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TESTIMONY OF

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ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING

DEVELOPING A PARTNERSHIP BETWEEN STATES AND THE FEDERAL GOVERNMENT TO SPUR ECONOMIC GROWTH AND JOB CREATION

BEFORE THE

FINANCE COMMITTEE

UNITED STATES SENATE

FEBRUARY 11, 2003

Chairman Grassley, Ranking Member Baucus and distinguished members of the committee:

I am Oklahoma State Senator Angela Monson, president of the National Conference of State Legislatures. I serve as Assistant Majority Leader of the Oklahoma State Senate, and have previously served as chair of the Senate Finance Committee. I am pleased to testify before you today on the fiscal condition of the states and to discuss how we can develop a partnership between the federal government and the states to spur economic growth and job creation.

INTRODUCTION

State budgets are under siege. The sluggish national economy, declines in the stock market, contraction in the manufacturing and high tech sectors and soaring health care costs have combined to undermine state revenues and place unprecedented demands on state spending. States have experienced three straight years of budget shortfalls, outpacing the rainy day funds that we had accumulated during the economic expansion of the late 1990s and requiring us to take extraordinary actions to balance our budgets. And the gaps keep growing. In a survey that we released last week, NCSL reported that the states' cumulative budget gap for fiscal year 2003 has grown more than 50 percent in the last two months to nearly $26 billion. This is only a few months after states had closed most of an estimated $50 billion gap. The projected gap for fiscal year 2004 looms even larger. With only 39 states reporting, the aggregate shortfall is more than $68 billion. Taken together, the multi-year cumulative budget gap from fiscal year 2002 to fiscal year 2004 exceeds $180 billion.

For the most part, the sharp decline in revenues and increased spending demands that states are experiencing are not unlike those facing the federal government. However, there is one critical difference. States, unlike the federal government, must balance our operating budgets and cannot carry a deficit over from one year to the next. As a result, states cannot afford to take farsighted measures that would temporarily cause a deficit but would improve the economy - and our own fiscal situations - over the long term. Instead, the actions we take to balance our budgets tend to counteract economic growth. As federal lawmakers attempt to spur economic growth, we find ourselves in the tragic position of working against you, eliminating jobs, cutting health and welfare programs just when our constituents need them most, raising taxes when more consumer spending is required, and reducing our investments in infrastructure and economic development.

It doesn't have to be this way. We commend you for holding these hearings and for seeking our testimony on how to design a partnership with states that will create the conditions for short-term economic recovery and long-term growth. I understand that the purpose of this hearing is to discuss means to boost consumer spending and I will focus my remarks on that point. I will also provide some brief comments on the purpose of tomorrow's hearing on stimulating business investment. First, however, I would like to discuss with you the fiscal conditions that I, and my colleagues across the country, are facing in our own states.

FISCAL CONDITION OF THE STATES

Last week, NCSL released a survey that shows states are facing a cumulative budget gap for the current fiscal year of nearly $26 billion. This is only a few months after states had closed most of an estimated $50 billion gap. Some states are still able to tap rainy day funds or can shift funds from other state accounts. Most states have cut spending. Twenty-nine states have imposed across-the-board budget cuts. No area of state spending has been spared; elementary and secondary education, higher education, Medicaid, corrections and funds to local governments have all experienced cuts. This year, eight states have already laid off state employees and five have enacted furloughs. Nine states reported that they have delayed planned capital projects. This information is for the current fiscal year and does not reflect actions taken to close prior-year budget gaps. As the fiscal year draws to a close, states face fewer and fewer options for raising revenues or cutting spending. The cuts that take effect the quickest - fee and tuition increases and cuts in benefit programs - take money directly away from consumer spending.

I would like to give you a few examples of the actions that states are taking to balance our budgets and that are countering your actions to provide economic growth. Arizona has eliminated 1,800 full time positions.

Connecticut has laid off 2,800 state employees and is expecting to layoff another 1,000. Maine is requiring all state employees to take three furlough days. Wisconsin has placed a hold on all new construction projects and declared a moratorium on requests for new space or renewal of space leases. In Nevada, the governor has proposed increasing cigarette and liquor taxes, the business license tax and fees that are paid to the Secretary of State. Maine has assessed Medicaid providers and delayed the filing period for its business equipment tax reimbursement program. In addition, Maine - one of only three states that explicitly passed legislation to provide the bonus depreciation allowance under last year's economic stimulus legislation - reversed course and has since decoupled. In my own state of Oklahoma, state employees have been furloughed and all state agencies have been subject to an across-the-board reduction of 6.5 percent. Because of declining revenues for a dedicated education fund, the K-12 education budget has taken a hit of almost eight percent.

There is no light at the end of the tunnel. For the 36 states that reported a budget gap for fiscal year 2004 -- eleven states have not calculated their gaps and three did not report a gap -- the cumulative shortfall is more than $68 billion. Half of these states are facing gaps of more than 10 percent of their entire general fund budget. Oklahoma is better off than most, with an anticipated gap of 6.7 percent of our general fund. In addition to spending cuts, in at least half of the states, the governor or a member of the legislature has offered a proposal to increase taxes. Many states, including both Iowa and Montana, may consider increases in cigarette and other so-called "sin" taxes. Montana is considering a wide variety of tax increases, including taxes on rental cars, hotel accommodations and energy. Sales and income taxes are also on the table. Ten states report that an increase in sales or personal income taxes is possible during the state legislative session this year. California is considering an increase in both the personal income tax and the sales tax. The New York legislature is considering eliminating the sales tax exemption for clothing. New Jersey is considering increases in income tax rates and hotel room occupancy taxes.

Before I move on to discussing proposals to spur the economic growth that we so badly need, I would like to answer a criticism that I have frequently heard in recent months. There are some who say that states' fiscal problems are the result of poor decisions that states made during the 1990s, either because we spent too much or enacted excessive tax cuts. I believe that an examination of the facts will show that states acted responsibly. During the 1990s, states saved an unprecedented amount of money in rainy day funds. Every year from 1992 to 2000, states ended their fiscal years with higher balances than they started. States ended fiscal year 2000 with an aggregate balance of more than $47 billion, or more than 10 percent of their general fund budgets.

States also increased spending in such areas as education, transportation and public safety and expanded Medicaid to serve an increasing number of low-income parents and children. During the late 1990s, some of the factors driving our current expenditure growth began to emerge, such as the spiraling costs of health care, out-of-control increases in special education expenditures, the costs for our on-going commitment to standards-based education reforms and court-ordered improvements to our systems of financing public education. But for the most part, we avoided the temptation to use one-time revenues to expand long-term spending and targeted those increases to meet critical needs and one-time expenses. We boosted spending in some areas, such as higher education, that typically receive new revenue during boom times and experience cuts in a downturn.

We also felt that it was appropriate to give surplus revenues back to the taxpayers who paid them. However, as a percentage of personal income, state taxes have remained largely constant throughout the 1990s. From 1995 to 2000, states enacted roughly $35 billion in tax reductions. Even if these tax cuts had never been enacted, the states still would be facing huge budget gaps. As I noted earlier, the cumulative three-year gap is more than $180 billion.

STATE-FEDERAL PARTNERSHIP TO SPUR ECONOMIC RECOVERY

NCSL supports a federal economic stimulus package to spur consumer spending and capital investment and to encourage job growth. Only a long-term, sustained economic recovery will ease the fiscal pressures facing the states. From here, there are two paths that we can follow. The first is to forget the states and

ignore our fiscal crisis. While you extend federal unemployment benefits, we will be cutting job training, health insurance and child care funding. While you cut taxes, we will be raising taxes and fees. The economy will be caught in the middle of a tug or war that states do not want, but do not have the resources to avoid. The second path is to move forward in concert with each other.

Last month, NCSL's executive committee adopted a resolution calling for a state-federal partnership to spur economic recovery. Such a partnership would:

- Recognize the critical link between states and the national economy;
- Ensure that the state-federal partnership avoids unfunded mandates and underfunded national expectations;
- Include tax strategies to spur, not constrain, state investment;
- Invest in capital projects that leverage state and private investment; and
- Provide immediate, temporary relief for states.

PROVIDE IMMEDIATE, TEMPORARY RELIEF FOR STATES

I would like to focus on the last of these points first. Temporary fiscal relief to the states through countercyclical revenue sharing, as proposed by Senator Baucus, or through one-time revenue grants, as proposed by Senator Snowe, would certainly go far in easing the states' fiscal crisis to avert counterproductive cuts in the safety net and tax increases that sap consumer spending. We support their efforts and look forward to working with you, Mr. Chairman, and with the rest of the committee to incorporate their proposals into economic stimulus legislation.

In addition, our executive committee resolution identified several more targeted approaches to ease the states' fiscal burden.
These include:

- Preventing unspent funds for the State Children's Health Insurance Program from reverting to the federal treasury.
- Preventing the scheduled reduction in disproportionate share hospital (DSH) payments, extending the inflationary increase adjuster to FY 2003-FY2005 and increasing the DSH cap by 3 percent for "low" DSH states.
- Assisting unemployed workers who are seeking employment and encouraging job retention through an increase in mandatory funds for the Child Care and Development Block Grant, with a temporary match waiver.
- Delaying implementation dates, providing temporary waivers or reductions of state matching rates and/or suspension of program sanctions or permitting states to pursue corrective compliance plans.
- Supplementing existing block grants, such as the SSBG or NEGs, for FY 2003 and/or FY 2004.
- Holding harmless states confronted with Medicaid matching rate reductions for FY 2003 and FY 2004 with a temporary, unconditional boost in matching rates for FY 2003 and FY 2004.
- Infusing $3.6 billion in general revenues into the existing Temporary Extension of Unemployment Compensation system.

We commend Senator Rockefeller for introducing legislation to extend the availability of unspent funds for the State Children's Health Insurance Program and Senators Grassley, Baucus, Hatch, Snowe, Bingaman, and Lincoln for cosponsoring this important legislation.

INVEST IN CAPITAL PROJECTS THAT LEVERAGE STATE AND PRIVATE INVESTMENT

A second part of our resolution calls upon the federal government to invest in capital projects that leverage state and private investment. I understand that your hearing tomorrow will focus on investment incentives, so I will keep my remarks on this point brief and point out that we cannot build the economy without maintaining our commitment to infrastructure development. Unfortunately, states find ourselves with no choice but to draw back from that commitment and achieve cost savings by delaying capital projects. On this point, we would also like to commend Senator Baucus for his proposal to enhance highway spending through the issuance of new highway bonds. Expanded federal investments in highways, mass transit and

passenger rail, and in water and wastewater infrastructure projects, especially if it is paired with a temporary waiver of requirements for states to match funding, would make it possible for states to continue with planned capital projects that have been cancelled and to build the necessary infrastructure to accommodate both current and future economic growth.

ADOPT TAX STRATEGIES TO SPUR, NOT CONSTRAIN, STATE INVESTMENT

The difference between states working with, or working against, federal government actions to spur the economy is perhaps most striking in considering changes in the federal tax code. Federal lawmakers from both sides of the aisle have proposed tax changes that are supported by NCSL. For example, NCSL called upon the federal government more than a year ago to accelerate the scheduled increase in the child tax credit. We support a payroll tax holiday that would lift both the employee and the employer share of payroll taxes. We support the use of tax rebates to provide cash that is linked to scheduled reductions in federal marginal income tax rates. We would also support an investment tax credit to spur business investment.

I would like to cite an example of the kind of federal tax change that you should avoid. A major component of last year's economic stimulus legislation was an acceleration of the depreciation schedule for certain investments in equipment. At first glance, it appeared to be a very good way to provide economic stimulus. It provides a high up-front benefit to the taxpayer and encourages near-term investment. In the long run, it avoids exacerbating the federal deficit because depreciation that is claimed now cannot be claimed later. Although the first-year costs to the federal government are high, the ten-year cost was substantially lower.

For the states, however, it was a worst case scenario. Before last year's economic stimulus legislation was enacted, 46 states used the same depreciation schedule as the federal government. If every state had continued to do so, it could have cost states up to $14 billion over a three-year period. Because states must balance their budgets over a one-year or two-year horizon, we were unable to assume cost savings later in the decade to offset the immediate cost. States were faced with a no-win situation. If we conformed to the depreciation bonus, we would have to either raise other taxes or identify additional spending cuts by that amount, putting a damper on the economic growth it was designed to encourage. If we decoupled from the depreciation bonus, we would reduce the effect of the stimulus - and increase complexity for taxpayers, who would be required to maintain two sets of basis calculation for qualifying investments. Most states chose the latter. Sixteen states, as well as the District of Columbia and New York City, passed legislation to explicitly decouple from the bonus depreciation allowance. Only three states passed legislation to conform - and one of those, Maine, has since reversed its course. Currently, taxpayers in all but 17 states cannot claim the full intended benefit, and must keep two sets of books to comply with both federal and state tax laws. Those 16 states have had to make offsetting changes in their budgets to accommodate the costs of the depreciation acceleration. Some state legislatures have not met since last year's federal legislation and have not yet determined whether to conform or decouple, further adding to the confusion for taxpayers.

For this reason, NCSL had supported a credit against federal tax liability for investments in qualifying equipment. An easy rule of thumb to avoid this kind of situation is to provide tax relief and incentives for economic growth through tax credits and other means of changing federal tax liability - rather than definitions of adjusted gross or taxable income - whenever possible.

As you consider tax incentives to spur economic growth, we ask that you keep one goal in mind: to first do no harm. Should you pursue dividend tax relief as proposed by the president, we would like to work with you to avoid substantive changes in IRS reporting requirements upon which states rely, and to maintain a level playing field for tax-exempt bonds. We are also eager to work with you to adopt legislation, such as that proposed by Senator Smith, to lift administrative burdens that inflate the cost of public financing.

We stand ready to work with you, as you consider tax reform measures, to ensure that these are accomplished in a manner that will improve, rather than exacerbate, state fiscal conditions.

ENSURE THAT THE STATE-FEDERAL PARTNERSHIP AVOIDS UNFUNDED MANDATES AND UNDERFUNDED NATIONAL EXPECTATIONS

Also in the category of "first do no harm" is avoiding the imposition of unfunded mandates on the states. Since 1995, NCSL has praised the Unfunded Mandates Reform Act for curbing the practice of shifting the cost of federal laws onto the states. But in the recent past, Congress has exploited loopholes in that law to move away from its spirit and intent. We have entered into a new era of unfunded mandates and underfunded national expectations.

The Help America Vote Act, a vital piece of legislation that will ensure that every one of our citizens has full access to the polls and that every vote is counted, was signed into law just four short months ago. States have less than 11 months to meet the first deadlines for implementing many of the required election reforms. It is imperative that full funding of $2.2 billion be appropriated for fiscal year 2003. In addition, states will need the full authorized funding for fiscal year 2004. Sadly, both the omnibus appropriations bill now being considered in conference and the president's request for 2004 fall far short of providing full funding. Now is not the time to be imposing a new unfunded mandate on the states.

Another new burden that the federal government has recently imposed on states is in the area of homeland security. State and local governments have spent billions of dollars with the expectation of reimbursement from the federal government. The Public Health Security and Bioterrorism Preparedness and Response Act of 2002 required every community water system that serves a population of greater than 3,300 persons to perform vulnerability assessments, but provided funds only for the largest. These assessments will cost hundreds of millions of dollars. Inoculating our first responders and public health officials from smallpox will carry a substantial cost and states may be legally liable for complications that arise. But the only funds that we have seen so far have been insufficient to cover the need and recent proposals to increase funding have come at the expense of other critical law enforcement and public safety needs.

The burdens that unfunded mandates place on the states are extraordinary. Every year, states must appropriate funds to cover tens of billion dollars that the federal government has promised, but failed, to send our way. There is no more vivid example than the Individuals With Disabilities Education Act. More than a quarter century ago, the federal government promised to pay the additional cost for states to provide a free and appropriate public education for special education students. At the time, the Congress authorized payments to the states to cover 40% of average per pupil expenditures, the estimated additional amount needed to educate a special education student. Congress has never lived up to this commitment, and it would require $11 billion in immediate, one-time spending to cover that commitment for the current fiscal year. The Center for Special Education Finance, which is funded by the U.S. Department of Education, has estimated that the actual cost for states exceeds $25 billion per year. That is equal to the entire aggregate state budget gap for fiscal year 2003.

And that is only the beginning. Funding to implement the No Child Left Behind Act is $5 billion short of the authorized amount. Some state estimates of the cost to conform are much higher. New Hampshire has estimated that for every new federal dollar, state and local jurisdictions will need to spend $7 of their own. If these numbers hold true across the country, the one-year cost to implement the No Child Left Behind Act could be as high as $35 billion.

NCSL has done a preliminary analysis of the costs to states for these four mandates and underfunded national expectations - special education, No Child Left Behind, election reform and homeland security. The costs range from a minimum of $26 billion to almost $100 billion. There are some who have suggested that federal assistance to the states would be a handout. That kind of logic not only ignores the reality of state balanced budget requirements, the reasons for our current imbalance, and the need to avoid budget-balancing decisions that put a brake on economic stimulus, but it also ignores the fact that every year, the states appropriate tens of billions of dollars in handouts to the federal government to pay for programs that the federal government has promised but failed to fund.

There is no time like the present to rectify this current imbalance by providing fiscal relief for the states. We stand prepared to work with you to do so as part of an economic stimulus package. NCSL looks forward to working with this committee to enact legislation that will spur economic growth. We can best achieve a rapid economic recovery is if we work together, rather than at cross purposes.

I thank you for this opportunity to discuss these important issues with you today and would be happy to answer any questions.