S. HRG. 110–1000

# ECONOMIC AND FISCAL CONDITIONS OF THE STATES

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

FEBRUARY 26, 2008

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

54–998—PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
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# ECONOMIC AND FISCAL CONDITIONS OF THE STATES

**TUESDAY, FEBRUARY 26, 2008**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Stabenow, Salazar, Snowe, and Kyl.

The CHAIRMAN. The hearing will come to order.

First, Governor, thank you very, very much for taking the time. I know how busy schedules are. It is very difficult. You are so busy as Governor of your State. A very strong thank you. Second, a big apology because the Senate will begin a series of votes shortly, which means that this is going to be a very efficient hearing, to get right down to it. But thank you very much, again.

Senator Grassley is not here, but Senator Kyl is here. Senator Kyl would probably like to make a statement here.

[The prepared statement of Senator Grassley appears in the appendix.]

## OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA

Senator KYL. If I could just make a short statement to welcome my Governor, Governor Janet Napolitano, to the Finance Committee here. We appreciate your being here. Senator Grassley asked me to express that he would not be able to be here at the very beginning of the hearing, but will try to come back. Now, in view of these votes, I am not exactly sure how that is going to work, but you know the drill here. He did want me to let you know that he will get here for part of the hearing.

So, rather than risk taking up all of the time with us speaking and to make sure you get your testimony in before we start the votes, I am going to pass it with that. But again, I welcome you, and thank you for being here, Governor.

The CHAIRMAN. Thank you. Thank you, Senator.

## OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Justice Louis Brandeis wrote, “There must be power in the States and the Nation to remold our economic practices and institutions to meet changing social and economic needs. It is one of the happy incidents of the Federal system that a single courageous State may serve as a laboratory and try novel economic experiments without risk to the rest of the country."

We meet today to examine the economic and fiscal conditions of the States. We meet today to learn how different States are reacting to the economy. And we meet today to discuss whether our Nation should remold our economic policies to meet the changing economic needs of the States.

Today, the Nation's economy is hurting. Last month, the U.S. economy lost jobs for the first time in 4½ years.

Some States have been hit especially hard. Michigan's unemployment rate is 7.6 percent; Mississippi's is 6.8; Alaska's is 6.5 percent.

Economic conditions vary from State to State. With high oil prices, States that pump oil are doing all right. With high prices for many crops, many farming States are doing well. Mining and farming have helped to keep the unemployment rate in my home State of Montana at 3.6 percent.

A State's economy affects the State's budget. When the State's economy weakens, the State government's revenues generally fall off. As unemployment increases and incomes decline, more people become eligible for programs like Medicaid.

Almost all States' constitutions require them to balance their budgets. During a time of economic weakness, States may have to raise taxes or cut spending to balance their budgets. Unfortunately, that is exactly the wrong policy for the economy.

State tax increases reduce the purchasing power of people in the State. And State spending cuts lower the purchasing power of the people who received the funds. Tax increases and spending cuts can thus accelerate the economic decline.

At least 20 States now project deficits for the coming fiscal year. California alone expects a $14.5 billion deficit. Taken together, these 20 States are projecting shortfalls that add up to more than $35 billion. If these deficits lead to tax increases or spending cuts, they could counteract some of the fiscal stimulus that we just enacted.

What can Congress do? For one thing, Congress could increase the number of weeks that unemployed workers receive federally funded unemployment benefits. The stimulus bill that this committee reported last month would have allowed for an additional 13 weeks of benefits for all States, and 13 extra weeks for benefits in States with high unemployment. Unfortunately, that proposal did not make it into the final bill. If unemployment increases, we could revisit that proposal.

During the last economic downturn, Congress passed two other measures that provided budgetary help to the States.

First, Congress increased the Federal matching rate for the Medicaid program for a little more than a year. Congress also provided direct fiscal assistance to the States through a block grant, distributed on the basis of State populations. Many thought these two measures worked pretty well. Should we consider using them again?

The application of a Federal system also finds other areas where the States and the Nation can work together to meet changing economic needs.

Let me just tick off a few. Many States couple their tax codes to those of the Federal Government. States and the Federal Government work together on Trade Adjustment Assistance. States and the Federal Government work together on infrastructure. The Federal and State governments share responsibility for Medicaid, a vital health care safety net.

The State Children's Health Insurance Program is also funded with a contribution with a combination of State and Federal dollars. The Temporary Assistance for Needy Families block grant provides critical support for work. And the child support program helps 17 million children. The Social Services Block Grant supports programs that serve our Nation's most vulnerable.

This year, the committee begins to work on comprehensive reforms to our Nation's health care and our tax systems. So we have many reasons to examine the economic and fiscal conditions of the States. We have many things to learn about how different States are reacting to the economy. We have much to discuss as we consider how the Nation and the States should mold our economic policies to meet these changing economic times.

I would like to introduce our witness, Janet Napolitano, Governor of Arizona. Thank you again, Governor, for coming. Thanks for taking the time. As you know, generally our witnesses speak about 5 minutes, but full statements are included in the record. This is going to be a bit different hearing this morning given our time constraints.

So, why don't you proceed?

**STATEMENT OF HON. JANET NAPOLITANO, GOVERNOR OF ARIZONA**

Governor NAPOLITANO. Thank you, Mr. Chairman. Thank you for inviting me. I'd like to especially thank Senator Kyl for being here. We come from different political parties, but I think for both of us, what is good for Arizona is what we are working toward jointly. So I appreciate, Senator, that you are here.

I do have a complete statement and ask that it be in the record.

[The prepared statement of Governor Napolitano appears in the appendix.]

Governor NAPOLITANO. I will speak swiftly and to the point because, even though I know you have a vote, this is a very important hearing and it is a very important message I have to send on behalf of myself, and I think I can speak for many of the Nation's Governors. We have just been meeting in Washington the past couple of days. That is, the fiscal condition of the States is precarious right now. Eighteen States currently are experiencing deficits of upwards of $14, $15 billion. It seems to change by the hour.

In 2009, an additional 17 States will also be in deficit situations. We are talking billions and billions of dollars that States have to manage and balance their budgets with. As you know, and as you remarked, Mr. Chairman, 49 of the 50 States require a balanced budget every year. So, when the economy goes down, that is felt immediately at the State level. I would give two basic rules for this committee, for the Senate, and for the Congress. That is, as we move through this economic downturn, as we manage our way through it as States and as a country, I would ask that the Congress, vis-à-vis the States, do two things.

One is, first, take the Hippocratic oath and do no harm. The plain fact of the matter is, the last stimulus package actually removed revenue bases from the States at a time when we were struggling to manage our budgets.

The second is, pay your bills. There are things that are being cost-shifted to the States as we speak, some of them proposed by the administration, some of them having been done by statute, some of them are statutes that have been on the books for years and have never been funded. Nonetheless, they are obligations that the States are having to undertake at a very difficult time.

So, first, the Hippocratic oath: do no more harm to the States whenever you consider another stimulus package, and, second, pay the bills that are outstanding.

Let me, if I might, I will give you a few quick lines or a few quick things there. First, if there is to be a second stimulus package, and there is some discussion that there will be, I would urge you to consider a State piece. That State piece could be inspired by what you did a few years ago when we were in a similar situation.

It is something that the National Governors Association has endorsed, Republican and Democratic Governors of the Nation. It is a $6-billion Medicaid FMAP piece and a $6-billion block grant piece. I was a Governor in 2003 and that was very useful to balance the budgets and help us manage our way through and not have to kick people or children off of health care, be able to manage our way through an economic downturn.

Seven specific areas for Congress to consider as we move through this, and we will have to move through it together. First, I believe there should be a moratorium on any new Medicaid regulations. The Medicaid regulations that are being proposed by the administration now violate the first rule: they do harm to the States. They violate the Hippocratic oath.

Second, stop CMS's August 2007 SCHIP Directive. It also violates the Hippocratic oath. Not only does it prevent States from trying to put more children into health care, some States would actually, under those regulations, have to kick children out of health care at a time when the economy is in a downturn. Not the right thing to do.

Third, restore the 67-percent slashing of the Byrne/JAG program. These are grants we use for local law enforcement. In many areas of our States, they are the sole source of funding for cooperative efforts on drug task forces. We use them in Arizona for gang and gang-related work. Those are very useful grants, and public safety is something we should never sacrifice at any time, much less in an economic downturn.

Fourth, fund the SCAAP program at the authorized level. This is a particular passion of mine and something that Senator Kyl and I have worked jointly on for several years. This is the statute that says that States are to be reimbursed for the costs of incarcerating illegal immigrants when they violate State law. We have never been reimbursed at our level in Arizona.

In fact, I have regularly sent the Attorney General of the United States a bill for our unreimbursed costs. I keep adding a late fee.

It still does not get paid. That bill right now is over $400 million for Arizona alone. When I look at our State budget and the millions that we are trying to cobble together to pay to educate our citizenry and to provide for Medicaid, that $400 million really sticks out like a sore thumb. That falls under my second suggestion to the Congress, which is to pay the bills. Pay your bills.

Fifth, the REAL ID problem. REAL ID is an unfunded mandate. I believe I can speak for the Governors of the country in our discussions over the weekend. Unless the Congress puts money in there to fund the implementation costs, our enthusiasm for moving forward is disappearing rapidly, or has disappeared.

Next, restore the funding of the State Homeland Security Grant Program. This is in line with Byrne/JAG and the others that I mentioned.

Finally, if you are looking for a place where the States really need some help and where our National security could use some assistance, it is in funding and replenishment of a National Guard. The administration's budget takes too long to replace the equipment and other resources that have been used by our Guard in their deployments to Iraq and Afghanistan, and we need those Guard resources. For example, in Arizona we use them in particular during wildfire season; other States use them during periods of flood, hurricane, tornado, whatever natural disaster may befall.

So, Mr. Chairman, that is as quick as I can make it. I have a more extensive statement. But I hope it has been clear in the sense of what we can do together and what we ask of the Congress, what I ask of the Congress.

The CHAIRMAN. You bet. Thank you, Governor. We have about 12 minutes left before we have to run off and vote, so I am going to be very brief in my questions, and maybe will let other Senators ask theirs.

Governor, this is a very impressive list you have read off here. I know it is difficult, but if you could just look at all the States generally, in addition to Arizona, in addition to what we did a couple of years ago with FMAP and the block grant, you listed six or seven others. If you could somewhat kind of prioritize, what really is needed at this point? What does it really come down to?

Governor NAPOLITANO. If I had to say what the top priority is as we manage our way through this, it would be on the health care and the Medicaid side. That is where the States incur an immediate cost out of their budgets. That is where the enrollment goes up as economic circumstances wane. Because of the formulas that are used, there is already a mismatch between the income levels that are used for judging when a State receives a Medicaid benefit versus what the citizenry is actually receiving, so we already have a disconnect. I would say that Medicaid would be my top priority.

The CHAIRMAN. But keep the moratorium. Do not allow CMS regulations to move forward.

Governor NAPOLITANO. That is right. Do no harm.

The CHAIRMAN. Do no harm. The same with the Children's Health Insurance Program.

Governor NAPOLITANO. Correct.

The CHAIRMAN. That bubbles up to the top, as you see it.

Governor NAPOLITANO. Yes, Mr. Chairman.

The CHAIRMAN. Thank you.

I will now turn to Senator Kyl.

Senator KYL. Thank you, Mr. Chairman. I will just make a couple of points. I want the record to reflect that I voted against the stimulus package. I thought it did do harm, including the harm that the Governor just pointed out. I think it would be a mistake for us to immediately consider a stimulus two, which is, I understand, an item of business that the Majority Leader intends to bring up later this week. Among other things, the bankruptcy provisions of the stimulus two, with the cram-down provisions, will, according to all estimates, increase interest rates for home mortgages.

Now, this is going to hit my State of Arizona, our State of Arizona, because of course we have a huge housing market. Because of the number of people moving into our State and a need to make that housing affordable, including with the mortgages, to increase the mortgage interest rates at a time of economic downturn is exactly the wrong policy. So I hope that my colleagues will think twice before considering another stimulus package which could do additional harm to our economy. I appreciate the Governor's pointing out that the first stimulus package did not help all that much.

Mr. Chairman, since we are now getting the 10-minute notice on the vote, I will not pose any questions to the Governor here. But again, thank you very much for being here, Governor.

Governor NAPOLITANO. Thank you, Senator.

The CHAIRMAN. Thank you.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman.

Welcome. It is good to see you, Governor. Just quickly, since Senator Kyl raised the Foreclosure Prevention Act which we will be discussing later this week, I wonder if you might speak to how an increase in the cap on Mortgage Revenue Bonds by $10 billion would help States, or allowing community development block grants to be used to purchase foreclosed properties. Those are two of the major items that are in the housing legislation that Senator Reid is bringing before the Senate later this week. I wonder if you might speak to the need to help the States and communities as it relates to foreclosures.

Governor NAPOLITANO. Yes. Mr. Chairman, Senator Stabenow, one thing I would say is, do not take my remarks as suggesting there should not be a second stimulus package. There will be. What I am saying is, when there is, it needs to be constructed in such a fashion that it does not deleteriously affect State budgets any more.

With respect to the bill that this body will be considering later this week, I have not had a chance to actually review it. I heard about it for the first time yesterday afternoon. By the way, it would be helpful, as we move through—it is good to have this dialogue to talk about what really will work at the State level. My overall view, however, is that the genesis of this economic downturn began with housing.

So, if you address housing as a central part of a second stimulus, for a State like mine which has really been impacted—our economy went from one that was one of the highest-performing in the country in terms of revenue growth and the like to one where we were really struggling. So, if you address what started that and what is the central part of it, housing, and getting credit back into the housing market and housing moving again, that would seem to me to be a logical place to look at for a second stimulus.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Salazar? We are being very efficient here.

Senator SALAZAR. We have to go. We cannot miss. Chairman Baucus, thank you for holding this hearing. I have a statement I will just include for the record.

[The prepared statement of Senator Salazar appears in the appendix.]

Senator SALAZAR. I want to make a personal comment, if I may, with Governor Napolitano. She was Attorney General during the time that I served as Attorney General for Colorado and did a masterful job there, including being the head of the Conference of Western Attorneys General, and now is doing a great job for the State of Arizona. I appreciate the seven points that you have raised to this committee, as well as the two principles under which you believe that we can function.

My one quick question is, your list of seven priorities, Governor Napolitano. Are those the view of both Democratic and Republican Governors or are these the views of Democratic Governors, or the view of the Governor of Arizona?

Governor NAPOLITANO. They are my views overall. But in terms of a second stimulus package, to considering having an FMAP feature with a block grant, that is an official position of the National Governors Association, so that is all Governors. In addition, I believe you will be getting a communication from the National Governors Association in the next few days. We are in agreement on the moratorium on further Medicaid regulations.

Senator SALAZAR. Thank you.

The CHAIRMAN. Thank you, Governor.

Since we have a little bit more time here and Senator Snowe is about to arrive, could you explain a little bit more—here she comes right here, Senator Snowe. I will let her speak right now. I was going to ask you about bonding, but I am not going to do that. That is, financing.

Go ahead, Senator.

Senator SNOWE. Thank you.

I would like to ask you, and I know you addressed this in your written statement, regarding the proposed Medicaid regulations, some of which are going to take effect on March 3. Can you discuss the impact to your State? I know it is certainly going to have an impact on mine, especially in the populations that it affects.

Governor NAPOLITANO. Yes, Senator Snowe, Mr. Chairman. There is no State that those regulations do not harm. As I said in my initial statement to the committee, I would like the Senate and the Congress to adopt two rules as you move through this economic downturn vis-à-vis the States. One is, first, do no harm. Second, pay the bills that we have. Pay your bills.

But it would reduce funding even now, even while we are coping with deficits. I will give you one concrete example. It would reduce current funding for residency programs, graduate medical education in our State, $31 million this year alone. Well, that is how we are getting physicians into the rural parts of America, and I believe it is probably something that is happening in your State as well, so to cut back on those now under the guise of Medicaid regulations does not make a lot of sense. There are all sorts of impacts on different populations and coverages as well.

Senator SNOWE. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. All right. Governor, I have 3 minutes left to get over and vote. My memory is, this is the shortest hearing we have had. I deeply apologize that we do not have the ability to take advantage of all of your deep knowledge in your State of Arizona, and also as a representative of the Governors. It is regrettable I did not know about the vote schedule until this morning. It just popped up.

Thank you very, very much for taking the time.

Governor NAPOLITANO. Thank you, Mr. Chairman. I used to be an appellate lawyer and a litigator. I am used to doing things in 15-minute increments, so it is all right. [Laughter.]

The CHAIRMAN. Thank you.

The hearing is adjourned.

[Whereupon, at 10:25 a.m., the hearing was concluded.]

# APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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*United States Senate* | *Sen. Chuck Grassley · Iowa*
*Committee on Finance* | *Ranking Member*

Statement of Senator Charles E. Grassley
Senate Committee on Finance
Hearing on the Economic and Fiscal Condition of the States
February 26, 2008

Rising oil prices, falling home prices, and declining job growth have led many observers to conclude the U.S. economy may dip into a recession this year. Although we often talk about our economy as a single unit, it is important to remember that economic conditions vary widely across the nation. For example, state unemployment rates vary from a low of 3.0% in Idaho, to a high of 7.6% in Michigan.

Just as economic conditions vary from state to state, so do state budgets. Some states have an income tax, but no sales tax, while other states have the reverse. Some states have integrated their income tax with the federal tax code, others have not. Some states have delegated much of their tax collection duties to their local governments, some have not.

According to the U.S. Census Bureau, total state and local revenue was \$2.5 trillion in Fiscal Year 2005, the latest year available. This total included \$438 billion in grants from the federal government. State taxes accounted for just 26 percent of total revenue. This amount ranged from a low of 16 percent in Alaska, to a high of 42 percent in Vermont (see Table 1).

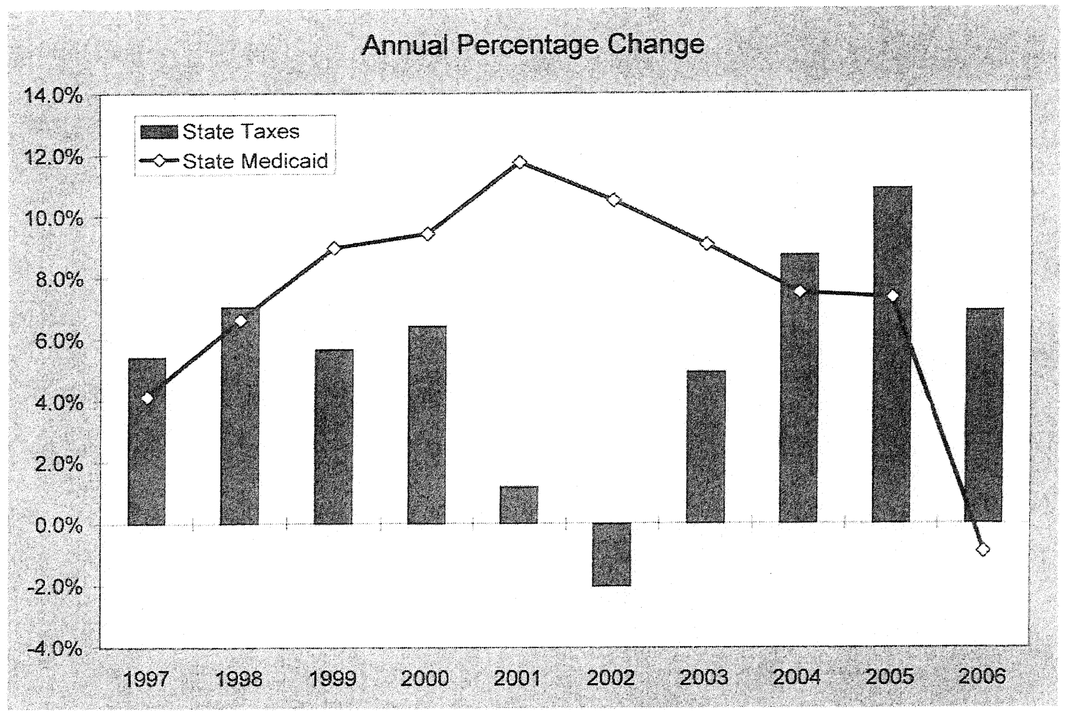
Although most states have balanced budget requirements, these requirements are neither stringent nor binding. The states can and do run deficits. According to the Federal Reserve, total state and local debt outstanding in 2007 was \$2.2 trillion. That's up from \$1.1 trillion in 1997. It should also be noted that the federal government exempts the interest paid on state and local debt from federal income taxes. The Joint Committee on Taxation estimates this exemption is worth more than \$20 billion a year.

Congress has often responded with a package of fiscal relief during tough economic times. These packages have generally focused on broad-based tax relief for both consumers and businesses. When Congress enacted a state-aid package in early 2003, conditions were much different – state taxes had been declining and Medicaid costs had been rising at double digit rates. Today, revenue growth is positive and Medicaid growth is in single digits (see Chart 1).

Unfortunately, many states have responded to slower Medicaid growth by expanding their programs. For example, the Kaiser Commission on Medicaid and the Uninsured recently reported that thirty-two states have expanded access to their Medicaid and SCHIP programs between July 2006 and January 2008.

The case for state-aid is harder to make in today's environment than in the past. But, today's hearing will allow us to examine these issues more closely in light of changing economic conditions.

Chart 1




http://www.bea.gov/national/nipaweb/Index.asp (Table 3.20)
http://www.cms.hhs.gov/NationalHealthExpendData/downloads/tables.pdf

Table 1

**State and Local Government Finances by State: 2004-05**

| ($Thousands) | Total Revenue | Federal Grants | State Taxes | % of Total |
|---|---|---|---|---|
| United States - Total | $2,523,005,780 | $438,155,977 | $648,111,258 | 26% |
| Alabama | $33,606,093 | $7,437,692 | $7,799,948 | 23% |
| Alaska | $11,334,457 | $2,553,249 | $1,858,311 | 16% |
| Arizona | $41,134,826 | $8,238,501 | $11,008,428 | 27% |
| Arkansas | $18,876,794 | $4,338,891 | $6,552,449 | 35% |
| California | $380,476,699 | $54,578,422 | $98,434,685 | 26% |
| Colorado | $38,930,181 | $5,102,276 | $7,648,456 | 20% |
| Connecticut | $30,584,258 | $4,448,985 | $11,584,728 | 38% |
| Delaware | $7,638,188 | $1,184,432 | $2,590,217 | 34% |
| District of Columbia | $9,326,744 | $2,814,574 | $0 | 0% |
| Florida | $135,338,670 | $21,097,833 | $33,894,971 | 25% |
| Georgia | $60,292,959 | $10,573,988 | $15,675,655 | 26% |
| Hawaii | $11,000,269 | $1,964,554 | $4,434,356 | 40% |
| Idaho | $10,003,867 | $1,876,814 | $2,934,459 | 29% |
| Illinois | $100,447,028 | $15,387,326 | $26,411,689 | 26% |
| Indiana | $43,792,014 | $7,192,834 | $12,853,976 | 29% |
| Iowa | $23,249,871 | $4,380,491 | $5,750,629 | 25% |
| Kansas | $19,921,338 | $3,402,605 | $5,598,700 | 28% |
| Kentucky | $28,043,814 | $6,115,805 | $9,090,882 | 32% |
| Louisiana | $35,847,751 | $7,848,173 | $8,638,674 | 24% |
| Maine | $11,346,337 | $2,647,192 | $3,071,161 | 27% |
| Maryland | $45,327,471 | $7,540,629 | $13,497,281 | 30% |
| Massachusetts | $61,507,149 | $9,198,142 | $18,014,681 | 29% |
| Michigan | $81,370,429 | $14,195,442 | $23,525,187 | 29% |
| Minnesota | $45,464,495 | $7,307,853 | $15,881,131 | 35% |
| Mississippi | $21,092,104 | $5,987,016 | $5,432,152 | 26% |
| Missouri | $41,339,990 | $8,573,060 | $9,543,814 | 23% |
| Montana | $7,438,139 | $2,002,965 | $1,875,545 | 25% |
| Nebraska | $15,883,267 | $2,668,570 | $3,796,551 | 24% |
| Nevada | $18,953,181 | $2,240,559 | $5,670,169 | 30% |
| New Hampshire | $8,924,491 | $1,625,172 | $2,022,146 | 23% |
| New Jersey | $77,812,162 | $10,626,825 | $22,933,999 | 29% |
| New Mexico | $16,649,605 | $4,258,072 | $4,471,477 | 27% |
| New York | $231,011,453 | $45,701,539 | $50,190,396 | 22% |
| North Carolina | $64,823,562 | $13,066,924 | $18,639,618 | 29% |
| North Dakota | $5,240,123 | $1,311,019 | $1,403,293 | 27% |
| Ohio | $102,601,496 | $17,182,975 | $24,006,560 | 23% |
| Oklahoma | $24,552,073 | $5,179,250 | $6,859,030 | 28% |
| Oregon | $32,392,874 | $5,257,787 | $6,522,665 | 20% |
| Pennsylvania | $103,730,295 | $19,258,927 | $27,262,969 | 26% |
| Rhode Island | $9,729,274 | $2,106,180 | $2,628,747 | 27% |
| South Carolina | $33,276,639 | $7,100,845 | $7,318,388 | 22% |
| South Dakota | $5,824,750 | $1,369,870 | $1,110,035 | 19% |
| Tennessee | $43,686,248 | $9,071,470 | $10,007,292 | 23% |
| Texas | $163,057,453 | $28,960,854 | $32,784,942 | 20% |
| Utah | $19,186,196 | $3,219,817 | $4,686,381 | 24% |
| Vermont | $5,392,814 | $1,313,181 | $2,242,902 | 42% |
| Virginia | $56,858,890 | $6,934,683 | $15,918,847 | 28% |
| Washington | $57,586,458 | $8,336,629 | $14,839,634 | 26% |
| West Virginia | $14,739,417 | $3,540,319 | $4,301,156 | 29% |
| Wisconsin | $48,429,818 | $7,100,591 | $13,152,250 | 27% |
| Wyoming | $7,931,306 | $2,734,175 | $1,739,646 | 22% |

http://www.census.gov/govs/www/estimate05.html

**Testimony of the Hon. Janet Napolitano**

**Governor of Arizona**

**Hearing on**

**State Economic Conditions**

**Submitted to the**

**Finance Committee**

**United States Senate**

**Tuesday, February 26, 2008**

Chairman Baucus, Ranking Member Grassley, and Committee Members, thank you for the opportunity to testify on the economic conditions of the states. On behalf of all of the Governors, I appreciate your interest in the fiscal conditions in our states, and your recognition of the importance of the states' economic health to the economic well-being of the entire country.

My name is Janet Napolitano, and I am the Governor of Arizona. I am also the immediate past chair of the National Governors Association, a bi-partisan organization representing the nation's Governors.

Today, I would like to provide you with a "ground-level view" of what is happening in the states. I will include a summary of the condition of the Arizona economy, a brief overview of the national economic outlook among the states, and my specific recommendations for action Congress should take with respect to states and the national economy. At a minimum, I believe your actions should include adding a "state piece" to any "Round 2" of a federal economic stimulus plan, and that Congress should identify and eliminate any cost shifts to the states associated with the states' roles in implementing federal legislation.

Arizona is particularly important because we reflect many of the extremes currently at play in the American economy. Arizona is the second-fastest-growing state in the nation. We are among the states hit hardest by the burst of the real-estate bubble and the tragic after-effects of under-regulated sub-prime mortgages. And because of our geography, we are dealing with the brunt of illegal immigration into our country, and are suffering most directly from the failure of the federal government to deal comprehensively with immigration reform.

While some of Arizona's problems are fueled by the struggling national economy, Arizona also has a unique set of challenges common to states that are experiencing explosive population growth. Arizona has grown by 1.9 million people in the past 10 years – that is more than a 40 percent increase. Our population growth means that we have 600,000 more people on Medicaid, more than a quarter million more children in school, and nearly 14,000 more inmates in prison. So, while the economic downturn is reducing state revenues, our growth requires us to continue to provide the kinds of basic services that government should provide: education, health care, and public safety.

Whether or not our nation's economy is currently in recession is a question I will leave to the experts. But no matter what we call it, America's economy is hurting, and there is no question that most state economies are experiencing a significant downturn. In Arizona, for example, while jobless numbers overall were positive for 2007, job creation has significantly slowed. The construction and financial services industries continue to be soft, and have been since early 2007.

Unlike the federal government, all but one state – 49 of the 50 – have balanced budget requirements; we cannot engage in deficit spending. Eventually, the Federal Reserve's recent interest rate cuts will have a positive impact, but in the meantime, states are left with the very real problems of service delivery – educating children, maintaining roads and providing health care – at the same time that we must cut our budgets to compensate for dramatic declines in revenue.

The outlook is not encouraging. We may only be at the beginning of the economic downturn, yet 18 states already face budget shortfalls totaling $14 billion in 2008, and 21 states project shortfalls totaling more than $32 billion in 2009. History tells us that both the number of states facing shortfalls and the severity of them will grow over time. If the current downturn continues and follows the path of most recessions, between 35 and 40 states will face severe budget cuts in 2009.

As the economy slows, state sales tax revenues are the first to decline because of reductions in personal consumption. Unemployment increases invariably lead to increased demand for food stamps, unemployment benefits and particularly Medicaid coverage, which currently comprise about 22 percent of state budgets.

Before we turn to my specific suggestions of what Congress can do to *help* states, I would like to urge you to make sure that your actions do not *hurt* states. Adopt a Hippocratic Oath where states are concerned: **"First, do no harm."** Unfortunately, the recent federal stimulus package already violated this principle and will result in a revenue loss to states of nearly $2 billion because of its impact on conforming state and local tax codes. The principle of "do no harm" requires that any additional stimulus package avoid policies that would diminish state revenues, shift costs from federal to state programs, or impose new unfunded mandates.

Given this impact of state fiscal conditions on the national economy and how these conditions could blunt the positive effects of the relief Congress has recently enacted, my first and strongest recommendation is that you must ***include a state piece in any "Round 2" of Congressional economic stimulus measures.*** One very reasonable option is already before you: enact the National Governors Association proposal for counter-cyclical funding, which includes a temporary increase of $6 billion in Medicaid assistance by adjusting the Medicaid FMAP, and another $6 billion in a block grant. This is exactly the same structure of effective fiscal relief that Congress provided to states in 2003 during the last economic downturn.

Medicaid assistance is important because states are now expecting higher Medicaid costs for several reasons:

- As I have mentioned, the economic downturn will increase unemployment, which will drive more people to seek a lifeline through Medicaid and other poverty-based programs. During the most recent economic downturn, Medicaid enrollment rose 8.6 percent between 2001 and 2002. In Arizona, the increase was even more pronounced. During my first fiscal year as Governor, Medicaid grew by almost 17 percent while revenues grew by less than 1 percent. For the current fiscal year, we are projecting Medicaid caseload growth of 8 percent.
- The share of the Medicaid program financed by the federal government is based on state per capita income calculations that are several years out of date. Robust growth in state economies from 2004 to 2006 will mean that the federal match for 2008 and 2009 will be significantly reduced, just as state economies experience a downturn.
- Growth in Medicaid rolls historically lags behind economic downturns because it can take several months for children and families to become eligible and apply for health care assistance. Despite this lag, evidence indicates that increases are already occurring in many states.

A major advantage of increasing the Federal Medicaid Assistance Percentage (FMAP) for each state is that this policy can be implemented the day it is signed. There is no need for new rules or regulations, and states could immediately eliminate scheduled budget cuts.

Block grant funding would allow states to set priorities and avoid many (though not all) cuts to critical programs – including elementary, secondary and higher education; non-Medicaid health care and existing state programs that focus on assisting individuals to avoid defaults on home mortgages; and infrastructure repairs to schools, highways and bridges.

My second recommendation complements my first recommendation: ***members of Congress must reduce, if not eliminate, federal cost shifting to the states.***

Over the last several years, the rate at which the federal government has shifted costs to the states has dramatically accelerated, often without serious dialogue or discussion about what is fair and reasonable. Congress should stop this practice and work with state leaders to coordinate the type and level of services that government should provide for its citizens ***and the corresponding way to pay for these services.***

Although there are many more examples, I would like present to you seven specific areas that merit your immediate attention. Congress should:

- Enact moratoria on the various Medicaid regulations proposed by the Bush Administration;
- Stop the CMS August, 2007, SCHIP directive;
- Restore the 67 percent slashing of the Byrne-JAG grant program;
- Address one of the most pressing effects of illegal immigration, and fund the SCAAP program at the authorized level;
- Provide adequate resources for the under-funded mandate of REAL ID;
- Restore the State Homeland Security Grant Program to fiscal year 2005 levels;
- And ensure that the National Guard is properly re-equipped.

Again, Medicaid needs your immediate attention. States are facing a convergence of challenges with regards to providing health care to our neediest citizens – as previously mentioned, states like Arizona are already seeing escalating Medicaid enrollment precisely as state revenues and Federal Assistance begin to decrease. States expected an enrollment increase during our economic downturn. But what the states did not expect – and should not occur – was the intentional move by the Administration to remove billions of federal Medicaid dollars from our existing health care system, without taking on any of the responsibilities that states must pay for. These cost shifts are poised to wreak havoc on state budgets and, ultimately, will leave our vulnerable citizens without the services they need. The President's fiscal year 2009 budget, if enacted, would go even farther and decrease federal Medicaid investment by an additional **$18.2 billion over five years.**

To compound this problem, CMS has proposed or issued eight different regulations that fundamentally alter the federal-state Medicaid partnership and force states to enact significant changes in their Medicaid programs. In many cases, these regulations simply shift costs to states and localities. Taken together, these regulations reduce federal investment in Medicaid by close to $15 billion dollars over the next five years and enact substantive policy changes that, in many cases, Congress has considered and expressly rejected. Each regulation has a direct impact – on states, on local communities, and, ultimately, on the people that we all serve who are in dire need of help. In Arizona, we stand to lose nearly $30 million dollars this year in investments in Graduate Medical Education – a program that has been essential to attracting and training new health care professionals and extending access to low-income individuals. As a fast-growing state with a physician shortage, I can report to you that this cut would clearly move Arizona backwards in creating access to care for our residents.

In a similar vein, Congress ***should overturn the requirements laid out in CMS's August 17 directive on the SCHIP program.*** That directive placed new and extreme requirements on states that wish to continue covering or extend coverage to children in families with incomes above 250 percent of the Federal Poverty Level (FPL). As health care costs rise and access to affordable private insurance becomes further out of reach of many working families, now is not the time to put up roadblocks to extending access to health care. These new SCHIP requirements will result in a loss of coverage to tens of thousands of children already on SCHIP and could block efforts underway in many states to insure more youngsters. You should act now to void implementation of this directive.

Next, you should restore the ***67 percent slashing of the Byrne-JAG grant program*.** As you know, the Byrne-Justice Assistance Grant (Byrne-JAG) program at the U.S. Department of Justice is the only comprehensive federal crime-fighting program in existence. As such, it allows communities to target scarce resources to their most pressing law enforcement needs. Yet, in the Fiscal Year 2008 Omnibus Appropriations bill, Congress cut Byrne-JAG grants by 67 percent, from $520 million in fiscal year 2007 to $170 million, an all-time low. This will have a serious impact on the ability of state and local governments to fight crime. For example, Byrne-JAG funds multi-jurisdictional drug and gang task forces, information sharing and technology, county jails, prosecutors, drug courts, juvenile delinquency and drug treatment programs. In fact, Byrne-JAG is often the ***only*** source of federal funding for multi-jurisdictional task forces, corrections, reentry and prosecutors – especially in rural America.

Once interrupted, many Byrne-JAG-funded programs will lie fallow for years because they cannot quickly restart. Once a multi-jurisdictional task force is disbanded, for instance, law enforcement officers return to their departments, informants are lost and complex investigations are put on hold.

When the economy lags, crime often spikes. With the forecast of an economic downturn, now is not the time to cut funding to the principal federal crime-fighting program. Congress must follow the advice of every major law enforcement organization and act fast to remedy this situation and restore funding to the Senate-passed amount of $660 million for fiscal year 2008.

You must also ***fund the SCAAP program at the authorized level.*** As the Governor of a border state, I have long insisted that the federal government live up to its responsibility to secure the Southwest border. With the failure of Congress to pass meaningful, comprehensive immigration reform, the federal government must, at a minimum, live up to its financial obligation to compensate for the costs of these failures borne by the states. Specifically, the federal government must fully compensate states under the State Criminal Alien Assistance Program (SCAAP) and ensure that these funds are distributed promptly and in full. I have regularly billed the Department of Justice for the costs of illegal immigrants in the Arizona prison system. The federal government now owes Arizona at least **$419 million**, which, if paid, would significantly reduce the deficit we are incurring during this economic downturn. So, in addition to the principle of "first, do no harm," I would add a second: "Pay your bills."

Your help is needed on two more issues relating to SCAAP: Ask the Bureau of Justice Assistance to account in writing for the details surrounding the apparent rescission of more than $66 million appropriated in fiscal year 2006 funds; and resist future rescissions of these limited SCAAP funds.

With states already compensated only pennies on the dollar for the costs of jailing criminal aliens, I was shocked to learn that fiscal year 2006 SCAAP payments as reported by BJA totaled only $333,695,957 – an apparent $66.1 million dollar rescission. If, in fiscal year 2006, BJA withheld $14.1 million for Federal administrative costs (2.3 percent more than in fiscal year 2005), then SCAAP payments should have totaled $52 million more than the actual amount paid. Though some of this funding was later reinstated, I request that Congress, in its oversight capacity, ask BJA to account in writing for these $66 million in unobligated funds, including why these funds were targeted and why no one was notified.

The lengthy and unaccountable process for SCAAP disbursements leaves SCAAP funding especially vulnerable to future rescissions. Further cuts to this already-underfunded program are simply unacceptable. I ask that Congress direct DOJ to provide transparency to the SCAAP application and disbursement process, as well as work to prevent the targeting of SCAAP funds in the future.

REAL ID is another unfunded mandate that is falling on the states. We finally have regulations, and we appreciate the chance to actually begin a reasonable planning process to discover if and how REAL ID can be implemented. Remarkably, just as states had begun their analysis, the federal Department of Homeland Security issued its own estimated cost of implementation to a not-paltry $3.9 billion. Other estimates have gone to $11 billion and beyond. Yet, Congress has appropriated only $90 million to assist states with implementation of REAL ID. The figure in the presidential budget for implementation in the states: zero. [1]

In Arizona, we are in the process of working with the Department of Homeland Security (DHS) to implement what we call a "three-in-one" ID. It will serve as a driver license, provide proof of citizenship for use in conjunction with the new Arizona law that sanctions employers who hire illegal immigrants, and act in the place of a passport for those citizens returning to the United States from Mexico or Canada, in compliance with the Western Hemisphere Travel Initiative (WHTI).

It is my hope that our new card will be REAL ID-compliant. But without some indication that federal dollars will cover the federally mandated costs of REAL ID, I can give no guarantee. The cost gap is too large for states to cover. To make REAL ID work, you must step in.

You must also step in and ***restore the necessary funding to maintain our nation's security through the State Homeland Security Grant Program.***

[1] National Council of State Legislatures, 2008.

In fiscal year 2005, Congress appropriated $1.1 billion for the State Homeland Security Grant Program. That money helped plant the seeds for a secure nation. At that time, the federal government laid out plans for our country to be ready for any major event – whether it is a terrorist attack, a natural disaster or another emergency. The initial focus was to implement the national incident management system and the national response plan. We also expanded regional collaboration and implemented the Interim National Infrastructure Protection Plan. [2]

We started strong, laying a solid foundation for a secure America. Then, funding began to shrink, from $1.1 billion in 2005 to $509 million in fiscal year 2007. Now, President Bush has proposed only $200 million for fiscal year 2009. But our job is not done. Across the country, there remains critical infrastructure to evaluate and secure. Despite diligent efforts, we have communication gaps where first responders still cannot talk to each other at the scene of an emergency. And the need to protect against and train for response to Improvised Explosive Devices (IEDs) is one of the newest national priorities for Homeland Security funds. Returning to fiscal year 2005 funding would assist states, local governments and tribes in fulfilling the homeland security mission.

Finally, Congress needs to address our National Guard. The status and effectiveness of our National Guard is close to my heart, as it is to the hearts of all Governors. We are our Guards' commanders-in-chief, and we take that responsibility seriously. Last year, the National Guard Bureau briefed the nation's Governors, and told us the administration's National Guard equipment budget is almost ***$38 billion underfunded*** to a 90 percent level of readiness through 2013. This long-term situation is unacceptable.

The NGA is strongly united on this issue and has been on record advocating for sufficient re-equipment for several years. For example, I bring your attention to our NGA policy on this

[2] Interim National Preparedness Goal 3-31-05.

subject: the June 2006 NGA Statement for the Record to the Commission on the National Guard and Reserves, which includes a section on equipping the Guard; and a March 2007 NGA letter to the Hill, which requests adequate budget authority to re-equip Army and Air National Guard units.

Governors appreciate your efforts to provide much-needed equipment for the National Guard. Increases in funding under the 2008 defense authorization bill will allow the Guard to begin to obtain equipment necessary to prepare for and perform both the Guard's combat and domestic response missions. But we need Congress' long-term commitment to a comprehensive plan to fully fund sufficient re-equipping of the Guard, so that we do not have to expend valuable resources re-convincing the Congress every year of this critical need.

## **Conclusion**

Chairman Baucus, members of the Committee, you can see that the effects of the national economic downturn on states are varied and significant. I have presented to you ideas that I hope will meet with favorable consideration. This concludes my testimony. I am happy to answer questions from the Committee.

**OPENING STATEMENT**
**SENATOR KEN SALAZAR**
**SENATE FINANCE COMMITTEE HEARING**
**February 26, 2008**
**"The Economic and Fiscal Conditions of the States"**

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this morning's hearing on the economic conditions in the states.

I would also like to welcome Governor Janet Napolitano from the great state of Arizona. Thank you for being here this morning, Governor, and for offering your insights into what is happening on the ground in the states and what the federal government can do to help.

I want to start by saying that I am glad this Committee has continued its examination of the current state of our nation's economy and its consideration of proposals to help address various aspects of the problem.

I was a strong supporter of the effort in this Committee and on the Senate floor to pass a targeted short-term stimulus bill that put money in consumers' pockets and provided important tax relief for businesses.

I have also voiced my desire to see Congress follow up on that effort by focusing on mid- to long-term proposals that will ensure our economy remains strong in the years ahead, including the energy tax package we passed out of Committee last year, the 2007 Farm Bill, and proposals to address the housing crisis that is causing pain across the nation.

Assistance for states that are feeling the effects of the economic slow-down should be part of that conversation. Of course, many states are suffering the same economic stagnation that the nation as a whole is experiencing. In some states, it is a little better, but in others, it is far worse.

While parts of my state of Colorado are doing relatively well economically, there are troubling signs. The December unemployment rate in Colorado was 4.5%, up nearly half a percentage point from November. The average price of a gallon of gas in Colorado surged to over $3.00 last week.

And the housing crisis has Colorado especially hard. At one point in 2006, Colorado led the nation in foreclosure rate. In 2007, Colorado ranked fifth in the nation in foreclosures. Foreclosures were up 30% over 2006 and 140% over 2005. Families across the state are feeling squeezed.

Furthermore, the policies we enact at the federal level – on topics ranging from tax relief to Medicaid funding – have a direct impact on states' ability to collect revenue and fund vital services.

Colorado is one of 36 states that link their tax structures to the federal tax code – and because the taxes my constituents owe to Colorado are based on the taxes they owe to the federal government, tax cuts we pass at the federal level can have the effect of reducing revenue to state governments.

With that in mind, I am interested in discussing ways that the federal government can help as we consider how best to craft additional economic stimulus legislation. As part of that process, I believe we need to ask what kinds of proposals in this area are truly stimulative, and whether there are actions the states themselves can take to improve their fiscal fortunes.

Thank you again, Governor Napolitano, for being here today. I look forward to hearing your views on these and other important issues as we work to continue to provide economic stimulus that is timely and appropriate.