CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Phillip L. Swagel, Director

May 13, 2020

Honorable John Yarmuth
Chairman
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Re: Answers to Questions Related to Federal Funding for State and Local Governments

Dear Mr. Chairman:

During my presentation to the Budget Committee that you organized last month, I offered to provide more information about topics of particular interest to its members.[1] Congresswoman Schakowsky asked several sets of questions related to federal funding for state and local governments, and this letter provides answers.

Medicaid

The first set of questions was about the effects of the 2020 coronavirus pandemic on Medicaid. The sharp rise in unemployment caused by the pandemic will increase enrollment in the program. Many of the new enrollees will have experienced sudden declines in income, and some will have become sick because of the pandemic. Some would otherwise have been covered by employment-based health insurance or nongroup coverage subsidized through premium tax credits. Some would otherwise have been uninsured but with too much income to be eligible for Medicaid. Others would have been eligible for Medicaid but nevertheless unenrolled. New enrollees may sign up on their own or be enrolled by providers at the point of service.

[1] See Phillip Swagel, Director, Congressional Budget Office, "CBO's Current Economic Projections and a Preliminary Look at Federal Deficits and Debt for 2020 and 2021" (presentation to the House Budget Committee, April 27, 2020), www.cbo.gov/publication/56344.

In addition to health care costs ordinarily covered by Medicaid, states may opt to have the program cover the costs of testing for the disease caused by the coronavirus, COVID-19, for some uninsured people. (The federal government will cover all of those costs.)

Later this year, the Congressional Budget Office will report updated baseline budget projections for Medicaid that incorporate effects of the pandemic, as well as the increased share of Medicaid expenses covered by the federal government this year (a change put in place by last month's CARES Act).[2] For the remainder of 2020, CBO expects state governments to pay 35 percent of Medicaid's costs, on average, for most enrollees; the average in 2019 was 41.5 percent. For other enrollees, adults made eligible for the program by the Affordable Care Act, the CARES Act did not change the share of Medicaid's costs to be paid by state governments; that share remains 10 percent.

Budget Shortfalls

The second set of questions was about the effects of shortfalls in the budgets of state and local governments caused by the pandemic. State and local governments will collect less revenue because of the sudden drop in economic activity and resulting fall in taxable income in 2020. It is unclear how large those shortfalls will be.

At the same time, demand for social services provided by state and local governments will increase. In the 2007–2009 recession and subsequent recovery, state and local governments similarly experienced fiscal pressure. They responded mainly by reducing spending on education, health, and social services. Some of those reductions were achieved by cutting public-sector employment.[3]

On May 19, CBO will report interim economic projections for 2020 and 2021 that incorporate effects of the pandemic. As part of that work, CBO will provide its usual projection of growth in gross domestic product and its components, including growth attributable to purchases by state and local governments. That projection will take into account the expected effects of the pandemic on states' budgets.

Economic Effects of Federal Funding for State and Local Governments

The third set of questions was about how spending during recessions by state and local governments has affected the economy in the past and how the effects of such spending compare with the effects of other policies that federal lawmakers are considering today.

The federal government can boost economic output in various ways, including by providing funds to state and local governments. In the current economic environment,

---

[2] See Congressional Budget Office, cost estimate for H.R. 748, the CARES Act, Public Law 116-136 (April 16, 2020), www.cbo.gov/publication/56334.

[3] For details, see Tracy Gordon, "State and Local Budgets and the Great Recession," Brookings Institution (December 31, 2012), www.brookings.edu/articles/state-and-local-budgets-and-the-great-recession.

CBO expects, additional amounts of such funding would increase output by reducing the size of tax increases and spending cuts enacted by many of those jurisdictions to balance their budgets. The tax increases avoided and services provided would help residents in the short term. Providing such funds to state and local governments would, however, increase the federal deficit, and in the long term, increased federal deficits tend to slow the economy, in CBO's assessment.

CBO estimates that each additional dollar that was used to fund state and local governments by increasing the federal deficit would increase economic output over the next few years by about as much as would a dollar used to fund some policies recently enacted in the CARES Act. Such policies included funding provided to state governments for pandemic-related expenses and increases in unemployment benefits. The economic effects of increases in unemployment benefits depend on factors such as economic conditions, the type of increase, and the amount of the benefit relative to people's potential earnings, in CBO's assessment. The effects of additional expansions of unemployment insurance would therefore differ from those stemming from the CARES Act. For example, as social distancing dissipated, the per-dollar boost to the economywide demand for goods and services would be larger; and as the labor market strengthened, the reduction in the supply of labor per dollar of unemployment insurance benefits would be larger. The net effect on output of such factors would depend on the specific types of additional expansions.

Other provisions of the CARES Act, such as increases in federal spending on Medicare, are expected to have larger effects on the economy. Still other provisions, such as business tax provisions and refundable tax credits, are expected to have smaller effects—although the size of the effects would depend on the specifics of the provisions and the corresponding extent to which businesses and households spent the funds they received. And in addition to having different effects on output, policies in the CARES Act are expected to have different effects on other outcomes—such as employment and the distribution of income—and effects that vary by sector of the economy, geographic location, and demographic group.

Broadly speaking, CBO expects the CARES Act to support the economy in ways similar to those provided by the American Recovery and Reinvestment Act (ARRA), which was enacted in 2009; the agency's estimates are informed by research about that experience. That said, stay-at-home orders, other aspects of social distancing, and other factors are expected to lead to some differences in the impact of particular policies in 2020 as compared with 2009.

The funding for state governments provided by ARRA for purposes other than infrastructure totaled over $200 billion. In its analysis of ARRA, CBO projected that each dollar of such funding had a two-thirds chance of increasing output by an amount between $0.40 and $1.80 over two years.[4] That estimate used averages of effects from many different uses of the funds. In addition, ARRA provided about $60 billion for spending on infrastructure—specifically, on water, transportation, and housing projects—and CBO projected that each of those dollars had a two-thirds chance of increasing output by an amount between $0.40 and $2.20.

Spending for Purposes Other Than Infrastructure. CBO anticipates that the availability of additional funds would both increase states' net spending for any specified activities and also affect other aspects of states' budgets. Without further funding from the federal government, states' tax increases or spending cuts would be larger than they would be otherwise because of fiscal constraints, including requirements to balance their budgets, CBO expects; those actions would result from fiscal challenges arising from the pandemic and also from preexisting challenges, such as unfunded pension liabilities. Such actions would dampen spending by those governments and by households in those states, and more state and private jobs would be lost. Furthermore, many states would probably have to take such steps on an ongoing basis during the next few years.

Therefore, federal funding that was provided promptly would probably have a significant effect on output and employment. Such funding could lead states and localities to lay off fewer employees, hire more of them, give them more pay raises, impose fewer pay cuts, purchase more goods and services, spend more on safety-net programs, or impose lower taxes than they would without the funding. But some of the funding would probably be used to replenish or avoid drawing down states' reserve funds; funding used in that way would not boost the economy in the short term.

Spending for Infrastructure. Infrastructure spending directly increases employment because workers are hired to undertake construction projects. It also adds to demand for goods and services through purchases of material and equipment and through additional spending by the extra workers who are hired; that increase in demand leads to further hiring. However, government spending on infrastructure projects could also cause private-sector spending on infrastructure projects to fall. In addition, CBO projects that there is a two-thirds chance that states would reduce spending of their own funds on infrastructure by between $0.20 and $0.80 for each one-dollar increase in federal outlays

[4] The estimated effects on output differed by provision and the corresponding type of activity. The largest estimates were for direct purchases by the federal government. The smallest were for an increase in the exemption amount for the individual alternative minimum tax. See Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output in 2014* (February 2015), Table 3, www.cbo.gov/publication/49958.

for that purpose. Also, over the long term, spending on infrastructure can affect productivity, with effects that can differ substantially depending on the type of project.[5]

Infrastructure projects often involve considerable start-up lags. Although some projects (such as highway repair and resurfacing) can be implemented relatively quickly, large-scale construction projects generally require years of planning and preparation. For example, building new transportation infrastructure that requires establishing new rights-of-way or developing and implementing alternative energy sources would probably have their biggest effects on output and employment after a few years. Indeed, trying to increase certain types of spending too quickly would raise the risk of making poor decisions about what specific projects should be supported. As a practical matter, the experience with ARRA suggests that the spending of infrastructure funds is slow: By the end of fiscal year 2009, seven and a half months after the legislation was enacted, less than 10 percent of the infrastructure funds provided by ARRA had been spent.

Further Questions

I hope this information is helpful to the Committee. If you have further questions, please contact me directly.

Sincerely,

Phillip L. Swagel
Director

cc: Honorable Steve Womack
Ranking Member

Honorable Jan Schakowsky

[5] For example, see Congressional Budget Office, *Approaches to Making Federal Highway Spending More Productive* (February 2016), www.cbo.gov/publication/50150.