



April 17, 2008

Honorable John D. Rockefeller IV
Chairman
Subcommittee on Health Care
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This letter responds to your request for an assessment of the economic stimulus that would result from providing fiscal relief to states through either an increase in federal Medicaid assistance and general grants to states, or through an increase in funding for infrastructure projects. (CBO discussed a variety of options aimed at economic stimulus in its recent paper, *Options for Responding to Short-Term Economic Weakness*.)

Fiscal Relief to States

During economic downturns, state and local governments experience a reduction in revenues resulting from the effect of lower economic activity on sales, income, and other tax bases. Unlike the federal government, which faces no statutory or constitutional requirement to balance its annual budget, almost all states have some version of a balanced budget requirement, although the stringency varies. As a result, when state revenues decline sufficiently to create a budget deficit, most states reduce spending or increase taxes (or do some combination of both) to address the resulting fiscal problem. Such reductions in spending or increases in taxes constrain aggregate demand in the economy, which tends to worsen the decline in economic activity.

Some proposals would provide financial assistance to certain states through higher federal Medicaid matching rates and through general grants outside of the Medicaid program. Under current law, Medicaid matching rates vary across states, but range from 50 percent to 76 percent, and average about 57 percent. You asked about the effect of a proposal that would target the financial assistance to states in greater economic stress—as determined by a

formula that ranks states by recent increases in participation in the Food Stamp program, unemployment, and housing foreclosures.

In general, the extent to which additional federal aid to state and local governments would help stimulate demand depends on the degree to which those governments would alter their behavior. If they were to cut spending less or raise taxes less as a result of federal aid, the federal assistance would help keep aggregate demand from falling as much. Targeting federal aid to states that are experiencing economic difficulties would increase the cost-effectiveness of that assistance because the states receiving the funds would be the ones most likely to be experiencing fiscal difficulties and thus the most likely to change their spending or tax policies as a result.

Infrastructure Spending

You also asked about the stimulative impact of spending on infrastructure projects. Although some increase in spending for infrastructure may be justified in terms of improved efficiency and productivity for the U.S. economy, a substantial portion of such spending generally occurs well after funding is provided for such projects. In the case of highways, for example, most federally funded highway infrastructure projects take years to plan and construct. Most projects require state governments to match a share of federal construction funds. Although the Congress can require states to obligate funds quickly, it cannot mandate the pace of construction or the rate at which the states spend federal funds.

A variety of factors outside of governmental control, such as the weather, environmental concerns, and the availability of construction supplies and personnel, influence the pace of project expenditures. Even the reconstruction of the I-35W bridge in Minnesota—on which crews are working around the clock—is estimated to take a year and a half to complete. Currently, planning for the summer construction season—including road resurfacing—is already underway. Some smaller, routine road projects such as resurfacing might be able to proceed in the next few months, but on net it is unlikely that providing more highway funds in fiscal year 2008 would have a significant stimulative effect over the next 12 months.

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I hope this information is useful to you. If you have further questions, do not hesitate to call me.

Sincerely,

A handwritten signature in black ink, appearing to read "Peter R. Orszag". The signature is fluid and cursive, with the first name "Peter" and last name "Orszag" clearly distinguishable.

Peter R. Orszag
Director

cc: Honorable Max Baucus
Chairman
Committee on Finance

Honorable Charles E. Grassley
Ranking Member

Honorable Orrin G. Hatch
Ranking Member
Subcommittee on Health Care