With the flow of federal funding slowing dramatically, states will need to look to Washington for flexibility rather than dollars to meet their own budget challenges.

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Introduction

In the words of author David Osborne, the business of state government is to “educate, medicate, and incarcerate.” In the new age of austerity, however, the state-federal funding mechanisms that have underpinned these priorities for nearly half a century are beginning to fray.

Domestic Policymaking

The wave election of 2010 brought to a close one of the most intense periods of domestic policymaking in U.S. history. Over the span of a little more than a year, the Obama administration and its allies in Congress enacted both the $800 billion American Recovery and Reinvestment Act and the most extensive restructuring of health care in America since the creation of Medicare and Medicaid. But in the face of mounting deficits and divided partisan control, the 112th Congress has ushered in a new era underpinned by partisan gridlock and fiscal austerity.

The legislative achievements of the 111th Congress were a mixed bag for states. The Recovery Act played a decisive role in stemming the historic state budget crisis of 2008-10 by moving more than $140 billion in short-term deficits off of state balance sheets and onto the national debt. The Affordable Care Act, however, has created troubling new long-term costs for states as millions of patients will be added to a Medicaid system that already is crowding out virtually every other category of state expenditure.

The public’s reaction to the very costs of these programs propelled the GOP into the majority in the U.S. House. Given the mandate of the new majority, it is no surprise that standoffs between the president, House and Senate over budget resolutions and debt ceiling votes have defined the 112th
Congress and led directly to the only significant piece of legislation to emerge in the session, the Budget Control Act of 2011.

**Budget Control Act or Sequestration**

The Budget Control Act was designed to reduce projected federal deficits by at least $2.1 trillion through a two-part process. The first part included a $917 billion commitment to reduce the projected deficit by shaving more than 10 percent from discretionary spending over the next 10 years. These cuts will fall equally on defense and non-defense spending in the first two years, with Congress retaining the authority to redistribute the cuts across all discretionary categories in future years.

The second part of the act mandated the creation of the ill-fated supercommittee to attempt to identify an additional $1.2 trillion to $1.5 trillion in cuts and/or revenue measures. Knowing it would be difficult to reach a deal, Congress included an automatic trigger in the act that mandates a further $1.2 trillion in cuts through a process known as “sequestration” if the supercommittee failed.

Barring an unlikely effort to defang the automatic trigger in the Budget Control Act, Congress will be required to sequester, or remove from consideration, set amounts of discretionary spending below the $1.05 trillion 2011 fiscal year baseline spending level to achieve $1.2 trillion in savings by the end of 2020. Beginning in 2013, federal discretionary spending will dive nearly $100 billion to a total discretionary level of $967 billion and will then slowly increase each year thereafter. Total federal discretionary spending will not crest above the 2011 fiscal year level until 2019.

Sequestration cuts will be shared equally between security and non-security spending. The security spending includes not only defense, but also the State Department budget, foreign aid, intelligence agencies and many other aspects of America’s national security posture. Because the Department of Defense dwarfs these other budget components, however, the military will inevitably bear the brunt of the security cuts. Anticipating the impact of these cuts, some observers are already speculating that DOD will need to conduct another round of Base Realignment and Closure—or BRAC—as early as 2015.

One provision of the Budget Control Act could help ease the sting of these defense cuts. Defense Secretary Leon Panetta frequently mentions that his department is already grappling with plans to cut $450 billion over 10 years as a result of this summer’s $917 billion debt ceiling compromise. That $450 billion assumes that the cuts included in the $917 billion agreement, which are already taking effect, will be shared equally among security and non-security accounts.

Unlike the sequester cuts, however, the Budget Control Act only requires that the cuts used to generate $917 billion in savings be shared equally for the first two years. If sequestration kicks in as expected in 2013, triggering another $500 billion in security cuts, expect Congress to use this flexibility to dial back some of the $450 billion in scheduled cuts under the $917 billion compromise by forcing non-security accounts to cut even more. Given that grants-in-aid to state and local government constitute nearly 40 percent of federal non-defense discretionary spending, any effort to raid these funds will have an immediate impact on states.

The push to shift more cuts from the $917 billion compromise to domestic spending will be reinforced by the fact that domestic spending will fare much better than defense under sequestration. While at first glance it would appear that domestic discretionary spending is headed to a similar $500 billion dive, dramatically reducing intergovernmental transfers for everything from education to public transit, the blow will be lessened by the fact that domestic discretionary spending includes some areas of mandatory spending that also will be cut.
Although cuts to Medicare are capped at 2 percent per year, the cap still allows for $123 billion in Medicare spending to be trimmed over nine years. In addition, while Medicaid, welfare (Temporary Assistance to Needy Families), and food stamps (Supplemental Nutrition Assistance Program) are exempt, some other categories of mandatory domestic spending including farm subsidies and the new health exchange insurance subsidies under the Affordable Care Act are not exempt and can be expected to experience cuts of almost $50 billion. As a result, the total amount of domestic discretionary spending subject to sequestration comes in at roughly $300 billion.

Grants-In-Aid
The combined impact of sequestration and the initial Budget Control Act cuts will reduce grants-in-aid to state and local governments across 150 separate grant programs by a total of $12 billion. Final cuts could go even deeper, as even small cuts to federal agencies of 2 to 5 percent often translate into magnified cuts to state grant accounts of 20 percent or higher.

As the cuts will be spread out across a broad range of programs, covering everything from the Low Income Heating Assistance Program—known as LIHEAP—to emergency management grants, states will be able to pass on many of these cuts to local governments or community service providers. Some of the education funds set to meet the chopping block, particularly Title I disadvantaged schools funding and IDEA special education money, however, will need to be back-filled with state general fund dollars on a near one-to-one basis or risk court actions that could force states to spend even more money than they would otherwise.

While the Budget Control Act may be the most visible sign of the new age of austerity, it is not the only one. Recent debates in Congress over transportation reauthorization and the House budget resolution have witnessed proposals to cap federal expenditures on two of the most fundamental elements of the state-federal partnership, surface transportation and Medicaid, and to shift the programs into block grants to states. With Congress locked in partisan gridlock, it will become ever more tempting to devolve large components of public works and the social safety net to the states. In essence, these efforts are an attempt to shift political risk to a level of government that has proved more capable of making the hard choices over revenue increases or spending cuts that Congress is increasingly unable to make.

Conclusion
With Congress looking to reduce its share of the bill for the “educate, medicate, and incarcerate” programs that define state budgets, calls to reduce maintenance of effort requirements and other federal funding restrictions are sure to be at the top of the list in the state-federal dialogue for years to come. History will tell if the push to devolve will lead to a damaging reduction of programs and services or if it sparks a wave of state-led innovation in managing costs and speeding service delivery. Without clear and convincing advocacy from states, however, there is a real danger that Congress will shift the risk of devolution to the states without giving them the authority to reform and manage the programs that have underpinned the state-federal partnership for more than 50 years.

Notes
1 Federal Funds Information for States, Special Analysis 12-01, February 7, 2012.