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and Governmental Affairs
U.S. Senate**

“Follow the Money: State and Local Oversight of Stimulus Funding”

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Chairman Lieberman, Ranking Member Collins, members of the committee, on behalf of the nation's governors, thank you for the opportunity to appear before you today to discuss state efforts to implement the American Recovery and Reinvestment Act (ARRA).

Background

The economic conditions governors face in their states are unprecedented. Earlier this year NGA estimated that state budget shortfalls for fiscal years 2009 and 2010 would top \$230 billion as a result of falling revenues from the faltering economy. These shortfalls mean that governors must cut services or develop new sources of revenues to meet state balanced budget requirements -- actions that could slow an economic turnaround.

Furthermore, history has shown that states experience the worst fiscal conditions the year after a national recession ends. With economists forecasting that the economy will continue to contract through 2009, and unemployment rates increasing into 2010, governors are planning for difficult financial times through fiscal year 2011 and possibly 2012.

As a result, NGA issued a paper with recommendations regarding a possible federal stimulus bill to spur the economy and put people back to work. NGA's recommendations included countercyclical funding for states to reduce the need for cuts to services or tax increases; investments in infrastructure to create jobs and promote economic competitiveness; and funding for safety net programs to help individuals impacted by the downturn.

Governors also met with then President-elect Obama and Vice President-elect Biden to discuss the economy and encouraged the incoming administration to hold governors accountable for the use of federal recovery funds. Specifically, governors voiced support for use-it-or-lose-it criteria to ensure rapid deployment of federal dollars.

The ARRA reflects each of these recommendations. It provides more than \$135 billion to states in countercyclical funds through Medicaid and education. It invests in core infrastructure including highway, transit and water systems. It also provides additional funds to extend unemployment assistance and other benefits for individuals and families. All told, of the \$787 billion provided by the ARRA, more than \$246 billion will go to or be administered by states. This places states, and governors, on the front lines partnering with the federal government to make the ARRA work.

To one extent this hearing is premature. Having just passed in February, most ARRA funds remain in the hands of the federal government, and the federal agencies charged with distributing the funds are still developing the guidance and rules necessary for states to implement the act.

On the other hand, this hearing is well-timed because meeting the levels of transparency and accountability called for by the ARRA will take an extraordinary level of cooperation and coordination between federal agencies and state and local governments. If developed properly, federal and state rules should help spend federal funds efficiently and prevent waste, fraud and abuse. If, however, federal, state and local efforts are not well coordinated, funds may be spent too quickly or on projects that do not maximize job creation or economic growth.

As this committee begins its review of federal and state actions to implement the ARRA, NGA offers the following recommendations:

- Coordinate and streamline reporting requirements and oversight
Congress and the Administration should avoid duplicative or unnecessary reporting requirements by sharing information and developing common definitions to make state reporting easier and more usable.
- Provide resources for accountability and transparency
Millions of dollars were provided to federal Inspectors General to conduct oversight and prevent waste, fraud and abuse. Flexibility in the use of ARRA funds by states to meet transparency and accountability standards is necessary to develop and improve state systems and capabilities to meet ARRA requirements.
- Allow time for planning
The ARRA's objective of spending money quickly must be tempered with the objective of spending federal taxpayer dollars wisely. Congress and the Administration should provide states flexibility to organize and plan after federal rules are finalized to ensure proper handling and priority setting at the state level. This would allow ready-to-go states to move forward immediately and provide others time to build capacity to meet ARRA requirements.
- Communicate with and through Governor's Offices
The ARRA provides states and governors with central responsibility for using and administering federal recovery funds. Federal officials should therefore ensure that the governor's office is kept informed of all federal spending and activities that occur in a state.

The State Role

During any economic downturn, states are key players from three major perspectives. First, they administer most of the safety net programs in the United States. The four major programs that can both help stabilize the economy and provide benefits to individuals in need are 1) Medicaid, 2) welfare benefits, 3) unemployment compensation and 4) food stamps. All of these are federal-state programs that receive major federal funding. Second, states can quickly create jobs in the short-run through infrastructure investment such as highways, transit projects and water and sewer system modernization. States are able to do this quickly because states administer many infrastructure programs and have detailed information regarding unmet needs. Third, because of balanced budget requirements¹, states typically react to downturns by cutting spending and raising taxes, which make the downturn more severe. Direct federal government payments to states to help offset these actions is therefore one of the most powerful countercyclical actions the federal government can take.

¹ All but one state has a balance budget requirement.

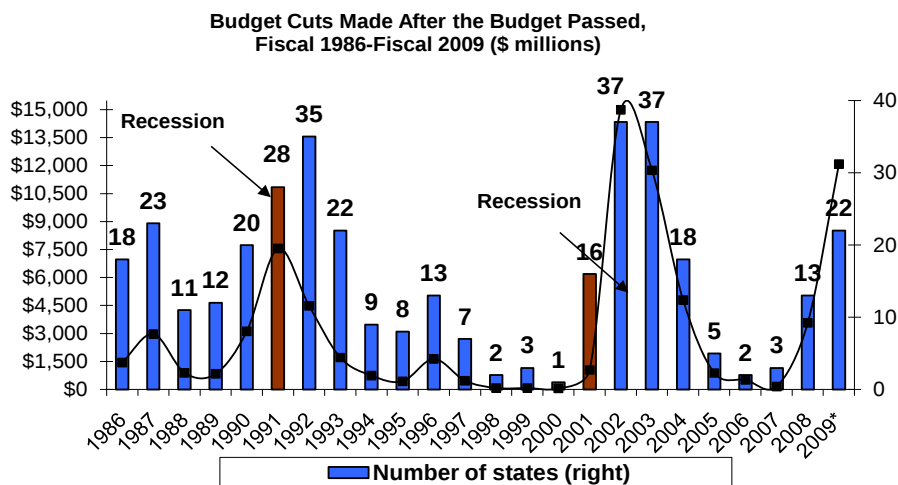
State Shortfalls

A survey of state fiscal conditions late last year projected state shortfalls of \$230 billion for FY 2009 and FY 2010. My best estimate today is that without ARRA dollars, states would face budget gaps of \$300 to \$350 billion through fiscal year 2011. Tax collections continue to trend downward with sales tax, corporate business tax and personal income tax revenue all staying negative during the first quarter of 2009. These revenues will be further depressed by the lack of capital gain tax revenues resulting from the sell-off in the stock market. Income tax revenues are likely to dip most after unemployment peaks, which could be as late as mid-2010.

State Impacts Lag the Downturn

Unfortunately, even with distribution of ARRA funds, states' fiscal picture will continue to deteriorate over the next two years. When the economy slows, state sales tax revenues decline as reductions in personal consumption often lead downturns. Rising unemployment is the next sign, which in turn leads to declines in state personal and corporate income tax revenues. The increase in unemployment also often leads to increases in the demand for food stamps, unemployment benefits and Medicaid payments, which is currently about 21 percent of state budgets.

The lag effect on states was evident in each of the last two recessions. The recession that ended in 1991 resulted in 28 states cutting budgets that year. States, however, continued to experience the recession's impact and in 1992, 35 states cut budgets. Similarly in 2001, when the most recent recession ended, 16 states cut budgets. However, 37 states cut budgets in each of the next two years—2002 and 2003. (See Chart: Budget Cuts Made After the Budget Passed). If the current downturn continues and follows the path of past recessions, most states will face budget shortfalls in 2010, 2011 and possibly 2012.



Managing the American Recovery and Reinvestment Act

With more than \$246 billion in recovery funds flowing to or through states, governors have taken an aggressive approach to managing ARRA funds and programs. Governors are keenly aware of the inherent tension the ARRA's objectives pose for states: spend funds quickly; target funds effectively; and prevent waste, fraud and abuse. These objectives must also be measured against the fact that ARRA funds are temporary and cannot be counted on to fund long-term reforms or benefit expansions.

From a state perspective, it is critical to think in terms of the ARRA's various categories of spending because they have very different intents and many require different management structures, reporting requirements, and the involvement of state legislatures. Four categories are particularly important.

a. Countercyclical Funds

There are two major categories of the countercyclical funds, which are the most flexible funds. First, there is the \$87 billion in estimated federal increase in Medicaid funds. Second, there is \$48 billion in the State Fiscal Stabilization Fund, which includes \$8.8 billion that can be used for any purpose as well as education, and \$39.5 billion that must be used for elementary, secondary and higher education. Because education averages about 46 percent of state budgets, it provides considerable fiscal relief. It is important to note that local school districts will also receive an additional \$25 billion in Title I and special education grants for education. The combination of Medicaid enhancements and the State Stabilization Fund means that the flexible funds provided under the act total about \$135 billion.

This \$135 billion is critical for states because it can be used to offset states' projected \$300-\$350 billion in shortfalls through fiscal year 2011. The new dollars are an appropriate amount that will help stabilize the economy and offset the most draconian cuts, but will keep the pressure on states to continue to consolidate, streamline and downsize state government. Already ARRA funds have had a positive economic impact: states are postponing planned cuts and tax increases for fiscal year 2010.

Although the allocation of countercyclical funds across states could be better targeted, the Medicaid formula does account for economic stress, and therefore many of the states with the worst underlying economies get a larger allocation of funds. There are only a few small states—generally those that produce energy—that may receive funds above their needs. For most states, these flexible federal funds are far short of need. The fact that the Medicaid funds were retroactive to October 1, 2008, was extremely helpful in allowing states to postpone planned cuts. It is important to note, however, that even after the recovery package, states will continue to face a shortfall of more than \$200 billion over the next three years, and will therefore continue to reduce spending and consider increasing taxes to balance their budgets.

b. Appropriated Programs

The ARRA contains a significant number of direct appropriations into existing federal-state programs, which run the gamut from \$27.5 billion for highways to \$1 billion for community services block grants to \$3.1 billion for state energy grants. States have little flexibility here and must spend these additional funds in the specified program areas. Many of these grants are

formula while others are discretionary or competitive grants. This category includes about 50 programs, and in many cases, states are required to obligate and spend these funds quickly to create jobs.

c. Safety Net

The ARRA also expands on a number of safety net programs such as transitional Medicaid assistance, food stamps and unemployment insurance. Most of these programs will require states to make decisions regarding new eligibility and benefit levels, which may require state legislative changes as well as major changes to business processes and management information systems. Safety net funds are generally spent quickly by recipients and, thus, have a positive macroeconomic impact.

d. Foundations for Economic Development

The ARRA also provides funds for several long-run investments with the potential for economic growth including: alternative energy and smart grid technology; Health IT; broadband deployment and access; high-speed rail; and funding for research and development. Most of the funding in these areas is for new programs that require significant planning and development by both the federal government and states. Maximizing these dollars requires a coordinated approach, governance structure and clear strategic goals. More than any other type of funding under the ARRA, these funds are targeted towards establishing capabilities to develop and promote long-term economic growth.

Accountability and Transparency

The legislation contains numerous provisions to ensure that the appropriated funds are spent as intended by Congress. As a result, state activities will be subjected to extensive public scrutiny and to enhanced oversight by a variety of federal entities, including federal program managers, agency inspectors general, and the Government Accountability Office (GAO). Federal efforts are being coordinated by the newly established Accountability and Transparency Board, which is charged with preventing potential waste, fraud and abuse and is made up of inspectors general from several federal agencies.

In addition, the legislation requires the board to operate the Web site, www.recovery.gov, as a portal or gateway to key information related to recovery efforts and to provide a window to other government Web sites with related information. States will be required to use this Web site to post information on the use of both operational funding and infrastructure investments. The required information is generally more detailed than mandated by current statutes including:

- Descriptions of the intended use of the funds;
- Impact on job development and preservation; and
- Copies of individual grants and contracts.

Finally, the legislation includes substantial increases in the appropriations for the GAO and departmental inspectors general. It also requires grantees to provide federal reviewers with unfettered access to state records and establishes new whistle-blower protections, including the authority for federal inspectors general to review and decide claims regarding retaliation. GAO has already identified and initiated reviews of implementation activities in 16 states.

Challenges for States

Governors expect to be held fully accountable for their use of ARRA funds. To best achieve these objectives, governors are acting to build or expand a capacity to:

- Plan and establish priorities;
- Obtain necessary legislative and public support;
- Coordinate the interaction between state and federal agencies;
- Oversee state agency implementation, including coordination and collaboration across agency and program lines;
- Expand workforce capacity to develop and monitor a rapid growth in contracts;
- Ensure compliance with grant requirements, including transparency and accountability provisions; and
- Facilitate local government and private sector opportunities to utilize federal grant and loan programs to the maximum extent.

State Planning

Governors understand that thoughtful planning and skilled implementation are necessary to achieve the full benefit of the opportunities encompassed in the ARRA. Planning is required to ensure that new spending is timed to provide necessary resources over the duration of the recession and initial recovery. Failure to plan early for the next two to three years could worsen the out-year impact because states may be hard pressed to meet service expectations or commitments once ARRA funds are exhausted.

Planning is also vital to ensure that available funds are used strategically to address both short-term needs of individuals adversely affected by the recession and opportunities to invest in future economic growth. A thoughtful planning process that involves multiple stakeholders at an early stage can help both to identify priorities and the opportunities to coordinate a variety of funding sources to help achieve broader goals. That process also can help identify and address issues relating to the sustainability of programs and services that may be initiated or expanded under the ARRA.

To organize ARRA planning and implementation efforts, states have tended to organize around a single individual or task force. These single points of authority provide the broad perspective and ability to coordinate funding across stove-piped federal programs to maximize job creation and economic growth. These are also generally the offices that will be in charge of fulfilling the ARRA's extensive public reporting provisions.

Good news about the ARRA

Although the Act is only a couple of months old, there is positive news.

1. The Administration, individual agencies and OMB have provided a substantial amount of guidance and funds are beginning to flow.
2. Every governor has appointed key staff to serve as their leads and many have appointed task forces with private sector and community leaders.

3. OMB, GAO and individual agencies have been accessible and cooperative in working with state organizations to solve problems as they become known.

4. Perhaps most important, the recovery package was well timed. The history on fiscal policy changes to stimulate economic growth has been very poor. Specifically, past stimulus packages have generally come too late and the impact is often after the economy has already turned up. Given the length of this downturn, however, this package will likely moderate the downturn in two important ways. First, the flexible or countercyclical funds have already allowed many states to postpone planned budget cuts or tax increases. This has had the positive impact of limiting the magnitude of the downturn. Second, the economy is still deteriorating although more slowly, and funds from the stimulus are now being spent. Thus, this recovery package should be helpful over the next year in both limiting the downturn and perhaps helping the economy to turn the corner. Unlike most previous fiscal policy changes, the ARRA was not too late.

Ongoing Challenges

While there is some very positive news, it is also true that governors and states face a number of challenges.

1. The first major challenge for states is to spend the money quickly to maximize job creation while maintaining program stability and efficiency and filling a budget gap that will last at least three years. The three year projection is based on the assumption that it will take two years for GDP to return to the 2008 level and a third year, based on historical observations that the year after a recession is generally the most difficult fiscal period for states. Given that all of the economic stimulus funds are temporary, it will be extremely difficult for states to spend funds quickly, fill a three-year budget gap and maintain program stability and efficiency.

2. States will be accountable not only to the various agencies and OMB, but also the new Recovery Act Transparency and Accountability Board and GAO. Since OMB has yet to publish the final reporting requirements, it is difficult to determine the degree of burden faced by states and ARRA fund recipients. Governors' greatest concern is that the federal agencies various requirements for information will not be consistent or coordinated further burdening states to meet duplicative requirements. Requests for information from congressional committees are also an issue because to date they have not been coordinated with reporting requirements from the Administration. NGA recommends that future congressional oversight activities rely primarily upon the massive volume of information the federal government will receive from states rather than requesting new or different information about the same projects from states.

3. While the ARRA provided ample funding for federal oversight activities, little was provided for states. Those funds that are available are linked to specific programs rather than applying to all ARRA funds. Governors are encouraged by suggestions that OMB is working on guidance to allow some limited use of ARRA funds for meeting ARRA reporting and transparency requirements, but until that time the lack of funding for accountability remains a major concern.

4. A primary focus of the ARRA is to save and create jobs. Yet estimating the direct jobs created and the number of jobs saved will be very difficult. The Administration needs to establish more specific guidance in this area to ensure proper data collection and accurate reporting. Even with additional guidance, however, the jobs data will have limited value to make comparisons across projects or states.

5. States will be challenged in those program areas where there was not an existing program or where the budget increases were dramatic. The weatherization program is a primary example as states will have to scale up capacity to manage and distribute a massive influx of funds over the next 24 months.

6. States need time to plan and execute in the five areas (Health IT, broadband, high speed rail, R&D and alternative energy and smart grid) for long-run growth. The focus of these programs is different from short-run stimulus programs and thus effective and efficient planning, as opposed to accelerating spending, should be the priority.

7. Most states have cut budgets over the last two years and therefore have less capacity to execute significant increases in spending or take advantage of new programs requiring state matching funds. States will rebuild capacity to take advantage of ARRA opportunities, but it will take time.

8. The transparency and accountability at the heart of the ARRA is quite different from that of existing programs. Consequently, it will require tracking systems and capabilities that may differ from those currently employed by states. Existing state information systems may need to be upgraded or replaced to meet ARRA standards.

9. From the public's perspective, governors are responsible for all funds that go to a state regardless of whether they flow through a state or go directly to a quasi-independent agency, (e.g., a port authority), or a local government. In order for governors to effectively manage ARRA implementation for their states, governors must be notified in a timely manner of all investments made in their individual states.

Mr. Chairman, I appreciate the opportunity to appear before you today to discuss implementation of ARRA. Again, I want to stress the fact that we are very early in the implementation process and therefore these comments must be viewed as preliminary. I look forward to working with you as you continue your review of ARRA funds and the actions of states to put people back to work, make our nation more competitive and speed economic recovery.