Testimony of

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Before the

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U.S. Senate

"The Costs and Impacts of Crisis Budgeting"

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Dear Chairman Carper, Ranking Member Coburn and members of the Committee:

Thank you for inviting me to appear before you today on behalf of the budget and finance officers of the nation's 50 states and territories. For over 60 years, the National Association of State Budget Officers (NASBO) has been the professional membership organization for state budget and finance officers. As chief financial advisors to our nation's governors, NASBO members are influential decision makers in state government. They guide their states in analysis of budget options and formation of sound financial management.

Federal Budget Uncertainty: Negative Implications for States

The uncertainty caused by federal actions in the appropriation process as well as other federal actions prevents state and local governments from efficiently delivering required government services.

Fiscal uncertainty at the federal level presents numerous challenges to sound financial management and long-term strategic planning at the state and local levels. The federal government provides states with financial resources to pursue key policy objectives and produce results. However, persistent uncertainty and short-term funding for various initiatives makes it extremely difficult for states to achieve these goals as efficiently and effectively as would otherwise be possible.

Measuring the precise impacts of federal budgetary uncertainty on state and local governments is for technical reasons difficult. However, identifying examples of these impacts and their potential ripple effects can improve our understanding of the costs associated with delayed and fractured appropriations, as well as other sources of federal uncertainty.

The following testimony:

- Provides a description of the current fiscal landscape of the states to provide some context of the challenges state governments and their citizens face;
- Explains the important role that federal funds play in state budgets;
- Discusses the sources of budgetary uncertainty caused by the federal government and examines the costs and impacts of this uncertainty; and
- Recommends a path forward that includes greater certainty and flexibility from the federal government for states, localities and other grant recipients.

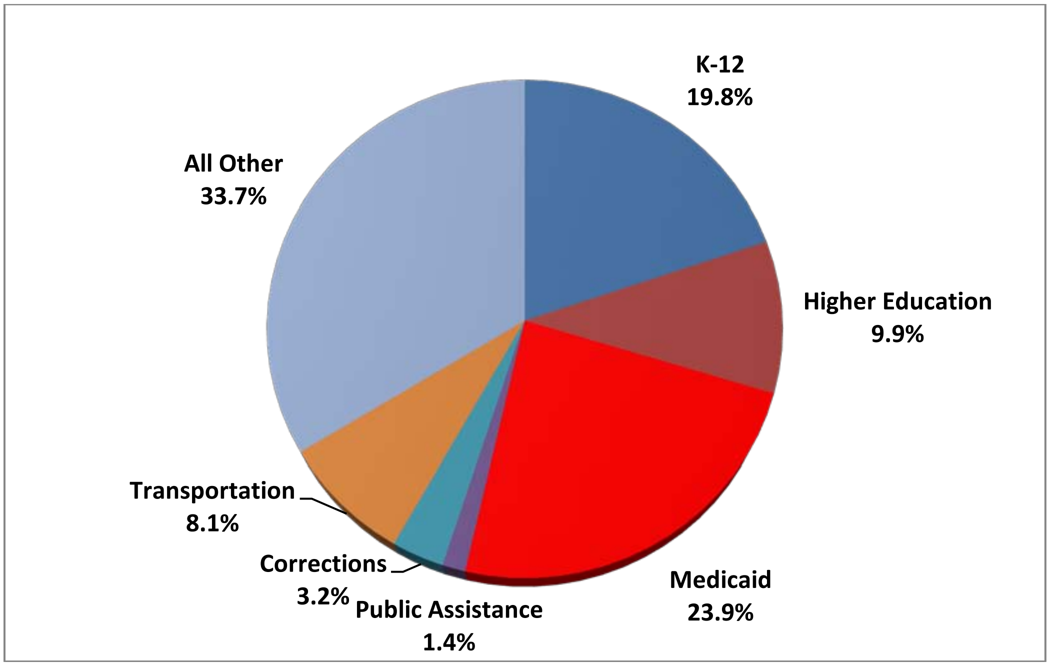
State Budget Outlook: Tight Fiscal Conditions

State government resources will be constrained for the foreseeable future and state officials have limited budget flexibility. Fiscal uncertainty at the federal level creates additional costs and unnecessary inefficiencies for states.

The state fiscal landscape has changed dramatically in recent years. Even with a recovering economy, the fiscal environment for states is expected to be very different and much more constrained compared to past decades. Future state spending is likely to grow more slowly than it has historically, meaning that resources will continue to be limited for years to come. (See Figure 1.) At the same time, the demand for funding continues to rise in a number of highpriority program areas, particularly Medicaid. As a result, competition for state funds is and will continue to be strong.

The fiscal challenges facing state governments are largely tied to the fact that a few program areas consume very large shares of state budgets. As shown in the figure below, elementary and secondary education and Medicaid – the two largest state expenditure areas – together consumed nearly 44% of total estimated state expenditures for fiscal 2012 (including spending from general funds, other state funds, bonds and federal funds).

Figure 1: Total State Expenditures by Function, Estimated Fiscal 2012



Source: NASBO 2010-2012 State Expenditure Report

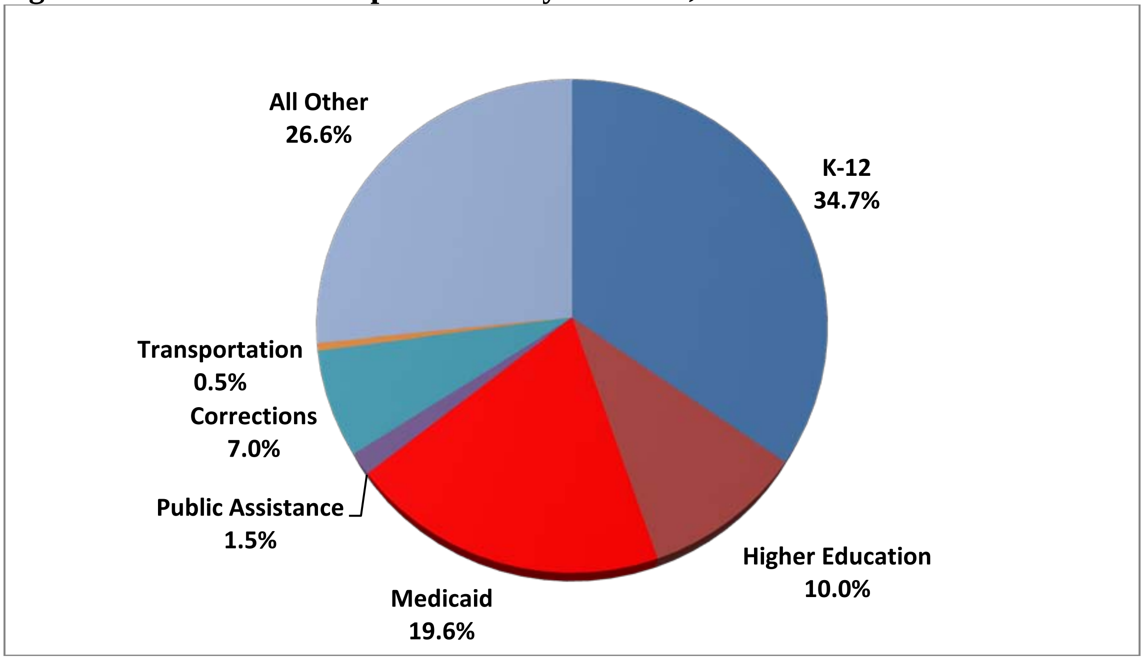
The relative size of these two spending areas is even more prominent when just looking at expenditures out of states' general funds – states' own source funds over which they have more control and discretion. As shown below, in fiscal 2012, K-12 and Medicaid expenditures were estimated to account for over half of all state general fund spending. (See Figure 2.) Both areas are generally top funding priorities for states, leaving state officials with limited room in their budgets to make program adjustments to close gaps caused by federal funding reductions.

Although state budgets have improved somewhat since the end of the national recession, general fund expenditures and revenues remain below pre-recession levels in many states.[1] General fund spending has increased for three consecutive years but growth levels have remained below historical averages. (See Figure 3.)

[1] National Association of State Budget Officers, *Fall 2012 Fiscal Survey of States*, December 2012.

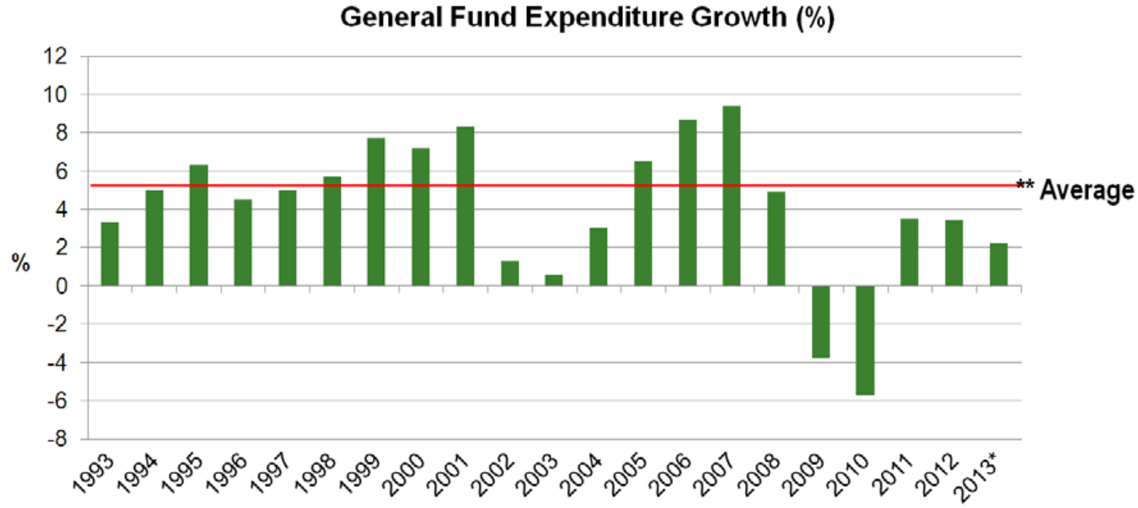
The bottom line is, even with the economy improving, states do not have enough money to go around. Tough decisions will continue to have to be made by states to maintain balanced budgets and fulfill their funding obligations.

Figure 2: General Fund Expenditures by Function, Estimated Fiscal 2012



Source: NASBO 2010-2012 State Expenditure Report

Figure 3: The "New Normal" for State Expenditure Growth



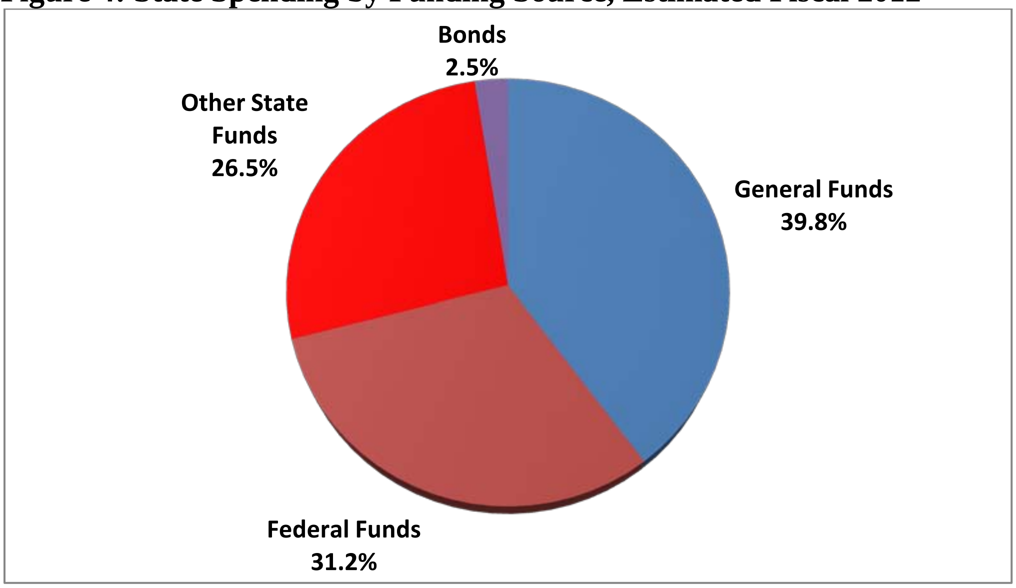
** Fiscal 2013 Numbers are appropriated.*
*** 35-year historical average annual rate of growth is 5.6 percent.*
Source: NASBO Fall 2012 Fiscal Survey of States

Role of Federal Funds in State Budgets

Federal funds play an important role in state government; almost one third of state budgets are funded by monies from the federal government.

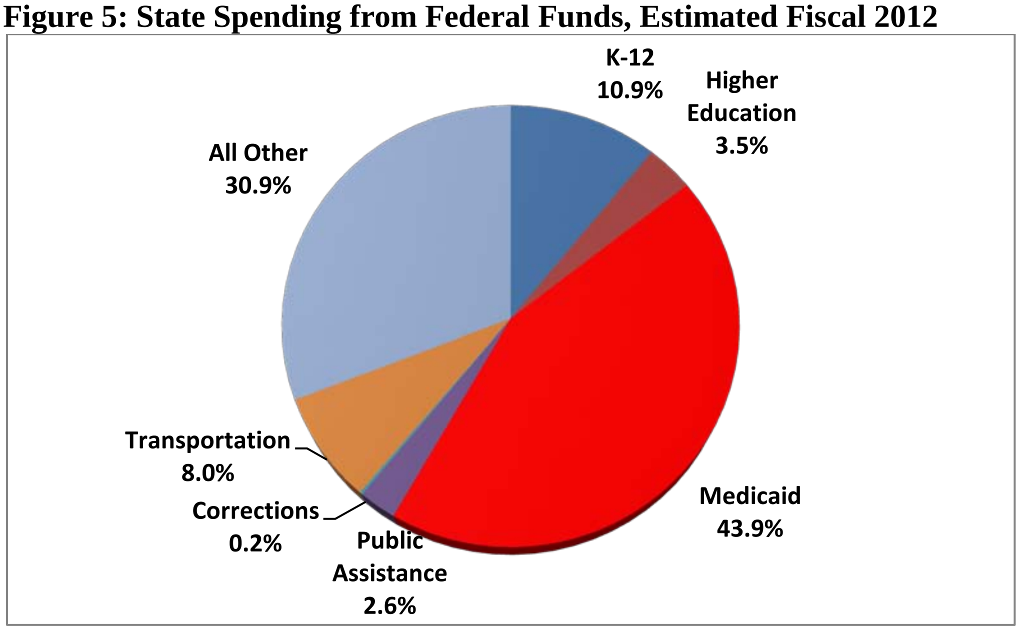
States rely on federal grants for many programs with policy objectives of critical importance to the federal government, as well as states and localities. More than 31 percent of all estimated state expenditures came from federal funds in fiscal 2012. As a result, delayed or short-term federal spending decisions can lead to significant uncertainty in state budgets. (See Figures 4 and 5 below.)

Figure 4: State Spending by Funding Source, Estimated Fiscal 2012



Source: NASBO 2010-2012 State Expenditure Report

Figure 5: State Spending from Federal Funds, Estimated Fiscal 2012



Source: NASBO 2010-2012 State Expenditure Report

Federal Sources of Budget Uncertainty

States and localities, as well as other funding recipients, have long wrestled with challenges and costs associated with "crisis budgeting" due to uncertain federal appropriations, delayed program reauthorizations, and other federal sources of uncertainty.

In recent decades, the use of continuing resolutions (CRs) in lieu of full-year appropriations bills by Congress has become commonplace.[2] Delayed and disjointed federal appropriation bills, along with short-term CRs and the recent sequestration, lead to a severe lack of adequate, timely information for states and localities about federal discretionary spending that is necessary to make tough spending decisions. This is especially true when both the timing and level of funds that will be available are uncertain.[3]

In addition to fractured and delayed appropriations, the common use of short-term extensions for mandatory programs in place of long-term reauthorizations is another source of great uncertainty for states. Congress's treatment of highway bill reauthorization over the past decade provides a telling example of this. From October 2003 to August 2005, and again from October 2009 to June 2012, federal surface transportation programs were authorized through a series of short-term extensions rather than a long-term reauthorization bill. This uncertainty has important impacts on the ability to plan and budget for long-term infrastructure projects, to be discussed more below. This problem is not unique to transportation. For example, another program of great importance to state budgets, Temporary Assistance for Needy Families (TANF), has been authorized under a series of short-term extensions since 2010.

Uncertainty regarding federal tax policy is another important issue for states. Tax law changes can have a significant automatic impact on state tax revenue collections. Most state tax systems are closely linked to the federal tax code; some states calculate their personal income taxes based on federal adjusted gross income or compute their tax as a percentage of federal tax liability. Uncertainty regarding possible federal tax and spending policy changes – as well as decisions such as whether to raise the debt ceiling – can have ripple effects throughout the economy related to consumer spending, business investment, and employment. These effects can also have important indirect impacts on state budgets. The longer the prospects for such changes remain uncertain, the longer states and localities are left in the dark about how such actions will affect their bottom lines. States have difficulty forecasting revenue, and unexpected shortfalls can occur causing spending cuts and in some cases tax increases.

The Costs and Impacts of Budget Uncertainty

Federal budgetary uncertainty has important impacts on states and localities and their ability to plan their own budgets, effectively deliver government services, and manage cash flows and contracts. While these impacts may be hard to measure, their costs are real, as well as significant.

[2] Congressional Research Service, "Continuing Resolutions: Latest Action and Brief Overview of Recent Practices," December 2011.
[3] Philip G. Joyce, "The Costs of Budget Uncertainty: Analyzing the Impact of Late Appropriations," 2012.

Impact on Ability to Plan

Budgetary uncertainty at the federal level presents significant hurdles for state and local officials trying to draft their own budgets, as well as develop long-term strategic plans around funding priorities. The uncertainty leads to short-term planning, which results in shorter-term and more costly actions and contracts. For example, the uncertainty surrounding the recent "fiscal cliff" debate left state officials around the country scrambling to put together budget proposals that relied on major assumptions about what actions federal lawmakers would take. States ran alternative fiscal scenarios and developed contingency plans if those assumptions turned out to be incorrect, leading to decreased staff productivity, inefficiency and lack of strategic, long-term planning.

A budget officer in a Western state cited multiple examples of how uncertainty about federal funding has disrupted program management, forcing states to focus on short-term programmatic issues rather than on long-term results and outcomes. One example is that the state must make plans ahead of time to determine what pests may be threatening to agriculture in the state and take precautions months ahead of planting season to prevent crop devastation. However, this planning is made difficult when the state does not know how much and when federal funding will be available for these preventative measures. Another example cited involves teacher layoff notices. Due in part to uncertainty around federal appropriations amounts, school districts in the state have some years issued layoff notices in the spring for the following school year, as required by state law, that are subsequently "pulled back" once appropriation levels are more certain. This causes substantial disruption for school districts' planning efforts for the next academic year.

Impact on State and Local Government Staff and Services

Uncertainty at the federal level can hinder states' ability to effectively develop and implement an initial budget plan, and can also generate the need to rework that plan to adapt, often in a crisis mode. Federal funding volatility, especially during tough fiscal times, leads to program instability and increased staff turnover. Ramping up and down staffing to carry out a federal program can be especially expensive to carry out. Inconsistent, short-term funding can lead to increases in on-boarding, training, and separation costs, and can be detrimental to staff morale, which in itself can lead to decreased productivity of programs. These staffing changes can also be costly to state government contractors affected, and these costs may be passed onto states through higher bids for services.

Another negative impact of chronic federal budget uncertainty is diminished confidence in the federal government's ability to make difficult choices and maintain a fair and consistent set of expectations and regulations, which in turn can have an effect on government programs. When state budget officials lack confidence in the federal government, they may be less likely to engage voluntarily in partnering with the federal level to finance and deliver services. Each state government must decide whether to proceed or put on hold specific actions that obligate or expend public resources that are dependent upon partial federal financing of the ultimate cost. According to one state budget official, "It appears, at least anecdotally, that most state governments have established a policy of putting on hold and ultimately terminating plans or actions for which the federal government has not assured continued financial participation." "State officials' decisions turn significantly on measures of confidence and risk, both of which move in negative directions when there is increased uncertainty regarding matters of policy and finance," explains a budget officer in the Midwest.

State budget officials will often discontinue obligations and services that are dependent upon federal financing when federal funds are reduced or uncertain. In that sense, state operations/budgets are simply impacted by a discontinuance of the actions otherwise of interest to the federal government for which financing is not forthcoming. State budget officials will deliver certainty when/where none exists.

Lack of funding certainty from Congress can lead to forgone investments, delayed hiring decisions, and other missed opportunities, the impact of which can be hard to measure. As discussed above, surface transportation programs were authorized by Congress through a series of short-term extensions between October 2009 and June 2012, and prior to that from October 2003 to August 2005. In a survey of state transportation agencies conducted in 2003 by the American Association of State Highway and Transportation Officials (AASHTO), 33 of the 45 states responding to the survey reported that a short-term extension of the surface transportation bill, instead of a six-year bill reauthorization, would result in $2.1 billion in project delays and more than 90,000 job losses.[4]

More recently in March 2012, after another temporary extension of surface transportation programs was passed in place of a long-term reauthorization, a number of state transportation officials reported the negative impacts of the short-term extension. North Carolina's transportation secretary cited they delay of project awards totaling $1.2 billion that would have employed 41,000 workers, while Michigan cited 3,500 jobs at risk as a result of project delays.[5] Delays in road construction and repair due to federal funding uncertainty can be especially costly in northern states with short construction seasons. The present uncertainty over the impact of the sequester has similarly resulted in decisions to delay projects and hiring. One state budget officer has noted that local school districts, which are developing their budgets this spring for the following school year, are choosing not to hire their full allotment of teachers in order to hold back some funds in case the state is unable to provide the funding level promised or has to reduce funding in the future.

Impact on Credit Ratings, Cash Flow and Contracting

Federal budgetary uncertainty can have an impact on state and local credit ratings, and therefore affect the ability of states and localities to borrow and their borrowing costs. In July 2011, Moody's Investors Service cautioned that if it were to downgrade the U.S. government's credit rating, it would likely lower the credit rating for five states – Maryland, Virginia, South Carolina, Tennessee and New Mexico – determined to be most dependent on federal government revenue.[6]

Federal budget uncertainty can also create cash flow problems for state and local governments. During the federal budget debate in 2011, many states were concerned about a possible federal

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[4] American Association of State Highway and Transportation Officials, "TEA Impacts of Delay," September 2003.
[5] Council on State Governments, "Congress Passes 9th Transportation Extension; State Governments Remain Concerned About Continued Uncertainty," March 2012.
[6] James Nash and William Selway, "5 States May Lose Moody's Top Debt Rating on U.S. Reliance," *Bloomberg Businessweek*, July 19, 2011.

government shutdown and its potential to worsen an already tight state fiscal situation. In April 2011, New York's Office of the State Comptroller issued a report on the implications of a federal government shutdown for the state. The report highlighted the cash flow challenges a possible prolonged shutdown would have if the state were unable to draw down certain federal funds, including "delayed payments to contractors, aid for local governments, and tax refunds for individuals." In addition, the report noted potential impacts on state capital spending, local government services, and federally-funded state employees.[7]

Federal funding uncertainty has other impacts too, such as increased contracting costs over time if volumes and spending levels are volatile and prevent state and local governments from signing long-term agreements at reduced costs. In addition, for state government contracts already in place that need to be modified as a result of an unexpected decline in federal funds, there can be direct and indirect costs associated with revising the scope or cancelling. State government financial controls and contract monitoring may also be weakened indirectly if unexpected federal funding reductions force cuts in overhead and oversight functions to preserve program services.

A Path Forward

More certainty about federal funding levels and greater flexibility can enhance states' ability to make informed decisions, address tough fiscal challenges, improve program performance and plan for the long term.

Any actions that provide increased certainty of federal appropriation amounts and when they will be provided will be positive. Greater certainty regarding federal actions, coupled with increased flexibility for states to generate efficiencies and achieve results, would put states in a much better position to make smart, responsible choices and address fiscal challenges in a resource-constrained environment. More certainty about federal funding levels and greater flexibility can also improve states' ability to engage in budgeting practices focused on improving performance and strategic planning over the long term. Developments concerning actions to reduce the federal government's budget deficit are likely to affect states, but significant uncertainty remains, making budget preparation, financial management and strategic planning extremely difficult at the state and local levels.

[7] State of New York, Office of the State Comptroller, "Implications for New York State of a Federal Government Shutdown," April 2011.