2006 Rockefeller Institute Reports on State and Local Government Finances

Impact of Proposed 2007 Federal Budget Actions on States

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This is the third in a series of three reports by the Rockefeller Institute of Government on current financial challenges and issues facing state and local governments. It is based on Donald Boyd's article "State Finances: Solid Recovery But Challenges Ahead," from the 2006 edition of *The Book of the States*, scheduled to be released in June 2006 by the Council of State Governments.

While the federal government defines and funds many important national programs, state and local governments often implement these programs, and are highly dependent on federal aid. When the federal government cuts grants in aid, as the president's budget for fiscal year 2007 proposes, it is felt in statehouses throughout the nation.

Federal grants to state and local governments amount to about 17 percent of the federal budget. Nearly 90 percent of these grants go directly to state governments, and account for almost 30 percent of state general revenue. Medicaid, the federal-state program that finances health care for the poor and medically needy, is by far the largest federal grant program and accounts for more than 40 percent of all federal grants. Income security (such as housing assistance and nutrition programs for children and pregnant women), education and training, and transportation are the other large federal grant areas, as Figure 1 shows.

The president's 2007 budget proposed to cut most grants to state and local governments substantially, particularly in years beyond the initial budget year. Figure 2 shows that after adjusting for inflation and population growth, reductions in most categories are proposed to be 20 percent or more between 2005 (the most recently completed year) and 2011. The two major exceptions to this

Figure 1

Federal Grants to State and Local Governments
Federal Fiscal Year 2006 (OMB Estimates)

		Amount *($ billions)*	Share of Total
Medicaid	$	192.3	42.8%
State Children's Health Program (SCHIP)		5.8	1.3%
Other health programs		12.5	2.8%
Health total		210.6	46.9%
Temporary Assistance to Needy Families (TANF)		17.4	3.9%
Housing and urban development		31.3	7.0%
Other income security		45.0	10.0%
Income security total		93.7	20.9%
Education, training, employment, and social services		60.3	13.4%
Highway aid from the Highway Trust Fund		32.6	7.3%
Other transportation aid		14.1	3.1%
Transportation total		46.7	10.4%
Community and regional development		22.3	5.0%
Other federal grants		15.6	3.5%
Total federal grant outlays	$	449.3	100.0%

Source: Federal Budget for Fiscal Year 2007, Historical Table 12.3

are Medicaid and transportation. Real per capita Medicaid expenditures are projected to grow 21.6 percent over the period, driven by the many factors currently affecting health care spending throughout the economy. (The president's budget does propose some cuts that would reduce the growth of Medicaid spending, as the previous section noted.) Transportation grants are expected to grow 4.6 percent, reflecting the revenue projected in the federal Highway Trust Fund. All other categories, on average, are expected to be cut by 21.6 percent, with the three largest areas all suffering extensive cuts.

These cuts, if implemented, would have a broad impact on individual programs and on state budgets as a whole. The net cuts in non-Medicaid grants would be equivalent to about 4.4 percent of total state government tax revenue. This is about half as large as the falloff in state tax revenue between 2001 and 2003, and is several times larger than the falloff in the previous fiscal crisis. It would not be as sudden; it would give states opportunity to plan, but it would undoubtedly be more enduring. And although states can reasonably expect revenue to rebound after the worst of a recession is over, there would be no reason for states to expect a resurgence of federal grant revenue after cuts go into effect.

Figure 2

Proposed Federal Outlays for Grants to State and Local Governments, Real Per Capita
President's Budget for FFY 2007

	2005	2011	Change	% Change
	(real per capita, 2006 dollars)			
Medicaid	$ 627.3	$ 762.8	$ 135.6	21.6%
Transportation	149.7	156.6	6.9	4.6%
Other grants	$ 694.4	$ 548.3	$ (146.0)	-21.0%
Income security	313.7	274.0	(39.8)	-12.7%
Community and regional development	69.6	30.8	(38.8)	-55.7%
Education, training, employment, and social services	197.6	159.0	(38.6)	-19.6%
Administration of justice	16.5	6.7	(9.8)	-59.2%
Non-Medicaid health	55.7	48.5	(7.2)	-12.9%
Natural resources and environment	20.2	14.4	(5.8)	-28.6%
General government	15.1	10.0	(5.1)	-33.6%
All other	5.9	4.9	(1.1)	-17.9%
Total outlays for grants to state and local governments	$ 1,471.4	$ 1,467.8	$ (3.6)	-0.2%

Sources: Federal Budget for 2007 historical table 12.1 and budget tables 12.1 and 25-13; Census Bureau population data for 2005; plus assumed population growth of 0.85% annually.

Notes: 2005 is used as comparison year, rather than 2006, to ensure that the base year is not boosted by temporary payments related to Hurricane Katrina, which would overstate the size of cuts

State budgets may also be affected by changes to federal tax policy, not just spending reductions. In large part, many changes to federal income and corporate tax bases automatically pass through to corresponding state tax bases. It can be difficult both administratively and politically for states to "de-couple" from federal tax policies in these areas. The president's budget includes proposed tax cuts that would flow through to states, as well as extensions of existing tax cuts. A $69 billion tax cut package has been passed by Congress and signed by the president that would extend certain existing reductions. The largest proposed new tax cut is a liberalization of the rules for Health Savings Accounts (which allow tax-deductions for savings dedicated to health spending); this measure would increase the amounts that taxpayers may exclude from taxable income. Some federal changes may increase revenue in the short term, including a provision that would allow taxpayers to pay taxes now on Individual Retirement Accounts to receive more favorable tax treatment in future years — raising federal and state tax revenue in the short term — and reducing it in the longer term. In aggregate these changes have been projected to cost states about $8 billion in foregone revenue from 2007 through 2011[1] — significant, but a fraction of the proposed cuts in grants they face.

Will these spending cuts and tax changes come to pass? Not in the short term, if we accept press reports pronouncing the budget "dead on arrival" or from the experience of the 2006 federal budget when enacted cuts were far smaller than proposed. At this writing, Congress is still in the early stages of deliberating the 2007 federal budget and only limited measures have been passed, such as the tax cut extension. In March, the full Senate approved a budget resolution — a broad outline of its proposed budget action, with appropriation limits for major spending areas but with no programmatic details. This resolution called for smaller cuts in domestic discretionary spending than the president's budget — about $23 billion less over the five years from 2007 through 2011, but the cuts would still be substantial. The House of Representatives has not yet passed a budget resolution, although the House Budget Committee reported a resolution that has run into some difficulty in the full House. This resolution would cut domestic discretionary spending by $16 billion more than the president's budget, according to an analysis by the Center on Budget and Policy Priorities.[2] Both resolutions provide for smaller reductions in mandatory and entitlement spending than the president's budget.

It is a long way from here to a final budget, and Congress certainly will make changes to the president's proposed policies. At this point, substantial cuts in domestic discretionary spending — of which grants to state and local governments are a major component — seem likely.

Over the longer term, there is considerable reason for state and local governments to be concerned. Federal budget pressures are likely to be greater than those implied in the proposed budget. As many observers have noted, the proposed budget does not include funding to "fix" the alternative minimum tax, which is beginning to increase taxes on many middle and upper-middle income families who were not the intended target of the tax, and it does not include funds for the war in Iraq beyond fiscal year 2007, both of which could place considerable additional pressure on the federal budget.[3]

State budget planners well remember the mid- and late 1990s when states faced an unusual risk: a boom in tax revenue that many analysts and policymakers understood could not be sustained and eventually would reverse. Unfortunately, they did not know when that would happen. They face a similar risk now. The current federal budget deficit path is considered by many economists to be unsustainable, meaning that over the longer term, the federal government will have to bring the budget deficit under control. This may well lead to cuts in grants that are even larger than those the president proposed. But in the short term, absent a mandate on how much to reduce the deficit and without an agreement on how to do it, Congress is unlikely to enact cuts as deep as those proposed by the president. The short term outlook is for less substantial cuts than the president proposes, while over the longer term cuts may be deeper than proposed — but there is no clear way to predict when that will occur.

Endnotes

1 Lav, Iris J., *Tax Cuts Proposed in President's Budget Would Ultimately Cause Large State Revenue Losses*, Center on Budget and Policy Priorities, March 16, 2006.

2 Kogan, Richard, James Horney, Joel Friedman, and Robert Greenstein, *The House Budget Committee's New Budget Plan: A Brief Analysis*, Center on Budget and Policy Priorities, March 31, 2006.

3 See Burman, Leonard E., William G. Gale, and Jeffrey Rohaly, *The Expanding Reach of the Individual Alternative Minimum Tax*, The Urban-Brookings Tax Policy Center, Updated May 2005, for analysis of the Alternative Minimum Tax and reform options.