Tracking the Money: Preventing Waste, Fraud, and Abuse of Recovery Act Funding

Statement of the National Governors Association to the Committee on Oversight and Governmental Reform, U.S. House of Representatives

July 8, 2009
Chairman Towns, Ranking Member Issa, members of the committee, on behalf of the nation’s governors, thank you for holding a hearing to review and 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, 2010 and 2011 would be between $200 and $250 billion as a result of falling revenues from the faltering economy. These shortfalls mean that governors must cut services and 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, last January NGA issued a paper outlining possible federal stimulus options 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 or only recently completed 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 reviews 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. National and regional oversight activities also should be coordinated to avoid duplication and minimize the impact on limited state resources.

- **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. OMB efforts to allow states to use up to .5 percent of ARRA funds for administration may be helpful, but there remain a number of unresolved questions and the amount may not sufficient to adequately support state oversight and accountability efforts.

- **Allow time for planning**
  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. Governors must also have access to all reporting information on both a transactional and aggregate basis to ensure accurate, consistent and quality reporting of expenditure and job creation data.

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 requirements, 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.

State Shortfalls
NGA’s best estimate is that even with ARRA dollars, states face budget gaps of $200 to $250 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. 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 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.

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1 All but one state has a balance budget requirement.
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 $200-$250 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 postponed planned cuts and tax increases for both fiscal years 2009 and 2010. That being said, several state revenues fell well below worst-case-scenario projections during the first six months of this year. Consequently, while states hoped to use countercyclical funds in FY 2010 and 2011, many were forced to accelerate the use of such funds to close budget gaps in FY 2009.

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 increase 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 Recovery 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 ARRA**
Although the Act is only close to five months old, there is positive news:
• The Administration, individual agencies and OMB have provided a substantial amount of guidance and funds are beginning to flow.

• Every governor has appointed key staff to serve as their leads and many have appointed task forces with private sector and community leaders.

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

• 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.

• Spend funds quickly and create jobs versus accountability and transparency
A 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.

• Unprecedented reporting and transparency
States will be accountable not only to the various agencies and OMB, but also the new Recovery Act Transparency and Accountability Board, GAO and the public. OMB only recently published recipient reporting requirements states must follow for their October 10th reports. It will be difficult for states to fully and accurately report all recipient data a mere 10 days after the close of the fiscal quarter as required by the statute. Additional time to reconcile and correct state reports also will be necessary to ensure accurate and quality information, especially for the initial reporting period.

• Lack of funds for accountability and prevention of waste, fraud and abuse
While ARRA provided ample funding for federal oversight activities, little was provided for states. 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 will need to be upgraded or replaced to meet ARRA standards. OMB guidance providing access to up to .5 percent of ARRA funds for administrative purposes was welcomed, but the complexity of the system, the increased responsibilities being placed on state oversight and auditing resources and diminished state revenues raise questions about its effectiveness.

- **Uncoordinated requests for information**
  Multiple requests for information from the Administration and Congress are an issue because to date they have not been well coordinated. In some instances states are being asked for the same information from the national and regional branches of the same organization. Responding to these requests take time and occupy scarce state resources. NGA recommends that to the extent possible, future federal and congressional oversight activities rely primarily upon the massive volume of information the federal government will receive quarterly from states rather than requesting new or different information about the same projects.

- **Accurately counting jobs retained and created**
  A primary focus of ARRA is to save and create jobs. Although OMB established a single set of guidelines to calculate the number of jobs created and saved, the jobs data will likely be of limited value for making comparisons across projects, states or regions.

- **Launch new programs and run old programs with new requirements**
  States face significant challenges in those program areas where there was not an existing program before ARRA or where the budget increases were dramatic. The Weatherization Program is an example where states must scale up capacity to manage and distribute a massive influx of funds over the next 24 months. In addition, the application of “Buy American” and Davis-Bacon requirements to programs not traditionally subject to such provisions is proving problematic because without clear guidance and rules states are reluctant to sign contracts and expend funds that may result in future penalties.

- **Develop long-term plans to maximize ARRA dollars**
  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.

- **Maintain and rebuild state capacity**
  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. These cuts are likely to increase and continue throughout fiscal years 2010 and 2011. States will rebuild capacity to take advantage of ARRA opportunities, but it will take time.
Obtain access ARRA data to manage recovery

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. Governors must also have access to recovery information gathered at the federal level to ensure accurate, consistent and quality reporting of expenditure and job creation data from their states.

The National Governors Association appreciates the opportunity to provide its perspective on the implementation of ARRA by the states. We cannot stress vigorously enough that states are very early in the implementation process and therefore these comments must be viewed as preliminary. The nation’s governors welcome the opportunity to work with Congress as it reviews ARRA implementation and the actions of states to put people back to work, make our nation more competitive and speed economic recovery.