



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.