IMPACT ON STATES OF FEDERAL DEFICIT REDUCTION

States Concerned about Possible Cuts to Discretionary Spending and Entitlements

October 5, 2011

Introduction

Over the past year, Congress and the administration have taken up the issue, on numerous occasions, of federal budget deficit reduction. Many state and local officials understand the need for, and are supportive of, efforts to reduce the long term federal deficit. However, many state and local officials also have concerns about the way in which such actions will be implemented and believe it is important to understand the consequences of certain decisions. States are concerned about the impacts from disproportionate cuts to discretionary spending programs and secondly, cuts to entitlements, specifically Medicaid. States spent more than \$220 billion in federal Medicaid funds in fiscal year (FY) 2010 alone, the latest year for which data is available. Focusing on these two primary areas, below is an overview of how developments concerning actions to reduce the federal government's long term budget deficit may affect states and the significant amount of uncertainty that remains.

Discretionary Spending

In August 2011, as part of the agreement between Congress and the administration to increase the federal debt limit, the *Budget Control Act* (BCA) was signed into law. It included cuts of almost \$1 trillion dollars in discretionary spending; however this reduction is spread out over ten years. Additionally, when one examines the specific agreed upon levels of discretionary funding over the 10 years covered by the BCA, the \$1 trillion funding reduction is actually only a reduction in funding levels from previous CBO estimates, resulting in slight annual increases in actual discretionary funding[1]. Another important point is that the levels of funding stated in the Budget Control Act represent only the top line level of total discretionary spending, whereas specific program level funding would still be left up to the appropriate congressional committee. For example, the House's FY 2012 Department of Homeland Security spending bill reduced total funding by 2.6 percent but reduced funding for Federal Emergency Management Agency state and local programs by 57 percent compared to the FY 2011 enacted level. The Senate version of the FY 2012 Homeland Security spending bill also includes greater percentage cuts to state level programs than the total overall reduction in funding. The specific program levels of FY 2012 funding are not likely to be known until Congress completes an FY 2012 omnibus spending bill.

The second major component of the BCA called for the creation of the Joint Select Committee. The "supercommittee" as it is commonly referred to, is responsible for approving additional deficit reduction between \$1.2 trillion and \$1.5 trillion. If the committee does not agree on such a plan, this would trigger automatic cuts to the federal budget of \$1.2 trillion. While it is hard to predict whether the supercommittee will agree upon a plan, numerous events over the past year, including Congress's decision not to implement the deficit reduction plan approved by the National Fiscal Commission or take up any of the recommendations proposed by the "Gang of Six," as well as the failure of the debt limit negotiations to approve a "grand bargain deficit reduction package," indicate that the supercommittee faces difficult odds. However, the automatic cuts that would kick in if the committee does not approve a plan could push the committee towards a deal. One positive aspect of the automatic cuts within the Budget Control Act is a provision which states that Medicaid would be exempt, although the supercommittee could still recommend Medicaid cuts.

There was always the concern that an approved deficit reduction plan would impose significant cuts on Medicaid. This belief rested on the premise that any federalbudget deficit reduction plan would seek to reduce federal healthcare expenditures given the widely understood scenario that healthcare spending was expanding at a much faster rate than every other component of the federal budget and was consuming an ever growing share of United States GDP.

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Additionally, as many were calling for entitlement reform, Medicaid lacked a large voting constituency or a powerful organization in Washington to protect it, such as AARP, which strives to protect Medicare spending. One factor that may help Medicaid avoid significant budget cuts is its role in the implementation of the *Affordable Care Act* (ACA). Cutting its funding significantly could affect the program's ability to provide services to the millions of new enrollees it will cover when the ACA is fully implemented in 2014.

The President's Proposal

On September 19, President Obama released, the *President's Plan for Economic Growth and Deficit Reduction*, a detailed deficit reduction proposal which included provisions to reduce the federal deficit by an additional $3 trillion. Looking specifically at the President's plan, the provisions included in the proposal would reduce Medicaid funding by $72 billion over 10 years. Of the Medicaid changes included, the biggest change would be to institute a blended matching rate beginning in 2017 for Medicaid and CHIP, specific to each state that would reduce Medicaid costs to the federal government by an estimated at $14.9 billion over 10 years. The other significant Medicaid provision included would lower the threshold for state provider taxes beginning in 2015. Provider taxes would be phased down from the current law level of 6 percent in 2014, to 4.5 percent in 2015, 4 percent in 2016, and 3.5 percent in 2017 and beyond to save $26.3 billion over 10 years. A proposal introduced by the President earlier this year would have reduced Medicaid costs by $100 billion, although it is difficult to compare these two figures directly because of different implementation dates. Regardless, the $72 billion in proposed cuts to Medicaid are significantly less than the $250 billion in cuts to Medicare that the President proposes.

There are also other provisions within the President's proposal affecting state spending, including the provision to limit the value of allowable itemized deductions and exclusions at 28 percent for taxpayers with incomes over $200,000. This limit would include the interest on tax-exempt bonds issued by state governments and could force higher borrowing costs on states to make up the difference.

Uncertainty Remains

The concern among state officials that states would be significantly impacted by Congressional actions related to reducing the federal budget deficit led one state to prepare an analysis for both Fitch and Moody's, two ratings agencies, to show how they would cope with a 30 percent reduction in federal aid. The BCA requires that the Joint Select Committee approve their federal budget deficit reduction plan no later than November 23. However, even if the Joint Select Committee is able to agree on a deficit reduction plan, it remains quite difficult to definitively state what the exact composition of that plan might look like. Additionally, it remains unclear as to how Congress will specifically implement the reductions in discretionary funding as called for in the Budget Control Act; although FY 2012 began last Saturday, Congress has yet to put forth a full year budget. Combining the uncertainty from these questions makes it very difficult to estimate, at this juncture, how states will be impacted by actions to reduce the federal government's long-term budget deficit.

Finally, below is a timeline regarding upcoming actions of the Joint Select Committee (JSC).

<u>October 14</u>: House and Senate committees must submit recommendations to the JSC.

<u>November 23</u>: Deadline for the committee to vote on a deficit reduction plan.

<u>December 2</u>: Deadline for the committee to submit report and legislative language to the President and Congress.

<u>December 23</u>: Deadline for both houses to vote on the Joint Select Committee's deficit reduction plan.

<u>January 15, 2012</u>: Date that the "trigger" goes into effect leading to $1.2 trillion of future spending cuts, if the committee's legislation has not been enacted.

<u>January 2, 2013</u>: OMB orders sequestrations for defense and non-defense categories of spending necessary to meet spending cuts required by the "trigger."

[1]FY 2011 discretionary funding was approximately $1,050 trillion, while FY 2012 is expected to be $1,043 trillion. FY 2013 is scheduled to be $1,047 trillion and FY 2014 is scheduled to be $1,066 trillion.

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