

FEDERAL DEFICIT REDUCTION IMPLICATIONS

A Report Prepared for the
Legislative Finance Committee

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As you are aware, the federal government has in recent years run a very large budget deficit that began in earnest in the early 2000's and was accelerated by a number of factors, the latest being the Great Recession. In August 2011, Congress passed the Deficit Control Act of 2011 (DCA). This report examines the current federal action and what it could mean for the state's budget.

The budget reduction measures included in the DCA fall into two categories:

- A reduction in the spending caps of the federal appropriations bills
- A further (initially) across the board reduction triggered by the failure of the budget "supercommittee" to make deficit reduction recommendations (sequestration)

There is much that is still very uncertain at this point, including whether sequestration will remain in its current form, how the law will be interpreted, and what the actual impacts on funds coming into the state will be. However, what is known is that both the long and short-term outlook is for reduced federal support coming to the states for a wide array of discretionary programs.

While the report primarily uses a state budget perspective, local governments will also obviously be impacted to some degree by any reductions.

FROM A WHOLE STATE PERSPECTIVE

Only a portion of the federal funds received and spent in the state actually goes through the state budget. Therefore, the potential impact to the state is not only in the provision of state services but for citizens and the overall state economy.

Because the percentage of gross state product derived from federal funds is estimated at over 30%, it is important to look in some degree at the budget reduction components from that perspective. Federal outlays in FY 2009 were listed at over \$10 billion by the U.S. Census Bureau, of which only \$1.9 billion were made through state government. However, these other funds would in many cases still be impacted by deficit reduction actions. These non-state outlays can be direct payments to individuals, such as social security, to direct federal expenditure such as support of federal agency offices and military installations. Among the federal outlays that do not pass through the state are the following that are known to be exempt from current deficit reduction measures:

- Social security payments (about \$2.5 billion of the total outlays)
- Veteran's programs, including the VA hospitals
- Pell grants for higher education
- Various other retirement and disability funds

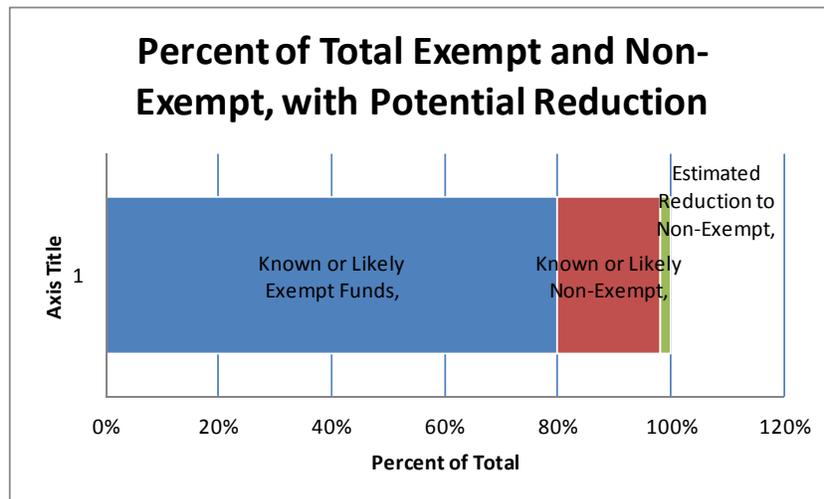
Among the programs that do not pass through the state that will be subject to reduction are Medicare payments, limited to a 2% reduction, and military installations.

THE STATE BUDGET

THE BOTTOM LINE

- An estimate by Federal Funds Information for States (FFIS) is that about 80% of federal funds that pass through the state budget will be exempt, leaving about 20% subject to reduction
- Using the general outlines and assumptions of FFIS, the Council of State Governments (CSG) has estimated the Montana impact from FFY 2011 to FFY 2013 as about \$48 million, or an estimated 9% reduction in state and local grant programs subject to reduction. Other estimates are that an 8-9% reduction in FFY 2013 would be in addition to an estimated overall reduction of 2.7% in FFY 2012

The following shows in graphical form the estimated total subject to reduction.



- According to both FFIS and CSG, this is the “best case scenario” in that it assumes the reductions would be required at a level that gives less leeway to federal agencies to determine where the cuts would be, which is an advantage to states
- While the average reduction is estimated at 9%, this does not mean a straight translation to a reduction in state and local grants of 9%. According to FFIS the actual reduction could in many instances be substantially higher
- The reductions are taken from the “baseline”, which is a number calculated by the Congressional Budget Office (CBO). The baseline is essentially expenditures in the base year with an inflation adjustment. This inflation adjustment has been very small in recent years and is assumed at an average of 1.1% annually across the 10 year deficit reduction period
- The Office of Management and Budget (OMB) will make the final determination of how to interpret the act in implementing sequestration when that portion of the act takes effect next January. Therefore, it will not be known until that time what the actual impact will be. However, states can expect potentially sharp reductions in non-exempt programs at that time

The following figure shows the top 10 federal funds expended through the state in FY 2009, including funds that initially go to the state but are passed through to other governments. FY 2009 was chosen to eliminate the influence of federal stimulus funds in the 2011 biennium. The top ten funds represent about 75% of all federal funds expended. About 89% of the top ten 10 funds are exempt or likely exempt from sequester.

Largest Federal Funds by Expenditure FY 2009		
Fund	Total	Status
Medicaid Benefits	\$623,723,345	Exempt
Highway Trust	383,059,502	Exempt
Education Grants, Various	129,953,202	Non-Exempt
SNAP (Food Stamps)	117,456,943	Exempt
Medicaid Benefits (100%)	30,967,264	Exempt
Medicaid Admin	30,465,994	Likely Exempt
CHIP	30,050,404	Exempt
Forest Reserve Shared Account	28,175,029	Likely Exempt
LIEAP Block Grant	26,881,967	Non-Exempt
TANF	<u>19,740,896</u>	Exempt
Total	<u>\$1,420,474,546</u>	
Total Federal Funds	\$1,890,674,805	

HOW WILL IT WORK?

Federal spending falls into two general categories:

- 1) “Mandatory” spending (“entitlement” or “direct” spending) that is driven by eligibility requirements in law, such as Medicaid, Medicare, and social security. Mandatory spending is a little less than 60% of the FY 2011 federal budget
- 2) “Discretionary” spending that is generally appropriated in any of 13 appropriations bills. Discretionary spending is for both defense and non-defense purposes

As stated, there are two parts to this story:

- 1) As in all budget years, the amount that can be appropriated in the 13 appropriations bills is subject to limitation set by Congress, with automatic reductions if the limits are exceeded. The DCA includes spending caps for 10 years beginning in FY 2012. Deficit reduction of about \$841 billion is estimated from this part of the reduction over the 10 year period. If the actual appropriations do not meet the limits, all non-exempt discretionary funds would be reduced to stay within the limits. This is the long-standing “discretionary sequester”.
- 2) The “deficit reduction sequester” is a further across the board reduction of non-exempt discretionary spending and some mandatory spending by the amount that would be needed to reduce the federal deficit by \$1.2 trillion over the next 10 years, beginning in January 2013, which is halfway through the state fiscal year.

Spending Caps and Discretionary Sequester¹

The initial spending cap reductions are a significant portion of the estimated \$48 million reduction. Under the current plan, that cap would be a larger and larger reduction from the projected baseline appropriations over the 10 year reduction period. If the spending caps are not met the discretionary sequester will be triggered. The appropriations committees will determine how the spending allowed will be allocated. If the recent past is an indication, there will not be uniform reductions across agencies or functions.

¹ On March 2 NCSL Washington D.C. staff sent an update stating that the House is currently considering lowering the FY 2013 spending cap by a further 9-11%.

Deficit Reduction Sequester

In looking at potential impacts to the Montana state budget of the deficit reduction sequester it is important to examine:

- What is exempt from sequester
- What is subject to sequester

How Would Sequestration Work?

The agreement signed last summer required automatic reductions in programs beginning on January 1, 2013 using the following guidelines:

- 1) Most “mandatory” programs are exempt, but about 1/3 of the \$55 billion of the reduction that is to come from non-defense spending in FY 2013 will come from non-exempt mandatory spending, primarily a reduction in Medicare reimbursement rates of no more than 2%.
- 2) Non-exempt security and non-security “discretionary” programs would be subject to an across the board, no exceptions reduction.

Exemptions are generally taken from existing sequestration statutes, with some differences. Therefore, whether certain funds are exempt will depend upon some interpretation and the question of what is exempt is still being refined. For example, in December FFIS estimated that the federal spending to states that was exempt from sequestration was about 75% of the total. In January they revised that figure to over 80% because they included more funds in the exempt “mandatory” category. Among the funds that FFIS began to categorize as exempt were various fish and wildlife management funds. As stated earlier, it could be next January when this becomes totally clear.

What is Subject to Sequestration?

The following provides samples of funds received by the state that fall into one of three categories. As stated earlier, this list is predominantly from current sequestration statutes:

- Known to be exempt
- Likely exempt
- Likely or known to be subject to sequestration

Known to be Exempt

- Numerous programs designed to aid low-income persons, including Medicaid, CHIP, supplemental security income (SSI), SNAP (food stamps), child care, various nutritional programs, and TANF
- Foster care and permanency payments
- Transportation trust funds, including highways, safety grants, and airports
- Programs administered by Veteran’s Affairs
- Unemployment Trust Fund advances

Likely Exempt

- Fish and wildlife management funds

Subject to Sequestration

- Natural resource grants such as clean water, clean air, remediation funds
- Title 1, IDEA, and various other grants for education
- Various human services block grants and other grants
- Community development grants
- Homeland security grants
- Community and migrant health services and Indian health services, limited to 2%

One of the distinguishing characteristics of this process from previous limitation discussions by Congress is the widespread, non-exempt nature of the reductions that would be made. No non-exempt program would remain

untouched, and at least initially all would get the same reduction in FY 2013. In future years, the reduced spending caps in the appropriations bills will follow the standard course and the committees will determine how to stay within the caps.

Will it Change?

Sequestration has been discussed in the context of the current statutory requirement. However, it should be noted that there have already been a number of moves to change how sequestration would be applied. There is strong feeling among several observers that the current scenario will not take place. However, there also appears to be widespread agreement that states will need to brace for likely significant reductions in discretionary federal funds over a wide swath of programs. The main difference between the current sequestration requirement and the actual scenario, if it plays out like the last budget session, could be that fewer programs will be hit harder than the current widely applied reductions of the sequestration.

IMPACT TO STATE

There can be a number of ripple effects of a reduction in federal funds, including the impact on the proprietary funded programs that derive a portion of their proprietary income from federal funds. The more imperative question of whether the state will be under significant pressure to replace any or all of the lost federal funds will of course depend upon a number of factors, including the clients impacted, possible corollary impacts, and potential legal action.

The 2013 Legislature will face this issue, including the potential that FY 2013 appropriations may have to be adjusted, in addition to projected impacts for the 2015 biennium. As stated, the final allocation of the budget reduction sequester will likely not be known until after the session begins.

Potential Actions

Because of the uncertainty and the general consensus that an age of reduced federal funds has very likely arrived, the committee may wish to recommend a proactive step for dealing with the short and long-term impact.

- Utah passed legislation in 2011 that requires state agencies to report to the legislature on the potential impact of a reduction in federal funds of 5% and 25%. This report is in addition to current federal reporting². The committee may wish to recommend that staff explore the implementation of a like requirement, similar to the 5% reduction plan requirements currently in statute
- Several states have set aside funds to deal with the most disruptive impacts of potential federal fund reductions. The committee may wish to recommend that a methodology for setting aside funds, including the amount, source, and use of the funds be explored

² Including the functions supported and any matching, in-kind, or maintenance of effort required