs. All these categories of assistance have reduced the harm to low-income families from recession-induced state budget cuts, and this represents a success story that can be built upon for future recessions.

At the same time, there is little doubt that states will continue to bear a very large share of the responsibility for antipoverty programs for a long time into the future. The experience of states in this recession, combined with the substantial possibility of a very slow recovery for state and local finances, suggests that states must enact major reforms to tax and budget systems in order to fulfill that responsibility.

This analysis first examines the factors that constrain states’ abilities to maintain critical services and respond to increasing need during times of high unemployment and economic vulnerability. It then describes how states and the federal government responded to the Great Recession. It concludes with an outline for financing strategies for the federal government to reduce poverty in the upcoming protracted period of high unemployment, and mechanisms that the federal government could enact now to provide, automatically, the additional funds needed in the next recession. These include improvements to the matching-rate formulas in Medicaid, TANF, and other programs. The final section also outlines the steps that states must take in order to make their own tax and budget systems better able to respond to periods of economic distress, including improvements to rainy-day funds, revenue and expenditure forecasting, and revenue reform.

State Budgets and Antipoverty Programs in the Great Recession

Healthy state budget systems are necessary to finance antipoverty efforts adequately. Most major U.S. antipoverty programs, to at least some degree, rely on state as well as federal dollars. Direct assistance programs such as Temporary Assistance for Needy Families, Medicaid, and unemployment insurance are all jointly financed by federal and state tax dollars, although the specific mechanisms vary greatly. The Food Stamp Program (now the Supplemental Nutrition Assistance Program, or SNAP) is entirely federally funded, but states help finance the cost of administration. States have even taken a role in providing assistance to working families by creating state-funded earned income tax credits (EITCs) that build on the federal credit; about half the states supplement the federal EITC with a state credit that they finance and administer themselves.

States also play the lead role in other key areas of domestic spending essential to securing long-term economic benefits for low-income individuals, families, and communities, in areas that
range from early childhood education, K–12 education, community colleges, and public universities to public safety, transportation, and community development.

It has long been recognized that there is a major danger in giving states the primary responsibility for financing these programs, particularly during recessions. Recessions reduce the amount of tax revenue available to finance programs. Unlike the federal government, states are very constrained in their ability to run operating deficits. Every state except Vermont legally requires a balanced budget, and on top of those requirements, every state faces legal, political, and practical barriers that make it somewhere between very difficult and impossible for them to borrow money to cover operating costs.

As a result, a recession is a time when states have less resources to pay for public services. But the cost of those services—principally education, health care, transportation, public safety, and support for vulnerable families—does not decline. A recession is also a time when the number of people in need is higher, meaning that the need for those resources is higher, not lower. The result is that in every recession, the vast majority of states experience budget shortfalls—gaps between available revenues and the cost of ongoing services. And even states that prudently set aside funds in good times never have enough reserves to fully close those gaps. So they must cut services, raise new revenues, or—most commonly—do both to bring their budgets back into balance.

Cuts in services can harm the economy and often burden those whose services are cut. Cuts for vulnerable residents in an economic downturn are particularly problematic. It is impossible to justify a system where people who become unemployed and poor in a recession receive less assistance from public programs than if they had become unemployed and poor in an economic expansion.

The Great Recession that began in late 2007 has given us a particularly stark lesson in the flaws of the current system. Declines in housing values and other forms of wealth have depressed consumption, reducing revenue collected through state sales taxes. Declining incomes and rising unemployment have depressed state income tax collections. Total state tax revenues in the first three quarters of 2009 were 13.3 percent below the level of the year before, according to U.S. Census Bureau figures. State revenue forecasters expect tax revenues to continue to underperform, remaining weak at least as long as unemployment remains high, which means it will be 2012 or 2013 before there is significant recovery. Meanwhile, Medicaid enrollment grew in 2009 at a 7.5 percent rate, placing large new financial pressures on states, and rising participation in food stamps and other programs has further challenged states’ abilities to provide adequate services.

The result of declining revenues and increasing need is record-level budget gaps that states must address. For the 2009 fiscal year, states faced $110 billion in budget gaps that they had to address. For the current (2010) fiscal year, reported gaps—both those already closed and those that have more recently opened up—total $193 billion, equal to 28 percent of states’ general fund spending. Gaps could well total another $180 billion for fiscal year 2011 and $120 billion in 2012.

(Note that neither local governments nor private philanthropy can fill the gaps left by reductions in state funding. Local governments face many of the same budget strains as state governments, due to declining revenue from sales taxes and, in many places, property taxes. And private philanthropies, which even in the best of times are not well funded enough to fill in for
States’ solutions to those budget gaps have been very harmful to vulnerable families. The Center on Budget and Policy Priorities has been tracking state responses to budget shortfalls, and the results are sobering. At least 43 states have scaled back services that are important to vulnerable families. These include cuts to health care programs (28 states), services to the elderly and disabled (24 states and the District of Columbia), K–12 education (27 states and the District of Columbia), higher education (36 states), and other areas.2

- In health care, for example, Minnesota is cancelling a health insurance program for 29,500 low-income adults, Rhode Island eliminated coverage for 1,000 low-income parents, Tennessee has frozen enrollment in its children’s health insurance program (CHIP), and California is increasing the costs borne by families of nearly 1 million children that participate in CHIP. Washington is increasing premiums by an average of 70 percent for a health plan serving low-income residents.

- In the area of seniors and people with disabilities, Ohio has made deep cuts to community mental health services, Rhode Island is requiring low-income elderly people to pay more for adult day care, and Arizona eliminated temporary health insurance for people with serious medical problems, among other cutbacks.

- Education cuts are affecting the ability of school districts to provide an adequate education to all children. A cut in funding means that as many as 10,000 children in Illinois may lose eligibility for early childhood education, and Massachusetts is reducing funding for a number of early care programs. Education funding formulas that equalize spending between low-wealth and high-wealth school districts are being cut in a number of states as well. Michigan and New Mexico have made deep cuts to need-based financial aid programs for colleges and universities.

- Direct assistance programs for low-income families also have been reduced. Among other examples, Arizona is reducing TANF cash assistance grants for 38,500 low-income families. The District of Columbia has cut homeless services funding by more than $12 million, or 20 percent, and reduced cash assistance payments to needy families. A tax credit for low- and moderate-income renters in Minnesota has been cut by 27 percent. Texas has cut the number of children in a child care subsidy program by about 4,000 and increased waiting lists.

Governors are now releasing their budget proposals for the upcoming fiscal year, 2011. Initial indications are that these proposals—and the eventual enacted budgets—are likely to include additional, deeper cutbacks in all these areas.

**Federal and State Strategies to Reduce the Negative Impacts of the Recession**

Despite the severity of the budget cuts, they could have been worse. Both the federal government and state governments have taken significant actions to mitigate cuts to antipoverty and other programs resulting from this recession. At the federal level, the primary response has been enactment of the American Recovery and Reinvestment Act (ARRA). States have used those reserve funds that have been available, some limited borrowing and other “one-time” measures, and—of particular significance for low-income families—tax and fee increases.
**Federal Action: The American Recovery and Reinvestment Act**

ARRA includes three key strategies to help states meet the needs of vulnerable citizens: state fiscal relief, direct aid to families (such as increased food stamp and unemployment benefits), and targeted assistance to help pay for increased expenditures directly related to the recession. Fiscal relief was the largest and most important to states. ARRA allocated significant funds to help states close their budget gaps, mostly in the form of (1) a temporary increase in federal Medicaid matching rates (FMAPs) consisting of a 6.2 percentage-point increase in every state’s matching rate, plus a “hold harmless” provision preventing matching rates from declining under the current formula, and an additional increase for states with large jumps in unemployment that is boosting the federal share for the hardest-hit states by an additional 5 to 7 percentage points; and (2) a new State Fiscal Stabilization Fund (SFSF) distributed to states mostly on a per capita basis for education and other services.

It is difficult to know with any certainty what states would have done in the absence of those federal funds, but nearly every analyst of state finances agrees that cuts in state services would have been much greater. On average, the ARRA Medicaid and SFSF funds are closing one-third of states’ budget gaps for the current fiscal year. Had those gaps been closed with additional state spending cuts instead of federal funds, the consequences for state services would have been dire.

However, as things now stand, the ARRA aid to states will run out sooner than state revenues will have recovered sufficiently. The enhanced FMAP rates expire on December 31, 2010, midway through most states’ fiscal year 2011. SFSF funds are available until September 2011, but preliminary indications are that states will have used up most of the money by the end of the current fiscal year. The House of Representatives has approved a six-month extension of the enhanced FMAP and an additional $23 billion in the SFSF for education jobs, which will help bridge the gap. In separate legislation, the Senate also has approved the FMAP, suggesting a significant likelihood that the FMAP extension will pass this spring.

**State Action: A Balanced Approach That Includes Revenues**

Since states must balance their budgets, reserve funds now are largely expended and federal funds (even with extensions) will close only a portion of budget gaps, states have only two choices: either enact very deep cuts in services or take the more balanced approach of somewhat smaller cuts combined with some new revenues.

Since the recession began, states have enacted some $31.7 billion in tax and fee increases, reducing their 2010 budget gaps by roughly one-sixth. Tax and fee hikes are generally preferable to cuts in services for vulnerable families because they spread the burdens more broadly. And some states have structured their tax increases in ways that mostly affect higher-income families and corporations. Nonetheless, a substantial share of those tax and fee increases—roughly one-third—have been consumption taxes that have raised the cost of living for low-income families. Five states have increased general sales tax rates by a penny or more, and several dozen have increased excise taxes on tobacco, alcohol, or gasoline. And a number of states have increased vehicle fees, gambling revenues, or user fees. These new revenues represent a higher share of income for poor families than for other income groups. An option for states is to use refundable tax credits or other mechanisms to offset the impact of these tax increases specifically for low-income families. But only a few states have done so. Indeed, the governor of New Jersey has proposed reducing the size of the state’s earned income tax credit to help balance the budget.
In the coming year, as states grapple with their worst budget projections yet—further worsened by the waning of federal aid and the fact that state reserves now are mostly drained—they are likely to consider even more tax and fee increases. Their ability to do so will be hampered by several factors, including the existence in some 15 states of constitutional rules requiring a supermajority legislative vote to raise taxes and uncertainty over how voters would react to tax increases in the upcoming 2010 elections. (Three-quarters of the nation’s governorships and most state legislative seats will be at stake this November.) On the other hand, polling data show that state voters support a mix of tax increases and spending cuts rather than either tax increases or spending cuts alone, suggesting that tax increases might account for a larger share of the gap-closing measures in the coming year or two than they have until now.

**Long-Term Solutions to the Problem of Financing State Services in Recessions**

The federal and state policy responses to the problem of inadequate state financing for antipoverty and other programs in this recession offer lessons for the future. At the federal level, the Recovery Act offers a partial model. The success so far of the FMAP increase and establishment of the SFSF in reducing state budget cuts suggests that the federal government should consider similar action in future recessions, although perhaps with a greater commitment of funds relative to the size of the recession.

But there is no guarantee a future Congress would provide aid in a timely manner. Countercyclical aid to states in the wake of the 2001 recession was not enacted until late 2003, and even ARRA came over a year into the recession. Moreover, by enacting legislation now that creates an automatic countercyclical mechanism, Congress might be able to develop a formula that—in contrast to the SFSF’s per-capita formula—targets assistance more tightly on those states that turn out to be hardest hit.

One component of such a future mechanism could be a countercyclical Medicaid formula, in which the federal matching rate for a given state would automatically increase as unemployment rates rise during a recession (somewhat similar to the ARRA Medicaid increase). The goal in designing such a program should be covering not just the cost of caseload increases associated with a recession but also the loss of underlying tax revenue to pay for the state share that occurs in downturns. Similar adjustments could be made to the financing structures of other federal programs that have matching requirements or maintenance-of-effort requirements, including TANF, Title I and other education funds, and food stamp administrative funds, to give a few examples. (The temptation to relax maintenance-of-effort requirements in a downturn should be strongly resisted; if the federal government is to invest additional funds in such programs during a recession, states must assure a continued level of dedication to the programs.)

Such formulas should take into account both sides of the recession problem that states face—the increase in the number of people in need of assistance under these programs and the decline in states’ revenues available to finance the programs. A one-sided solution that only solves part of the problem could actually make things worse by giving the appearance of solving the entire problem.

Such changes could help rebalance the federal and state roles in financing antipoverty programs specifically and domestic public services more generally. The result would be good for the economy—by increasing the automatic countercyclical responsiveness of the federal government to recessions—and good for antipoverty policy.
States, too, could start to begin now to put in place policy changes to help them respond better to future recessions. States could put more money into their rainy-day funds and other reserves during economic expansions; one way to increase the likelihood that will happen would be to remove statutory or constitutional caps and other barriers that in a number of states limit the size of such funds.

States could also address the problem of “tax expenditures,” which are credits, deductions, and other aspects of tax codes that reduce revenues. Tax expenditures cost state treasuries money in much the same way as direct spending for schools, health care, or road construction. But states typically subject tax expenditures to less scrutiny than direct spending, and in a recession many states’ budget rules often make it difficult to cut tax expenditures—requiring even greater cuts in direct spending. States could change their budget processes so tax expenditures receive the same level of scrutiny and can be cut as easily as direct spending.

Finally, states could do more to uphold their end of the federal-state cost-sharing bargain—during good times and bad—by enacting long-overdue reforms to their revenue systems. Most states’ tax systems remain better suited to a 1950s manufacturing-based economy than to today’s service-oriented, multistate and global economy. For instance, most states’ sales taxes are levied predominantly on goods, not services, and often fail to capture much Internet-based commerce. Multistate corporations enjoy favorable tax treatment in many states relative to in-state corporations. State income taxes remain relatively flat and therefore fail to grow at a rate commensurate with the dramatic increase in incomes among the very wealthy. Inelastic. Property tax assessment practices are in need of modernization. And states are overly prone to cut taxes during economic expansions, meaning that their revenues are declining from a low base when recessions occur. State tax reform and budget-process reform can not only make state finances stronger but also address the oft-expressed federal concerns that states are too prone to fiscal self-sabotage to warrant increased federal assistance.

**Conclusion**

The Great Recession has shown clearly that the federal-state system for financing antipoverty programs and other public services, as it stands today, is deeply flawed. The response of the federal government in enacting ARRA—imperfect though it was—shows that it is possible to address these flaws, as do some of the actions that states have taken to reduce the size of the cuts in services they otherwise would have had to enact. But ARRA was a one-time measure that a future Congress may or may not repeat, and the combination of ARRA and states’ revenue-raising and other actions has not been sufficient to prevent extremely problematic cuts. What is needed is a strong, permanent, and automatic source of countercyclical funds for states, as well as an ongoing strategy of state fiscal reform.

**Notes**

2. These figures and the examples that follow are drawn from Nicholas Johnson, Phil Oliff, and Erica Williams, “An Update on State Budget Cuts,” Center on Budget and Policy Priorities, updated March 8, 2010.