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Chairman Pallone, Ranking Member Deal, and members of the subcommittee, it is an honor to appear before you today to discuss "Treatments for an Ailing Economy: Protecting Health Care Coverage and Investing in Biomedical Research."

The U.S. economy is in a severe downturn. (Although the National Bureau of Economic Research has not yet made an official determination, it will almost certainly declare, at some point, that the economy entered a recession in late 2007 or sometime in 2008.) The severity of the downturn has prompted calls for a fiscal stimulus package to boost aggregate demand. It is far from clear, however, that a fiscal stimulus package is necessary or useful, since monetary policy and automatic fiscal stabilizers are generally better suited to serve the goal of economic stabilization. Even if a stimulus package is adopted, increases in the federal Medicaid matching rate should not be included because they are an ineffective means of boosting aggregate demand. Even as Congress addresses the current economic difficulties, it is also important to foster long-run growth through tax and spending policies that promote private business investment.

1. Increases in aggregate demand cannot permanently increase the levels of jobs or output, but can play a role in stabilizing the economy.

Fiscal and monetary policies can boost aggregate demand by increasing consumer spending, residential and business investment, government purchases, or net exports. These policies are intended to boost output and create jobs by prompting firms to produce more goods and services for purchase by consumers, homebuyers, businesses, and foreigners. It is important to realize, however, that such policies cannot permanently boost output. In the long run, the level of output is determined by the supply of productive resources – the number of willing workers, the functioning of the

labor markets that enable them to work, the supply of capital and natural resources, and the availability of technology.

It is tempting to argue that increased spending on a specified item – medical care, alternative energy, defense, business investment, or anything else – will create jobs. It is always easy to see the large number of workers who will be employed to produce the specified item. But, it is also necessary to see the jobs displaced elsewhere in the economy, as an increase in spending on the specified item forces a reduction in spending on other goods and services. Attempting to spend more on everything simply bids up prices and interest rates without increasing total employment.

It is therefore a serious mistake to support spending on renewable energy on the ground that it will create "green jobs" or to support business investment because workers will be employed to construct the investment goods or to support defense or Medicaid spending because it will create jobs. It is quite a different matter, of course, to support renewable energy spending because it will provide cost-effective energy resources or to support business investment because it will expand the capital stock and make workers more productive (as discussed below) or to support defense spending because it will make Americans more secure or to support Medicaid spending because it provides health care to people in need. Those arguments must be evaluated on their own merits.

Increases in aggregate demand can boost output in the short run. Firms that experience a higher demand for their products may initially expand output and hire more workers rather than raising their prices. This short-run effect fades away as prices and interest rates adjust.

A sustained increase in any category of public or private spending generates only a temporary increase in output and employment. Because it is unlikely that spending would be boosted for all of eternity merely to obtain a short-run boost to output, it is more meaningful to consider a temporary boost to spending. A temporary increase in a category of public or private spending boosts output when the spending increase occurs, but reduces output when spending returns to normal. In other words, fiscal stimulus measures that boost public or private spending do not "buy" us extra output – they merely "borrow" it from the future. There is no free lunch.

Although it is not useful to boost output at one random date and lower it at a later random date, it may be useful to boost output when the economy is in a recession and lower it when the economy is booming. For example, boosting output during the current downturn may be useful even though we will have to "pay back" the output gains at some later date.

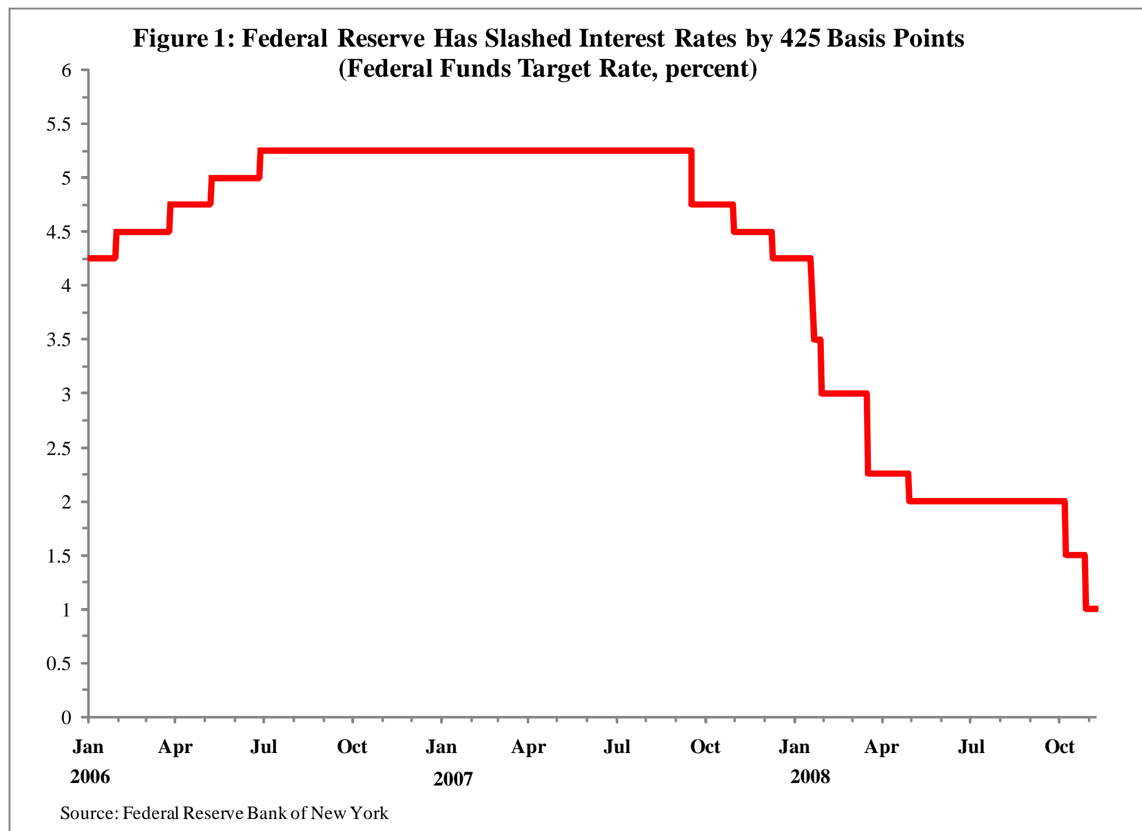
Although aggregate demand policies cannot permanently boost output, they can help stabilize the economy. The best policies are not those that permanently increase aggregate demand in a futile attempt to permanently increase output, but those that alter aggregate demand over time in a way that offsets the business cycle.

2. Monetary policy and automatic fiscal stabilizers are generally more effective than discretionary fiscal stimulus.

Monetary policy and automatic fiscal stabilizers are two important policy tools for managing aggregate demand in a way that stabilizes the economy. Monetary policy can change aggregate demand by changing interest rates, altering the amount of spending that people and firms desire to do. Automatic fiscal stabilizers boost

disposable income during downturns and dampen it during expansions, potentially changing the path of desired spending.

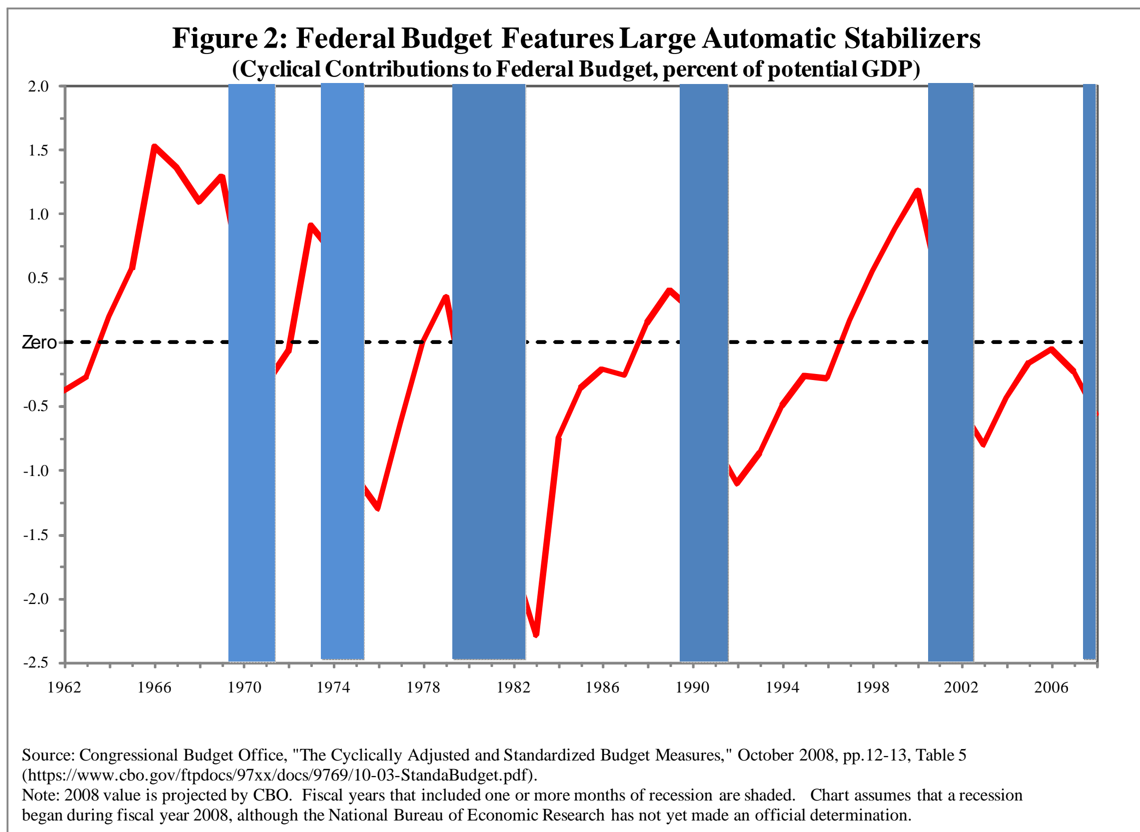
Monetary policy has responded aggressively to the current slowdown, as shown in **Figure 1**. From September 18, 2007 to the present, the Federal Reserve has lowered the federal funds target rate by 425 basis points, from 5.25 percent to 1 percent. Because monetary policy usually works with a lag, the full effect of the monetary easing has not yet been felt. Although interest rates cannot be reduced below zero, the Federal Reserve still has some further room to reduce rates and has left open the option of doing so.



Automatic fiscal stabilizers can also be significant. When the economy weakens, tax receipts automatically fall and outlays on social insurance and anti-poverty programs automatically rise. **Figure 2** shows the cyclical component of the federal budget deficit or surplus (the change in budget balance that results automatically from business cycle

conditions) as estimated by the Congressional Budget Office (CBO). Positive values indicate that business cycle conditions are reducing the federal budget deficit (or increasing the surplus) and negative values indicate that business cycle conditions are expanding the deficit (or reducing the surplus). Recessions, shown by the shaded areas in the chart, have been associated with significant cyclical increases in deficits, often about 2 percent of GDP. The chart further shows that automatic stabilizers are already responding to the current downturn.

Figure 2: Federal Budget Features Large Automatic Stabilizers
(Cyclical Contributions to Federal Budget, percent of potential GDP)



Source: Congressional Budget Office, "The Cyclically Adjusted and Standardized Budget Measures," October 2008, pp.12-13, Table 5 (https://www.cbo.gov/ftpdocs/97xx/docs/9769/10-03-StandaBudget.pdf).
Note: 2008 value is projected by CBO. Fiscal years that included one or more months of recession are shaded. Chart assumes that a recession began during fiscal year 2008, although the National Bureau of Economic Research has not yet made an official determination.

Most economists agree that economic stabilization is generally best achieved through monetary policy and automatic fiscal stabilizers. This consensus is reflected in a January 2008 article by Brookings Institution economists Douglas Elmendorf and Jason Furman (Furman later served as a senior economic adviser to Senator Barack Obama’s successful presidential campaign):

> Economists believe that monetary policy should play the lead role in stabilizing the economy because of the Federal Reserve's ability to act quickly and effectively to adjust interest rates, using its technical expertise and political insulation to balance competing priorities … monetary policy should generally be the first line of defense against an economic slowdown … Economists almost universally support the automatic stabilizers that do not require any legislative action, like mechanical reductions in tax payments and increases in unemployment insurance payments when incomes fall and unemployment rises.[1]

The advantages of monetary policy and automatic fiscal stabilizers should be considered carefully before considering discretionary fiscal policy. Discretionary fiscal policy seeks to offset the business cycle by altering particular categories of public or private spending, either boosting such spending during recessions or restraining it during booms. The February 2008 stimulus package, which combined tax rebates with temporary investment incentives, was an example of discretionary fiscal policy.[2]

Most economists approach discretionary fiscal policy with some degree of wariness, as Elmendorf and Furman note:

> During the past several decades, the idea that Congress should make legislative changes to tax or spending policies to counter the business cycle has fallen into disfavor among economists … the shift is based on very important political and administrative challenges to countercyclical fiscal policy, especially with regard to the timing and design of the stimulus … fiscal policy generally responds to

[1] Douglas W. Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus," *Tax Notes*, January 28, 2008, pp. 545-559, at pp. 545-546.
[2] Public Law 110-185, 122 Stat. 613 (enacted February 13, 2008).

> changes in economic conditions with considerable lags, due both to the time needed to enact a stimulus bill and the time needed for the bill to be implemented and the spending increases or tax reductions to actually reach the pockets of consumers. As a result, the effect of fiscal stimulus on household and business spending may be poorly timed.[3]

Despite the limitations of discretionary fiscal policy, most economists recognize that it can play a useful role in some circumstances. As Elmendorf and Furman explain, fiscal stimulus can sometimes operate more quickly than monetary easing, fiscal stimulus remains available when interest rates approach zero and further monetary easing is impossible, fiscal stimulus can operate in situations when spending is insensitive to interest rates, and fiscal stimulus can avoid interest-rate reductions that might (in some cases) be considered undesirable. Also, uncertainty about the economic impact of stimulus may be lower with a combination of fiscal and monetary stimulus than with either type alone.[4] These authors therefore reach the following conclusions:

> There are several circumstances in which fiscal stimulus can be helpful or even crucial … these circumstances are potentially relevant today … However, it would be better not to have a fiscal stimulus at all than to have tax cuts or spending increases that are poorly timed, badly targeted, or permanently increase the budget deficit.[5]

[3] Elmendorf and Furman, p. 546.
[4] Elmendorf and Furman, pp. 547-548.
[5] Elmendorf and Furman, p. 545.

In summary, fiscal stimulus proposals should be approached with caution and awareness of their inherent limitations. Stimulus proposals cannot permanently increase output; they can only stabilize it, boosting output during recessions and reducing it during expansions. In this regard, stimulus proposals play, at best, a supporting role to monetary policy and automatic fiscal stabilizers. If a stimulus package is to be adopted at all, it should be well designed. These principles should be kept in mind when evaluating proposals to increase Medicaid matching rates as a form of stimulus.

3. Increases in Medicaid Matching Rates Have Been Proposed as Stimulus.

Medicaid is operated by the states and the District of Columbia, which receive matching grants from the federal government. For each state, the Federal Matching Assistance Percentage (FMAP) equals 100 percent minus the state share. The state share is proportional to the square of the state's per capita income, with a value of 45 percent for a state with per-capita income equal to the national average. However, that the FMAP is at least 50 percent, meaning that the state share may not exceed 50 percent, even for states with the highest per-capita incomes. Also, the District of Columbia is assigned a 70 percent FMAP. For fiscal year 2009, the state FMAPs (based on 2004-2006 per capita incomes) range from 50 percent for thirteen high-income states to 75.84 percent for Mississippi.[6] The five overseas possessions also participate in Medicaid with FMAPs of 50 percent.

Temporary increases in FMAPs have recently been proposed as a form of fiscal stimulus. Such increases were also adopted as a stimulus measure in 2003.

Section 3001 of H.R. 7110, as approved by the House on September 26, 2008, would increase FMAPs for the fourteen-month period from October 1, 2008 through

[6] 72 *Federal Register* 67304 (Nov. 28, 2007), corrected by 72 *Federal Register* 69285 (Dec. 7, 2007).

November 30, 2009. Each state would be allowed to use its fiscal 2008 FMAP in fiscal year 2009 if it is higher than its 2009 value; each state would have a similar option to use its fiscal 2009 FMAP in the first two months of fiscal year 2010. In addition, all FMAPs would be increased by one percentage point. States would also be awarded additional increases of up to 3 percentage points if they have experienced, over the preceding two years, declines or slow growth in nonfarm payroll employment, increases in food stamp participation, or increases in the fraction of mortgages in foreclosure. To obtain the higher FMAPs, states would be required to maintain their July 1, 2008 Medicaid eligibility criteria. CBO has estimated that these provisions would increase federal outlays by $12.2 billion in fiscal year 2009 and by $2.5 billion in fiscal year 2010.[7]

Section 3001 of S. 3604, as introduced in the Senate on September 26, 2008, would provide FMAP increases for the fifteen-month period from October 1, 2008 through December 31, 2009. Each state would be allowed to use its fiscal 2008 FMAP in fiscal year 2009 if it is higher than its 2009 value; each state would have a similar option to use its fiscal 2009 FMAP in the first quarter of fiscal year 2010. In addition, all FMAPs would be increased by four percentage points. To obtain the higher FMAPs, states would be required to maintain their September 1, 2008 Medicaid eligibility criteria. States would be prohibited from using the additional aid to increase their reserve or rainy day funds.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 provided for FMAP increases for the fifteen-month period from April 1, 2003 through June 30, 2004. Each state was allowed to use its fiscal 2002 FMAP in the last two quarters of fiscal year 2003

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[7] Congressional Budget Office, "Estimated Cost of H.R. 7110, The Job Creation and Unemployment Relief Act of 2008, As Introduced on September 26, 2008" (http://www.cbo.gov/ftpdocs/98xx/doc9816/hr7110.pdf).

if it was higher than its 2003 value; each state had a similar option to use its fiscal 2003 FMAP in the first three quarters of fiscal year 2004. There was also a 2.95-percentage-point increase in all FMAPs. To obtain the higher FMAPs, states were required to maintain their September 2, 2003 Medicaid eligibility criteria.[8]

4. Temporary FMAP increases would be an ill-designed and ineffective way to stimulate aggregate demand.

Counter-cyclical increases in Medicaid matching rates would function poorly as a stimulus tool because any boost to aggregate demand would be limited and indirect. It is important to stress that financial transfers from the federal government to the states do not directly boost aggregate demand because they do not directly increase consumer spending, business or residential investment, government purchases, or net exports. A transfer from the federal government to state governments does not directly boost aggregate demand any more than would a transfer from one of the federal government's bank accounts to another of its bank accounts.

To be sure, aid to state governments can indirectly boost aggregate demand if the aid causes a change in state tax or spending policy. But, the size of the boost depends on the nature of the state tax or spending change. In a January 2008 report, CBO noted:

> In general, the extent to which federal aid to state and local governments helps arrest the decline in demand depends on the degree to which those governments alter their behavior. If they cut spending less or raise taxes less as a result of federal aid, the policy will help keep demand from falling as much in the economy. The cost-effectiveness of federal aid to states and localities will also depend on exactly how the recipients use the aid. Policies can have very

[8] Public Law 108-27, section 401(a), 117 Stat. 764 (enacted May 28, 2003).

> different effects on the economy and the principles of an effective federal stimulus that were discussed earlier generally apply to stimulus carried out by states and localities as well. The cost-effectiveness of the aid could also depend on who it is distributed geographically and on whether the aid is accompanied by maintenance-of-effort requirements … Additional federal aid to states that are facing fiscal pressures or are already in recession would probably stimulate the economy. However, federal aid to states whose budgets are relatively healthy may provide little stimulus, especially if those states use the aid to build up their "rainy-day" funds instead of increasing spending or reducing taxes. [9]

In a table summarizing stimulus options, CBO lists "Providing General Aid to State and Local Governments" as having "medium" cost-effectiveness and a "medium" lag from enactment to stimulus, with "large" uncertainty about the effects. The uncertainty arises because it is hard to know how states will alter their tax and spending policies. That uncertainty is present in full force in the FMAP context.

It is far from clear that states would actually change their Medicaid spending in response to a temporary increase in FMAP. States would be unlikely to adopt legislated increases to the program in response to the FMAP increase, as they would have to either cancel the increase when the FMAP increase expires or permanently bear the financial costs without the benefit of the higher FMAP. The only plausible story for why the FMAP increase might temporarily boost Medicaid spending above what it otherwise would have been is that the FMAP increase might allow states to avoid temporary

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[9] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, pp.18- 19 (http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf).

Medicaid cutbacks that otherwise would have adopted during the downturn in response to state balanced-budget requirements. It is far from clear that this effect would be significant. A study by the Rockefeller Institute of Government found that states generally avoided cutting Medicaid during the economic weakness of fiscal 2004 and that those decisions were generally not driven by the temporary FMAP increase in effect at that time.[10] On the other hand, a study by the Henry J. Kaiser Foundation concluded that states adopted a variety of Medicaid cutbacks during that downturn.[11]

If a temporary increase in Medicaid spending occurred, it would be unlikely to significantly boost aggregate demand. While a temporary relaxation (or avoidance of a temporary tightening) of eligibility criteria could prompt an increase in the consumption of health care, it is doubtful that the effect would be large. Furthermore, any temporary change to Medicaid spending would probably take the form of temporary increases (or avoidance of temporary reductions) in provider reimbursement rates, which would have economic effects largely similar to those of temporary transfer payments to the providers. This relatively high-income group would probably not increase its consumption sharply in response to temporary transfer payments.

If a temporary increase to Medicaid spending did not occur, the aggregate demand impact of the FMAP increase would become even more uncertain. If the federal aid prompted states to cut taxes or to increase non-Medicaid spending (perhaps by averting tax increases or spending cuts that would otherwise be required by balanced-

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[10] James W. Fossett and Courtney E. Burke, *Medicaid and State Budgets in FY 2004: Why Medicaid is so Hard to Cut*, Rockefeller Institute of Government Federalism Research Group, July 2004 (http://rockinst.org/pdf/health_care/2004-07-medicaid_and_state_budgets_in_fy_2004_why_medicaid_is_hard_to_cut.pdf).

[11] *Few Options for States to Control Medicaid Spending in a Declining Economy, Kaiser Commission on Medicaid and the Uninsured*, Issue Paper, April 2008 (http://www.kff.org/medicaid/upload/7769.pdf).

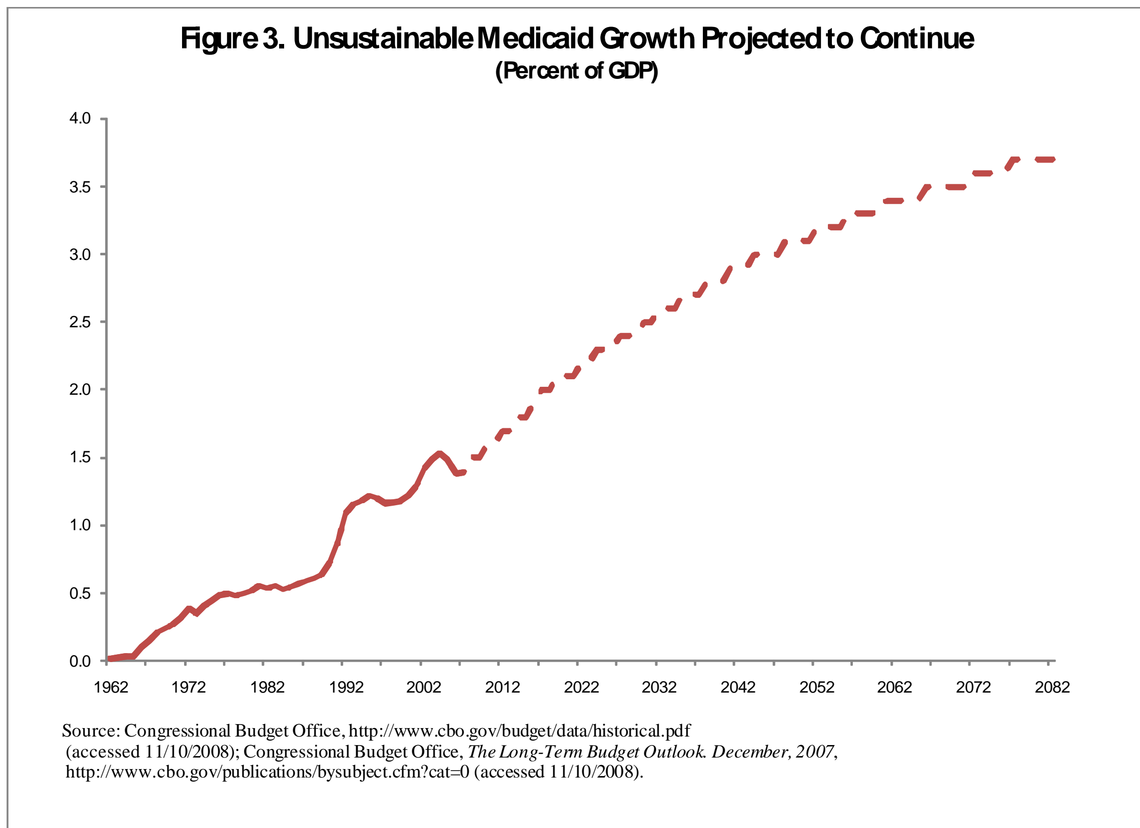
budget constraints), there could be a boost to aggregate demand. As CBO noted in its January 2008 report, however, many types of tax cuts and spending increases, whether done at the federal or state level, do not provide effective and timely stimulus. There is no mechanism to ensure that states would respond to the FMAP increase in a way that would provide effective stimulus. Indeed, some states might not cut taxes or increase spending in response to the FMAP increase, but might simply narrow their budget deficits, which would not boost aggregate demand at all.

Even if an increase in aggregate demand occurred, it might not be timely. Setting aside the lag before Congress enacts the FMAP increase, a further unpredictable lag may occur before state legislatures actually increase spending (on Medicaid or other programs) or cut taxes.

CBO also notes that aid to states is a more effective stimulus if it is targeted at states that have been hard hit by the recession. The provisions of H.R. 7110 that target aid to states with economic weakness address this concern. In contrast, the across-the-board FMAP increases in H.R. 7110 and S. 3604 provide the largest aid to states with the largest Medicaid programs. The provisions in those bills giving states the option to use their fiscal 2008 FMAPs (based on 2003-2005 per capita incomes) in place of their fiscal 2009 FMAPs (based on 2004-2006 per capita incomes) directs federal aid toward states that experienced rapid growth of per capita income between 2003 and 2006, an approach antithetical to helping states that have been hit by economic weakness.

The ineffectiveness of the FMAP increase as a fiscal stimulus makes it all the more important to consider its other policy implications. The most striking feature of an FMAP increase is that it would boost, if only temporarily, federal spending on a program

that is already growing at an unsustainable pace and is projected to continue doing so, as shown in **Figure 3**. Furthermore, the increase in FMAP perpetuates the fundamental flaws of the FMAP formula, notably its well-documented tendency to provide the greatest aid to the states that already have the greatest economic resources.[12]



5. Long-run growth can be promoted by tax and budget policies that increase private business investment.

The government exists to serve both the short-run and long-run needs of the American people. Meeting the short-run needs of the American people involves monetary easing and automatic fiscal stabilizers. At the same time, Congress must not lose sight of the need to promote long-run growth.

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[12] See General Accounting Office, *Medicaid Formula: Differences in Funding Ability Among States Are Often Widened*, GAO-03-620, July 2003 (http://www.gao.gov/new.items/d03620.pdf) and the July 22, 2008 testimony of Robert B. Helms before this subcommittee (http://energycommerce.house.gov/cmte_mtgs/110-he-hrg.072208.Helms-Testimony.pdf).

The current tax treatment of business investment impedes long-run growth. Corporate investment returns are typically subjected to corporate income tax and also to individual tax (at a 15 percent rate) on dividends and capital gains. As a result, savers cannot capture the full returns from their decision to postpone consumption. Reducing or eliminating the taxation of investment (financed by spending cuts) would allow an expansion of the capital stock, which would boost output and wages. Such tax relief could be financed by slowing the growth of entitlement spending. Another desirable approach is a revenue-neutral fundamental tax reform in which the income tax system is replaced by a progressive consumption tax, such as the Bradford X-tax.

Conclusion

Our economy is in a severe downturn, but the case for a fiscal stimulus package is problematic. Even if some type of stimulus is warranted, a temporary increase in Medicaid matching rates would be ill-designed and ineffective.