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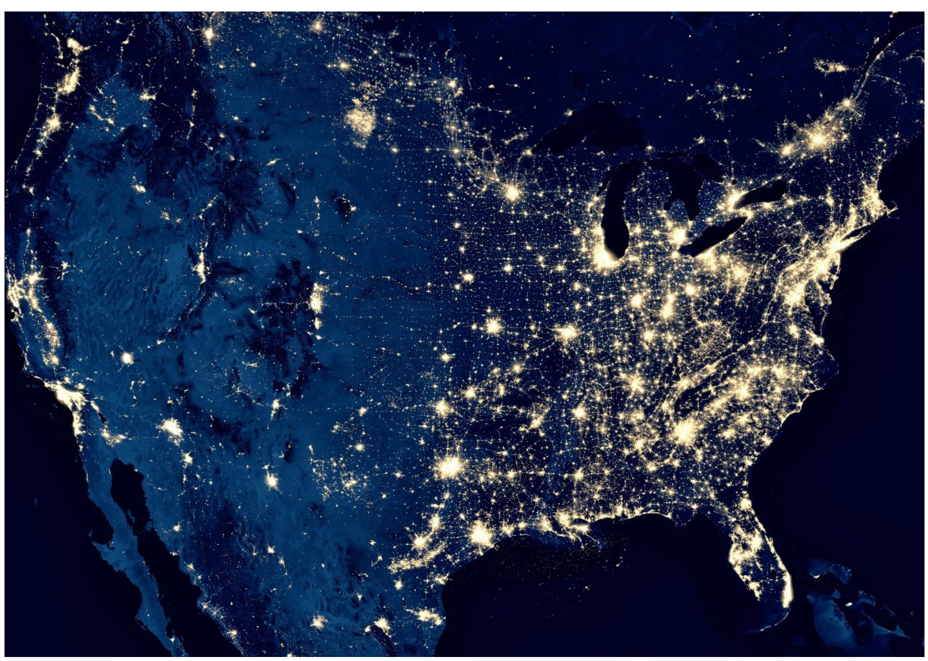
GOVERNMENT FINANCE
RESEARCH CENTER

Can States Provide Fiscal Relief to Local Government during a Recession?

Introduction

The COVID-19 pandemic and related economic downturn have created substantial fiscal pressure for state and local governments throughout the United States. Governments faced unexpected revenue declines as much economic activity suddenly halted due to the spread of COVID-19 and because of policies aimed at mitigating its spread, including prohibiting in-person retail shopping and dining. At the same time, governments faced increased spending pressure for a range of needs, like purchasing personal protective equipment for public workers, the larger public health response, and increased need for safety-net services. Projected revenue declines and increased demand for services led many governments to cut costs where possible.

The $350 billion of American Rescue Act money targeted to state and local governments will ease the situation significantly for these governments. But the pressures brought about by the pandemic have created an environment that encourages innovative approaches to government finance and builds capacity to help states and localities ride through difficult times. One approach depends on states, though hard-pressed themselves, lending a helping hand to their localities.



An absence of countercyclical funding
Both states and municipalities suffer fiscal downturns during a national recession, putting both types of governments in precarious fiscal positions. As a result, states suffering from fiscal pressures are not in a position to provide financial aid to municipalities that are also suffering fiscal pressures.

Macroeconomic events, including a national recession, can put otherwise well-managed municipalities in fiscal distress, but existing fiscal programs are not designed to be an anti-recessionary policy tool or general aid program. A close look at six Great Lakes states —Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin – reveals that none have a countercyclical component built into their general aid programs, and in many instances the programs are designed so that state aid *decreases* when there is an economic downturn.

This problem is amplified because, in many places, the dominant source of unrestricted state aid is income tax revenue. This source of funds is highly elastic, meaning that the percentage change in income tax receipts is greater than the percentage change in economic growth. As a result, when states tie aid to localities to income tax revenue, that flow of resources will decline during economic downturns; the precise point in time when local governments need such aid.

Consider the experience of the Great Recession. Unrestricted state aid for each of the six Great Lakes states declined in the wake of this period of national economic turmoil. The impact ranges from a 4.2% decrease in Illinois to an 85.6% decrease in Indiana. Such reductions didn't disappear when times improved. Local governments in 26 states received less aid in 2016 than they had in 2008, adjusted for inflation, according to a 2019 study by the Pew Charitable Trusts.

Fiscal Emergency Laws and Programs

In addition to aid programs, many states also have fiscal emergency programs in the event of local fiscal distress. According to a 2016 paper written by the late municipal expert James Spiotto, more than 20 states have adopted fiscal emergency mechanisms to intervene when a municipality reaches distress or emergency. These are designed to intervene when a local government has significant problems paying its bills, including pension and other post-employment liabilities, contracts for services, and short- and long-term bond debt.

Spiotto also found that at least 13 states, including Michigan, allow for financial control boards, emergency managers, and other methods of active supervision appointed by the governor or a state board or authority. Other states, like Ohio and Georgia, monitor all municipalities through an annual auditing process and may intervene if a set of statutory criteria are met. Interventions included in states' programs include: grants or loans; intercepts or refinancing; budget process involvement; required financial performance metrics; legislative assistance; moral obligations of the state; acceleration of loans; or consolidation of regional essential governmental services.

A look at the six Great Lakes States mentioned above, illuminates the variety of fiscal emergency laws and programs in place:

- Minnesota and Wisconsin have minimal programming for fiscally distressed cities and what programming exists focuses solely on bonded indebtedness. In both states, assistance is only offered when default on a municipal bond payment is imminent.
- Indiana and Illinois offer support to municipalities in fiscal distress, but the municipality must request assistance. In both states, the programs are narrow in scope and meant only for highly distressed cities.
- Michigan intervenes when municipalities are in fiscal distress, even if the municipality has not requested it. Its Local Financial Stability and Choice Act specifies characteristics that would allow the state to conduct a preliminary review of a municipality's finances. If probable stress is found during the preliminary review, a team is appointed by the Governor to conduct a full evaluation and determine if there is a fiscal emergency.
- Ohio's fiscal distress programs are the most comprehensive of the six states studied, partly because the state auditor proactively monitors the finances of all municipalities through an annual audit process. The state has a conventional fiscal distress program that can be initiated by the local government or the state auditor.

Unfortunately, state fiscal emergency

programs that are in place are far from a panacea for localities in distress. For example, fiscal emergency programs tend to view fiscal emergencies as temporary conditions resulting from mismanagement. However, many local fiscal emergencies are fully or partially the result of changing long-term economic conditions, meaning distress may not always be temporary or originate locally. This has been abundantly demonstrated during the pandemic-induced national economic downturn.

Moreover, during economic downturns both states and municipalities tend to suffer in their own ways. As a consequence, states suffering from several fiscal pressures are not in a position to provide financial aid to municipalities that are also suffering fiscal pressures.

Opportunities to Enhance State Aid Programs

Given the limitations and shortfalls of existing state aid and fiscal emergency programs, what can state governments do to provide fiscal support to local governments during economic downturns? In an ideal world for localities, states could create new programs which would automatically provide aid to local governments during economic downturns or crises. But such a move is unlikely, given the fact that states tend to be in economic distress at the same time as their localities.

To implement such a stabilizer program, however, would be an explicit acknowledgment by states that local aid will be preserved during economic downturns regardless of the impact on their other priorities. Whether an intended or unintended effect of a state stabilizer program, the budget balance requirements of states would require them to offset the amount that is stabilized by reductions of that amount elsewhere (or possibly raising taxes, which is politically difficult during recessions).

There are, however, less far-reaching reforms that could be helpful. For example, states that currently provide local aid through lump-sum programs, like Minnesota and Wisconsin, could index these payments to inflation to ensure that the real value of aid does not diminish in real-dollar terms over time. Currently, aid programs in those states are capped at nominal dollar amounts, which means that in real, inflation-adjusted dollars, state aid decreases over time.

Other alternatives could be useful in states like Illinois, where local revenue sharing is tied to income and/or sales taxes, including basing aid payments on multiyear revenue performance rather than revenues in a single year. This would smooth out year-to-year volatility in aid, allowing for local governments to engage in more comprehensive fiscal planning.

In general, states could improve the diversity of the revenue mix of tax sharing programs to reduce volatility in aid to local governments. Research shows that increasing revenue diversity in state and local governments reduces volatility in revenue collection. Current programs tend to share a portion of one or two taxes—often income or sales taxes which are relatively elastic revenue sources. Sharing a smaller portion of a wider group of taxes, or ideally a small portion of all state tax collections, may reduce year to year volatility in revenue sharing programs for local governments. Ohio already does this, though other design elements of its general aid program essentially cap the amount of aid municipalities can receive.

Yet while there is an urgent need to revise state aid programs that support county and municipal governments, reforms to state aid alone are insufficient as a means of insulating local governments from the risks associated with economic crises. Measures to diversify state revenue sources for local aid may help to limit volatility, for example, but they cannot change the fact that state revenue sources are, on the whole, highly pro-cyclical. Nor can they alter the reality of state fiscal rules that essentially preempt strong countercyclical action.

Could the federal government help?

It may be the case that an important long-term safety net for localities in economic distress could come from the federal government. Major federal-state programs such as Medicaid, Unemployment Insurance, and the Supplemental Nutrition Assistance Program (SNAP) already have an “automatic” component in that federal spending expands as economic conditions worsen and enrollment in those programs increases. Though there is not currently an automatic stabilizer program for general state and local aid, legislation during earlier economic crises provides a model. Consider the Antirecession Fiscal Assistance Program (ARFA), which was created by Title II of the 1976 Public Works Employment Act. Under that program, the federal government provided unrestricted grants to state and local governments that were afflicted by long periods in which unemployment rates were high. Automatic stabilizers should be seen as complementing rather than fully substituting for discretionary fiscal policies. Even if they had been in place prior to the COVID-19 pandemic, additional discretionary policies to deal with unexpected state and local fiscal needs would have been essential.

Read the full report here or on the GFRC site.