

**Testimony of Governor James H. Douglas of Vermont  
Before the U.S. House of Representatives  
Committee on Appropriations  
“Impact of Recession on States and Local Communities”  
December 11, 2008**

Chairman Obey, Ranking Member Lewis, Members of the committee, thank you for this opportunity to testify on the current fiscal condition of states and discuss ways in which states and the federal government may partner to speed the nation’s economic recovery.

My name is Jim Douglas, the governor of Vermont, and it is in that capacity that I testify today. I am, however, also Vice Chair of the National Governors Association (NGA), a bipartisan organization representing all of the nation’s governors.

A little over a week ago, 48 governors and governors-elect gathered in Philadelphia to meet with President-elect Obama and Vice President-elect Biden and discussed the state-federal partnership and the economic crisis facing this country. Our citizens are anxious, hurting, and in many cases, out of options, and they’re looking to us – those of us in state government and those of you at the federal level – for help. During our discussions, the President-elect underscored his commitment to work with governors and states. Governors emphasized our commitment to work as partners with the federal government to spur economic growth and speed recovery. All parties recognized the need for action. And as partners, governors noted the hard choices that they are already making in these tough economic times. States are taking a close look at government programs, and we’re working hard to streamline operations, ensure efficiency, and prioritize our investments. In Vermont, my top three priorities when building my budget are protecting the most vulnerable, investing in job creation, and insuring public safety.

However some decisions states must take to balance budgets also can slow recoveries and make downturns worse. Consequently, one of the most efficient mechanisms the federal government can use to speed a national recovery is investments in existing federal-state programs. This is effective because these programs are on-going and because state-by-state funding allocations, administrative procedures and staffs already are in place to quickly distribute any additional funds.

In October, NGA sent a letter to Speaker Pelosi and Minority Leader Boehner and leaders in the Senate to request that Congress invest in states as part of any national recovery strategy.

Specifically, governors called on Congress to temporarily enhance the Federal Medical Assistance Percentage (FMAP) for at least two years. Funding for FMAP is a particularly effective countercyclical tool because it immediately allows governors to eliminate planned budget cuts required to meet balanced budget requirements and continue services for those with the greatest need.

Likewise, investments in ready-to-go infrastructure projects are a cost effective creator of high paying jobs. These investments should include a broad array of infrastructure projects including highways, broadband, transit systems, clean water, sewers, airports, and perhaps environmental and higher education infrastructure. States should be given the flexibility to determine where their dollars would provide the most effective stimulus. Governors also welcome the opportunity to work with you on the details of the infrastructure provisions to target high priority projects, reduce the bureaucratic red-tape and obligate and expend funds quickly.

Finally, governors encouraged Congress to consider changes to the federal tax code that can spur economic growth, and avoid policies that preempt state authority, shift costs to states or impose new unfunded mandates that work against the goal of economic recovery.

### **Fiscal Condition of States**

States have already cut \$7.6 billion from state budgets since the fiscal year began in July. States have identified another \$30 billion in budget gaps that must be filled this year. That number is likely to double to \$60 billion by the end of June 2009. Twenty-five states already project shortfalls for 2010 of \$60 billion. Again, a number that is likely to double to more than \$120 billion if economic conditions continue to deteriorate. That means states could be facing shortfalls of nearly \$180 billion over the next two years. And states do not have the option of running deficits. In fact, 49 states have balanced budget requirements and the 50<sup>th</sup> state, my own state of Vermont, always balances its budget

In addition, tax collections are trending downward. Already sales tax growth compared with last year has gone negative along with business tax revenues. Personal income tax collections remain slightly higher than last year, but have trended negative over the past quarter. These revenues will be further depressed by the lack of capital gains 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 well into 2009.

**Rainy Day Funds** – Rainy day funds are used by states to fill budget gaps when revenues drop dramatically. Prior to the last downturn in 2001 and 2002, states built large rainy day funds totaling \$49 billion, or 10.4 percent of general fund spending. In 2007, once state economies began to recover, states again built rainy day funds totaling \$69 billion, or 11.5 percent of general fund spending, heading into the current downturn. This means that states have acted responsibly in that they have built large surpluses in good economic times for use in economic downturns. States also averaged only 4.5 percent growth in spending over the past eight years, well below the historical average of 6.5 percent. The economic crisis facing states is, however, much bigger than current state reserves, and federal action is necessary to ensure economic recovery and stability over the long term.

**Economic Outlook in Vermont** – Vermont is a small state, but our financial pressures are no less acute than larger states. Our SFY 2009 budget is approximately \$4.3 billion, including \$1.3 billion in Federal Funds. Vermont's budget is based on a Consensus Revenue Forecast, to which both the Administration and the Legislature adhere. Since the original SFY 2009 Consensus Revenue Forecast in January 2008, the current year General Fund Revenue and Transportation Fund Revenue Forecasts have been reduced by \$70.4 million (5.9%) and \$17.0 million (7.5%)

respectively; the Consensus Revenue Forecast will be adjusted in January 2009, with all the risk remaining on the downside for further revenue reduction. Declining revenues and increasing costs have combined to put a strain on our State's financial resources not seen since the early 1990s.

The recession in New England has become self-reinforcing with the next 2 – 4 quarters expected to be extremely difficult. Vermont has already seen business closures and announced layoffs in small and large organizations, including a layoff at our second-largest employer. In conjunction with a continued decline in our housing and construction-related markets, we will likely see more pressure on our auto and auto-dependent businesses, including dealerships over the next several quarters. Our Higher Education institutions have been seriously impacted by both the losses in their investment and endowment accounts and the inevitable reductions in State funding support. The tax burden on Vermonters is among the highest in the nation, according to several different studies. We, therefore, have no tax capacity for increasing the tax burden on our residents in order to address this recession.

As the State's largest employer, the State of Vermont took a preemptive step in November 2007 by announcing the reduction of 400 vacant state employee positions (roughly 5 percent of the state workforce), which will be accomplished by the end of December. In addition to the previously outlined rescissions, a further General Fund rescission plan of \$66 million and a Transportation Fund rescission plan of \$9.1 million are currently being developed for approval by the Legislature. For SFY 2010, we are requiring departments to develop budget submissions that reduce General Fund appropriation requests by an additional \$148 million (13%). Vermont is working hard to address this downturn and we are currently looking at all options to reduce expenditures. These reductions, however, will undoubtedly impact state services, including those services supporting Vermont's most vulnerable citizens.

Vermont wholeheartedly supports the NGA's call to temporarily enhance the Federal Medical Assistance Percentage (FMAP) for at least two years and increase Federal infrastructure funding without the state match required. Infrastructure needs can be found statewide and throughout several sectors in addition to transportation – information technology (IT), higher education facilities, and environmental infrastructure, to name a few. Federal investments in infrastructure would create jobs and spur economic growth throughout our state.

**State Impacts Lag the Downturn** – The state fiscal picture will continue to deteriorate over the next two years. When the economy slows, state sales tax revenues decline first because 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 especially Medicaid payments, which is currently about 23 percent of state budgets. Medicaid growth from women and children coming onto the rolls tends to occur very late in the cycle and constitutes a significant state expense.

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. If the current downturn continues and follows the path of past recessions, 35 to 40 states will face budget shortfalls in 2009.

### **Role of the States in Recovery**

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, 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 they administer many infrastructure programs and have detailed information regarding unmet needs.

Third, because of balanced budget requirements, states typically react to downturns by cutting spending and raising taxes, which make the downturn more severe. Direct payments to states to help offset these actions are, therefore, one of the most powerful countercyclical actions the federal government can take.

**Medicaid** - The Federal Medical Assistance Percentage (FMAP) is the share of the Medicaid program paid for by the federal government. FMAPs are recalculated each year and the new FMAP is applied at the start of the federal fiscal year. Small changes in a state's FMAP can have a significant impact on state budgets, and any reduction will force states to spend more than they otherwise would have.

In federal FY 2009, which began October 1, 2008, 17 states experienced FMAP declines over their federal FY 2008 FMAP. Twelve of these states had also experienced FMAP declines in the previous fiscal year. Fourteen states are projected to have FMAP decreases in federal FY 2010, beginning October 1, 2009.

The FMAP formula is based on a three-year rolling average that reflects economic conditions from several years ago, and as a result, can exacerbate problems states have financing Medicaid during fiscal downturns.

During the 2001-02 recession, states faced high unemployment and weak tax revenues, which, when combined with unexpected Medicaid growth, forced almost every state to seek serious cutbacks in Medicaid costs.

In response, Congress approved \$10 billion to temporarily enhance FMAPs for every state by 2.95 percentage points for five fiscal quarters in 2003 and 2004. Spending caps for the territories (which face unique financing challenges) were raised by 5.9 percentage points for the last two quarters of FY 2003 and first three quarters of FY 2004.

In addition, Congress implemented a hold harmless provision to prevent scheduled FMAP decreases for the same period. Studies conducted by the Government Accountability Office (GAO) and other experts found that temporarily increasing all states' FMAP levels provided immediate fiscal relief to states by alleviating Medicaid obligations and preventing cuts to programs important to residents during fiscal downturns.

An enhanced FMAP is most effective as a countercyclical measure if implemented at the onset of an economic downturn and for a period of time that allows states to meet anticipated increases in Medicaid costs for the duration of the economic downturn.

FMAP increases can provide some much-needed countercyclical assistance to states. To achieve the maximum effect, the funding should be one-third to one-half of the budget shortfalls in 2009 and 2010. It also is critical that the funding be for at least 24 months to include the year after the recession is over and counter the lag on the state impacts.

**Unemployment Insurance Trust Fund** –Vermont, and at least 33 other states, are facing challenges maintaining adequate balances in our unemployment trust funds.

One reason for this challenge is the pace at which Vermont is feeling the effects of the national recession. We have seen claims for unemployment increase in excess of 65 percent in the last year. We hear daily of small- to medium-size lay offs at employers impacted by the downturn in the automotive industry and access to capital issues. This will only exacerbate growth in unemployment rates and result in additional claims.

I encourage this body to reconsider a Reed Act distribution to the states for the purpose of bolstering unemployment trust fund balances. The funding provided will help blunt the impact on already overburdened and struggling Vermont businesses, if unemployment trends continue as projected. I support a distribution for the sole purpose of shoring-up the fund, versus increasing benefits. Unemployment benefits in Vermont already meet any standards previously considered by this Congress during earlier discussions regarding a Reed Act distribution.

**Infrastructure** - Infrastructure investments are an effective mechanism to create jobs in a slowing economy, especially when projections for economic weakness stretch into years, not months. These are generally high-paying jobs because there is very little international leakage in terms of imports from this type of spending. Federal investments that allow states to initiate ready-to-go infrastructure projects can, therefore, spur demand for labor and increase productive capital. For example, every \$1 billion in transportation infrastructure spending generates approximately 35,000 jobs and \$5.7 billion in additional economic activity.

Last month NGA worked with several national stakeholder organizations to identify approximately \$57.4 billion in projects that could be ready-to-go in 90 days. Given 24 months, states could initiate more than \$136 billion in infrastructure projects.

Vermont – as well as other small states – practices just-in-time delivery of bridge, paving, and road projects, and does not generally have large numbers of “ready-to-go” projects waiting for funding. Transportation projects are planned to mature based on expected future budgets. To

expedite additional projects to construction, some lead time is necessary to ensure proper preparation. A reasonable time frame to obligate FHWA-related stimulus funds would be no less than 180 days.

Congress and the White House should also shy away from legislative language that would place arbitrary time limits on when construction bids for roads and bridges should be awarded. A reasonable timeframe related to funding obligation will in and of itself assure reasonable timeframes for bid-awarding and the beginning of construction.

Small states generally don't have many, if any, large transportation projects that cost tens of millions or hundreds of millions of dollars. Large states will be able to expend large stimulus allocations on just a few expensive road or bridge projects. Small states, on the other hand, must schedule numerous smaller projects to stimulate their economies.

Small infrastructure projects, however, often come with large regulatory hurdles and lengthy red tape. A \$4 million project can take just as long to permit as does a \$40 million project. This means that small states face the prospects of having to navigate many more regulatory hurdles than do larger states that can use their stimulus money on fewer, more expensive infrastructure improvements.

To aid small states, Congress must streamline or eliminate federal regulatory hurdles and red tape that can bog down either the contract bid-letting process or the infrastructure construction process.

The stimulus bill should also relax current FHWA eligibility criteria and, for example, allow stimulus funds to be used for maintenance-related activities. This is particularly important to small states. We need to insure that stimulus funds allow culvert work as well as drainage, ditching and other highway maintenance activities. Materials procurement associated with maintenance activity on federal-aid highways – such as temporary bridge parts, guardrail, etc. – should also qualify. Additionally, acquisition of equipment used in federally-aided and required activities, such as vehicles needed for bridge inspection, should also be eligible for stimulus funding.

To execute funding as quickly as possible, a provision allowing or encouraging stimulus projects to be bid using federal agency “emergency procedures” would be extremely helpful. This would allow states to use force accounts and simplified bids, which would significantly expedite project delivery. Emergency procedures also allow states to get the work done now, and worry about federal paperwork related to agencies such as FHWA or the Army Corps of Engineers later, something that would significantly expedite project delivery.

We believe maintenance of effort (MOE) or anti “supplanting” language should not be included. Any ready-to-go project should be eligible for stimulus funding, thereby allowing any “displaced” funding to be used for additional activities or projects. This flexibility is key to putting the money to maximum use, and also will extend the positive effects of stimulus money out into the future. Only projects already under contract should be excluded.

Nothing will be more important than the rules that limit how stimulus money can be spent. We believe a broad definition of infrastructure will have the most impact – airports, highways, transit systems, clean water, sewers, information technology including broadband and even environmental infrastructure. For example, the purchase of vehicles like buses and trains, as well as highway-related material like guardrail and bridge parts is key to any solid transportation network. The manufacturing of these goods does create jobs, and their procurement should be allowed under a stimulus package. In addition, providing infrastructure for broadband and mobile wireless service in underserved areas of Vermont provides an opportunity to help our economy in the short run and the long run. In the short run, planning, engineering, and construction of fiber optic networks and towers will provide jobs. In the long run, ubiquitous availability of these services will provide greater opportunities for work and business, education, health care, and community development, and is a necessary prerequisite to sustaining a rural economy. And getting Vermonters to work making capital investments in our environmental infrastructure could have an immediate economic impact and a lasting impact on this state and the country. The Vermont Agency of Natural Resources has projects totaling almost \$292 million that could be set in motion quickly and effectively.

I should note that governors are not asking for a blank check.

We want to work with Congress to ensure that investments in infrastructure are tied to projects that are truly ready-to-go and perhaps include a “use-it-or-lose-it” provision to ensure that funds get into the economy quickly. These restrictions, however, must take into account regional limitations so that all parts of the country can benefit. For example, a 90-day requirement to have shovels in the ground would make little sense in Vermont and other northern states where the construction season cannot begin in earnest until April and must, due to weather conditions, end by late November. Congress also should temporarily lift state matching requirements that would otherwise restrict a state’s ability to begin projects due to fiscal constraints.

In addition, we support efforts by Vermont’s Congressional delegation to extend the state match waiver to include all SAFETEA-LU projects through September 30, 2009. In a letter last week to Speaker Pelosi, Rep. Peter Welch noted, “This flexibility will allow states to start priority projects immediately and stimulate the economy, create new jobs and make much needed infrastructure improvements at no additional cost to the taxpayer.”

**Federal Tax Proposals** - Changes to federal tax policy are generally aimed at providing additional cash for individuals to spend or invest or to encourage business to make investments they would otherwise delay during an economic downturn. When properly structured, tax changes can be very effective at getting cash into the economy quickly and nationwide.

State and federal tax systems are closely linked, meaning that changes in federal tax policy that reduce the federal tax base generally have the same effect at the state level. Any policy that would reduce both federal and state tax revenues violates the criteria of do no harm because losses at the state level have to be offset to meet balanced budget requirements. When considering tax changes for individuals or businesses to spur economic growth, Congress and the Administration should take into account the degree to which states conform their income tax

base to the federal base and whether the stimulus provided by federal tax changes will be undermined by corresponding revenue losses for states.

**Changes to Personal Income Tax** – A review of past stimulus packages demonstrates that tax changes focused on individuals can generate immediate positive results for the economy. In particular, tax benefits aimed at putting cash in the hands of lower-income households are most effective because such individuals tend to spend extra cash more rapidly than high-income individuals. Currently, 36 states plus the District of Columbia conform their individual income tax base to the federal individual income tax base. Refundable tax credits distributed directly to individuals through checks would not affect the federal or state tax base; that is, they would not reduce state revenues, but would put additional cash in the hands of individuals and benefit all income levels. Likewise, nonrefundable tax rebates would not reduce state revenues but would exclude those portions of the populations that have no income tax liability, thus diminishing their stimulus effect.

We also must take steps to re-engage Americans in equity investments. Investors have fled equity markets over the past year due to wild fluctuations in valuations that are not tied to changes in the health of the underlying business. We must put additional incentives in place so that investors return to equity investments, and the best way to do that is to reduce taxes on capital gains.

**Changes to Business Taxes** – Tax changes designed as incentives to encourage business to invest in equipment and structures are another popular form of tax stimulus. Studies of bonus depreciation policies enacted in 2002, however, indicate that such incentives are not as effective as measures aimed at individuals. They also reduce state revenues, thereby exacerbating economic conditions in states and undermining at least part of the effect of the federal stimulus.

Many states conform to federal rules on depreciation in the calculation of their business income taxes, therefore, changes to federal depreciation calculations also affect state taxable income. In 2002, federal bonus depreciation provisions were projected to reduce revenues in 47 states by more than \$14.7 billion over three years. To counter these revenue losses, all but 13 states decoupled from the federal depreciation rules. Decoupling prevents immediate revenue losses at the state level, but it also increases complexity for states and taxpayers as businesses must conform to different depreciation schedules in different tax jurisdictions. If federal officials adopt temporary accelerated depreciation provisions as part of a stimulus package, states will either once again decouple from the federal system or be forced to raise revenues or cut spending to counter the loss in business income tax revenues.

Alternatively, investment tax credits can have the same stimulus effect on business investment without undermining state revenues. Tax credits are preferable for states because they do not reduce federal taxable income upon which state business taxable income is based. The credit still encourages business to make investments in equipment and structures in the near term but does not require states to undertake countervailing measures to protect revenues.

Research and Development (R&D) tax credits function in much the same way, but act as a spur to innovation. The reauthorization of the federal R&D credit last year was an appropriate

response by Congress to the need to support innovation and research into new products and technologies. Consideration should be given to increasing the amount of credit available on the incremental increase on R&D expenditures in order to form an even more supportive relationship with innovative American companies.

**Reauthorize the EB-5 Immigrant Investor Visa Program** - The EB-5 Immigrant Investor Visa Program is an important program administered by the U.S. Citizenship and Immigration Service. The program brings foreign equity capital into private sector at-risk investments, which is of great value to many communities across our country. Congress reauthorized the program under the Continuing Resolution but it expires with that Act in March. The permanent reauthorization of this important investor program will send a very strong message to many projects that are waiting to utilize this type of investment and may yield thousands of new jobs.

### **Conclusion**

My state and our nation are at a crossroads. Those citizens who are losing their jobs, their homes and their hope are looking to their leaders for help. Working together, state, local and federal leaders can provide help to those who have stumbled, and a hand-up for those who have fallen. Timely, targeted and temporary investments by the federal government are needed now to get our economy going and put us on the road to recovery.

Mr. Chairman, I'd be happy to take any questions.