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**Submitted to the Subcommittee on Health, House Committee on Energy and Commerce**

**"Increased Federal Investment in Federal-State Partnerships as an Effective Economic Stimulus"**

**November 13, 2008**

Chairman Pallone, Ranking Member Deal, and Members of the Subcommittee – thank you for this opportunity to testify on the current fiscal condition of the states, and on how Congress can stimulate the economy through supporting existing federal-state partnerships.

My name is Janet Napolitano and I am the two-term governor of Arizona. I am also a former Chair of the National Governors Association, a bipartisan organization representing all of the nation's governors.

Amid discussion in Congress about the need for another stimulus package, my message today is simple: <u>One of the wisest and most effective things Congress can do now to speed a national recovery is to invest in the federal-state programs that Americans rely on during a downturn</u>. Congress can stimulate the economy, provide enormous relief to state budgets, and ensure the most vulnerable Americans have a health care safety net to rely on during difficult times – a win-win-win.

The position of the states in the economic downturn is a paradox created by the countercyclical demands on state budgets: By law, 49 states must balance their budgets every year, so during a recession, when most states will be in deficit, they either must increase taxes or cut benefits – either of which would worsen the national recession. Without greater federal investment in federal-state partnerships, states will be forced into this kind of action early next year — just at the time when most economists expect unemployment to continue to rise. But on the other hand, increased federal investment with the states is a surefire way to provide a boost to the economy.

Increased federal investment in federal-state partnerships, particularly in health care and infrastructure (including highway, transit, water, and border projects) is an efficient and effective way for Congress to stimulate the economy and create jobs while easing the dire fiscal conditions of the states. Congress has done this before to great effect, and I urge you to act again, while taking into consideration some more permanent changes.

In addition to infrastructure, many governors think a stimulus package should also include adjustments to the Federal Medicaid Assistance Percentage (FMAP), food stamps, unemployment benefits, and an initiative on green-collar job creation. In my testimony today before this Health Subcommittee, I will focus primarily on Medicaid.

I would note that providing additional infrastructure funding helps our capital budgets and creates jobs. However, we have to balance our operating budgets — which is where the FMAP and other benefit programs come into the mix. We need *both* the infrastructure funding as well as funding for these key benefit programs.

## ***<u>States' Fiscal Condition</u>***

A recent survey of state fiscal conditions found that more than 30 states are currently projecting budget shortfalls in FY 2009, totaling $26 billion. This number is growing rapidly; 35 to 40 states will ultimately face shortfalls in 2009. These states will accumulate deficits of at least $140 billion through FY 2010.

States have already acted to close the original 2009 budget deficits, but they are quickly running out of easy options to close the new 2009 deficits and the projected 2010 deficit. States are not flush – and when states face successive years of shortfalls in which deficits can't easily be rolled over, they are forced to look at cuts to important state programs like education and health care. In Arizona, for instance, we will deplete our rainy day fund in the next round of budgeting, from a high-water mark of $700 million less than two years ago — and still will have to make cuts. In short: States do not have easy options in front of them.

It's also important to note that state budgets lag behind economic downturns. During economic slumps, the fiscal conditions of states often continue to worsen even after the recession is deemed over. This will probably be the case in the next two years. We certainly expect continued state deficits into the 2011 fiscal year.

## ***The State Role in Stimulating the Economy***

In sum, the nation is looking at poor fiscal situations for the states not just this year, but well after any economic recovery has started.

But one of the most efficient mechanisms the federal government can use to speed a national recovery is to invest further in existing programs where it partners with the states. By investing resources in state programs, Congress can lessen the effects of a recession.

In October, the National Governors Association sent a letter to Speaker Pelosi, Majority Leader Boehner and leaders in the Senate to request that Congress invest in states as part of any national recovery strategy. There are two basic, but equally necessary, categories of federal-state programs with the greatest potential to assist with recovery efforts:

- Infrastructure programs with ready-to-go projects that will create new jobs; and
- Countercyclical programs where the federal government can help offset proposed budget cuts by increasing the federal share of key federal-state programs, such as Medicaid, special education, food stamps, and unemployment insurance.

## ***Infrastructure***

Investing in America's infrastructure is a course of action that is critical to our current economic recovery, will yield many long-run benefits, and is especially important to states like Arizona.

The construction industry employs 7 million people nationwide and represents over $1 trillion in economic activity. In Arizona alone, the construction industry is worth more than $34 billion. But in the past few years, the construction industry experienced first the burst of the housing bubble, and later the credit crunch, both of which have dried up demand for construction. In Arizona, housing prices have declined 36% in the Phoenix metro area over the past few years, compared to 18% nationally. From September 2007 to September 2008, Arizona lost 38,600 construction jobs – <u>more than 17 percent of the jobs in one industry just in a year</u>. Arizona was one of the nation's fastest employment-growth states in the past few years – it ranked second in the nation in 2003, 2004, and 2005 – but in 2008, it is just 46th in job creation.

Clearly, this is a sector of the economy in need of a stimulus.

We need new infrastructure both for short-term stimulus and long-term economic growth. But the economic downturn has diminished states' capital budgets, while the credit crunch has resulted in less beneficial borrowing terms that inhibit states' abilities to use financing to build new infrastructure.

An infrastructure stimulus would have a quick effect on the economy. An infusion of federal infrastructure funding would stimulate the critical construction sector immediately because <u>many infrastructure projects are already planned, and just need funding</u>. Nationwide, 3,000 highway projects representing about $18 billion in funding could be awarded and start construction within 90 days of federal stimulus legislation; in addition, there are probably about $10 billion of ready-to-go water infrastructure projects.

Lastly, the Department of Homeland Security has identified $500 billion worth of border security projects to be completed over 10 years; that schedule could be accelerated to help create jobs now while we build the infrastructure we need.

The long-term benefits are clear: According to the U.S. Department of Transportation, every $1 in highway infrastructure investment yields $5.40 in economic benefits.

Congress should not just write a blank check, however. For assurance that a significant infrastructure package is working – and putting people to work – I recommend Congressional oversight, and provisos that states must obligate this money within a defined period, say six months. In other words, use it or lose it. I also recommend that Congress designate an ombudsman for the states within agencies like the GSA in order to help speed the construction approval process.

With infrastructure investment, Congress has a golden chance: Assist states, put people to work, and improve our nation's infrastructure for the long term. It is a win-win-win.

***<u>Medicaid</u>***

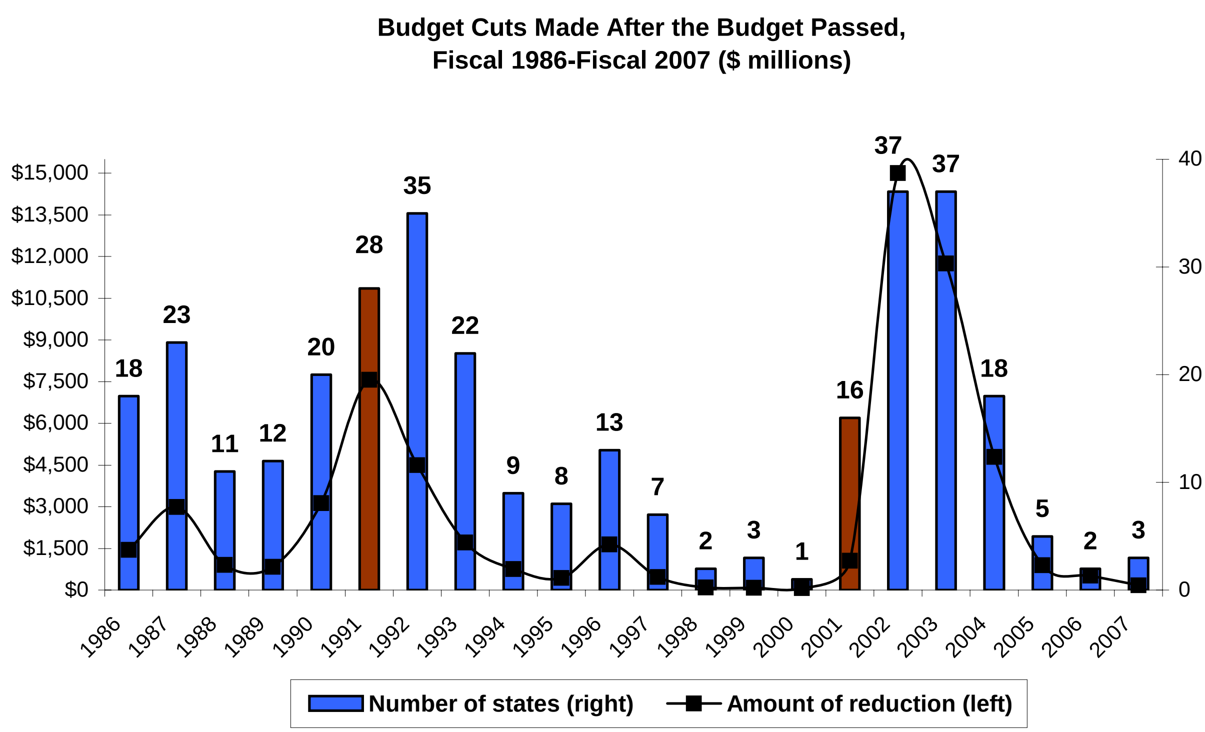
States experience economic downturns in a cascade of pressures from both ends – decreased tax revenues and increased demand for services. First, sales tax revenues decline, because reductions in personal consumption often lead off downturns. Then unemployment rises, which reduces personal and corporate income tax revenues. Higher unemployment then leads to increased demand for food stamps, unemployment benefits and especially Medicaid payments – which currently comprise about 23 percent of state budgets. Further Medicaid growth from women and children coming onto the rolls tends to occur even later in the cycle. And remember – 49 states must have balanced budgets.

Most states are now looking at Medicaid enrollment growth beyond what they projected. In Arizona, for instance, between August and September, we saw growth on our Medicaid rolls of more than 13,000 just in a month.

The lag effect on state budgets was evident in each of the last two recessions. The recession that ended in 1991 resulted in 28 states cutting budgets that year. But states continued to experience the recession's impact after that; 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 1, Budget Cuts Made After the Budget Passed). If the current downturn continues and follows the path of past recessions, 35 to 40 states will face budget shortfalls in 2009, and some experts say those numbers will be more than 40 states with cumulative deficits of $140 billion by 2010.

Chart 1



One of the most effective ways to aid in a national economic recovery is temporarily to increase the Federal Medical Assistance Percentage (FMAP), or the share of the Medicaid program paid for by the federal government.

State FMAPs are recalculated each year, and the new FMAPs are applied at the start of the federal fiscal year. Small changes in a state's FMAP can have a significant impact on state budgets. <u>Any reduction during a downturn will squeeze states to a greater degree than they already are squeezed</u>.

Currently, the FMAP is based on a three-year rolling average, which means some states are <u>already experiencing</u> reductions: 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.

Right now, the FMAP is based on economic conditions that existed several years ago. <u>But what states truly need is a FMAP that corresponds to what's occurring in the economy *right now*</u>.

The 2001-02 recession 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. In addition, during the last FMAP alteration, Congress implemented a hold-harmless provision that prevented scheduled FMAP decreases for the same period.

<u>The FMAP enhancements during the last downturn were a success.</u> 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 and prevented cuts to programs that residents were relying upon during the economic downturn.

Regardless of their particular form, FMAP enhancements will be most effective if they begin at the onset of an economic downturn, and last long enough for states to meet anticipated increases in Medicaid costs as long as the downturn lasts. This time around, to achieve the maximum effect, the funding should be close to half of the state shortfalls – or no less than <u>$25-35 billion per year over the next two years</u>.

Both the timeframe and the amount are critical. The 24-month timeframe includes the year after the recession will probably end, so it covers the lag period when state budgets will still be in deficit. And anything less than $25 billion per year for two years would limit the countercyclical effect.

The way that the House targeted this investment in the last bill is sound, providing the greatest assistance to the states in the greatest need – the ones that are feeling the effects of the economic downturn most acutely. Not all states are the same, and not all budget deficits are created equal – the states where the deficits are worst are probably also the states most in need of the most economic stimulus.

***Permanent Statutory Solution***

Apart from the stimulus package, Congress should make counter-cyclical stimulus a permanent part of the Medicaid statute when it undertakes wider health care reform.

There is broad consensus that an early enough, long enough stimulus during an economic downturn can ameliorate some of the downturn's worst effects. There is also consensus that temporary FMAP increases are one of the best ways to stimulate the economy. But it gets tiresome for Congress to make legislative changes to FMAP during every recession – and it also means that effective action may not occur soon enough. Congress would have to give great care to determine the appropriate triggers for an enhanced FMAP. But building such a mechanism into the statute would save time and resources that would otherwise go to re-creating the concept during every downturn. A countercyclical FMAP would likely kick in far earlier than if Congress has to act. This would help avert state cuts when the economy is weakening. Remember the GAO said the 2002 fiscal relief was good, but came too late in the downturn.

***SCHIP***

I would also like to note that the current extension for SCHIP lapses on April 1, 2009, and therefore Congress needs to renew its commendable efforts to pass a full 5-year reauthorization. This is a very high priority for the nation's governors, and we do not want to see a number of short-run extensions starting on April 1, 2009. States are going to see increased demand for SCHIP and if there is one area where states must be able to move forward, it is providing children with the health care they need during difficult economic times. The best solution would be to have a complete reauthorization as part of the economic recovery package.

***Conclusion***

To summarize, Congress is encountering an intersection of needs that it can act decisively to address. Americans need to be able to rely on a health care safety net in difficult times. States need to balance their budgets in difficult times. The economy needs a stimulus during difficult times. Congress can address all of these needs.

Mr. Chairman, thank you again for the opportunity to appear before the subcommittee. I am happy to answer any questions.