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*April 2021*

# **Strengthening Local Government Finances: State and Federal Aid Policies for a Crisis Era**

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## Acknowledgment

Financial support from the Joyce Foundation is gratefully acknowledged. The authors wish to thank Michael Pagano and David Merriman for their very helpful comments and suggestions on an earlier draft. Katherine Barrett and Richard Greene provided helpful synthesis of this work. Special thanks to Farhad Kaab-Omeyr in the Department of Public Administration at University of Illinois at Chicago for his research support. All errors, omissions, and conclusions remain the sole responsibility of the authors.

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## Introduction

The United States' public sector is an engine of economic and social development. Investments in public infrastructure—from the construction of light-rail systems to research on infectious diseases—not only result in measurable increases in private-sector productivity, they also provide benefits like cleaner air and water, housing, and education, that improve public health and the quality of life (Bivens, 2012). The nation's more than 90,000 local governments—including municipalities, counties, townships, school districts, and special districts—are the public sector's backbone. Collectively, they employ over 13 million Americans—nearly 10% of the US workforce, and more than federal and state governments combined. Local governments not only finance the construction of the roads, bridges, water utilities, and other infrastructures that make the economy work, they are also the frontlines of the public health workforce, and have been vital to combatting the COVID-19 pandemic.

Yet despite their pivotal role in the national economy, local governments' revenue structures leave them particularly vulnerable during economic recessions. Due to constraints on their fiscal policy space, in a survey of 900 municipalities, 90% reported they had—during COVID-19—experienced a revenue decrease, with most also experiencing increased spending needs (National League of Cities, 2020). The consequences of the pandemic for households and small businesses have been severe. Since February of 2020, local governments—excluding school districts—have thus far shed nearly 360 thousand jobs (“Current Employment Statistics”, 2020). Once educational employment is factored in, local government job losses have totaled over 1 million. Moreover, the

simultaneous public health and economic crises have created new spending needs for state and local governments, overwhelming state unemployment systems and creating unprecedented demand for housing, utility assistance, and anti-hunger programs. For local governments that rely heavily on property taxes, the effects could last years as the fallout of the crisis within the real estate market (especially for commercial properties) has yet to fully materialize (Buhayar, Gittelsohn, and Gu, 2020). Federal Reserve Chair Jerome Powell warned that financially struggling state and local governments will “hold back” economic recovery, noting that state and local budget cuts contributed to slow growth following the 2007-09 recession (Smialek, Rappeport, and Cochrane, 2020, n.p.).

Given the crucial role of local governments in the economy and society, how can state and federal aid programs better insulate them from the effects of recessions? This report suggests that state aid programs, as currently designed, further limit the ability of local governments to respond to economic crises, because, most often, funding for these programs relies on volatile revenue sources like income and sales taxes. As such, state aid programs could benefit from reforms that index transfers to inflation, basing payments on multiyear revenue performance, as well as other measures to reduce payment volatility.

Yet while state aid programs are in dire need of reform, stabilizing local revenues during economic recessions will also require rethinking the federal role. The federal government has the *capacity* to engage in countercyclical spending to support state and local finances during crises, but it tends to rely on a *discretionary* approach to using these capacities. That means that support for state and local governments does not

automatically expand during a crisis, but relies on congressional negotiations on fiscal policy. Assuming a high level of federal responsiveness, discretionary approaches have the virtue of being able to respond to spending needs that are unique to a particular crisis period. During COVID-19, for example, federal aid was crucial in supplying state and local governments with personal protective equipment as well as support for hazard pay and adaptations to remote work. As this report highlights, relying on discretionary aid *alone* has drawbacks, especially if the goal of federal fiscal policy is to shorten the length of a recession. Rather than automatically increasing when a recession occurs, discretionary federal aid is contingent on political choices to create and sustain temporary “strings attached” aid programs. This means that aid may arrive too late to stave off the fiscal consequences of a crisis or expire prior to the end of the crisis. In contrast, we present some design considerations for a program of automatic intergovernmental

stabilizers, which would short circuit these problems. Importantly, however, we note that ensuring robust fiscal capacity at the state and local level will also require exploring ways to enhance federal fiscal equalization for both state and local governments.

The remainder of the report is as follows: We first discuss the role of intergovernmental fiscal policy during economic crises. Next we examine existing and historical federal and state aid programs. Throughout the report we focus specifically on six Great Lakes states—Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin. Of the six states, none have a countercyclical component built into their state general aid programs, and in many instances the programs are designed so that state aid *decreases* when there is an economic downturn. Last, we offer policy options to fill existing gaps in intergovernmental aid, both at the federal and state levels. Existing programs can be augmented, but to fully support governments during recessions what is needed is an automatic stabilizer program.

## What Fiscal Challenges Do Local Governments Face During Economic Crises?

Fiscal federalism plays a fundamental role in structuring the US response to economic crises. On the one hand, state and local governments are a significant source of employment and economic activity, employing more than nine million people (Employment Situation, 2020).<sup>1</sup> Nevertheless, these governments lack appropriate fiscal tools to stimulate economic activity during downturns (ACIR, 1987). Not only are states incapable of creating money, most have balanced-budget requirements (BBRs) and statutory spending limits. Moreover, all but a small handful of states have placed similar restrictions on local governments (Peck, 2014). Hence, economic crises tend to place state and local governments in a ‘fiscal vise,’ simultaneously

gripped by both increasing demand for services and dramatic revenue shortfalls (Pew Charitable Trusts, 2012). Relative to sub-national governments in other federations, the procyclical nature of crisis response in American states and cities remains extreme (Blöchliger et al., 2010). For a given unemployment gap shock, cuts to state and local spending typically offset about 25% of the federal government’s total stimulus during a recession (Sheiner and Ng, 2019).

By contrast, the federal government has two powerful sources of countercyclical spending capacity that are crucial to crisis response (Armingeon, 2012; Francis, Jackson, & Owyang, 2017). First, the Federal Reserve

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<sup>1</sup> This figure is for state and local government employment, excluding education. If education is included, then the figure is much higher, at nearly seventeen million.

can engage in expansionary monetary policies. Second, Congress does not face the same legal constraints on deficit spending that exist in nearly all states, allowing for strong countercyclical fiscal policies. As a result, actions to stabilize the economy during a recession invariably occur at the federal level. Following the Great Recession, the United States pursued expansionary policies between 2008 and 2010 that were ultimately essential to economic recovery (Council of Economic Advisers, 2014).

Countercyclical policy in the United States tends to be *discretionary* (Boushey et al., 2019). This means that, during a crisis, policymakers must work on a relatively quick timeline to enact policies they believe will have the magnitude and duration appropriate to match the scale of the economic decline. Even when so-called automatic stabilizers such as Unemployment Insurance and Medicaid ‘switch on’ during recessions, they usually require some form of discretionary expansion or recalibration. In response to the Great Recession, Congress adopted a patchwork of emergency programs. The American Recovery and Reinvestment Act (ARRA) devoted a roughly even share of outlays to tax cuts, expansions to existing programs like Medicaid and unemployment benefits, and discretionary spending, including direct assistance to individuals and support for infrastructure programs. Between 2009 and 2012, Congress expanded its relief programs, with the largest shares of fiscal support devoted to, among

other things, extensions to unemployment insurance (Council of Economic Advisers, 2014). Yet while ARRA was crucial to the macroeconomic policy response, its major provisions expired prior to the peak of long-term unemployment and the depths of local fiscal crises. This limited its countercyclical impact (Sheiner and Ng, 2019).

The importance of federal aid for local governments in particular is accentuated when we consider the vulnerability of municipal revenue structures to procyclical pressures. Table 1 illustrates the major sources of general revenue for municipal governments in the six Great Lakes states. Locally imposed sales taxes, and—in Ohio—local income taxes are susceptible to the effects of economic recessions, as are other local sources of revenue (like charges and fees). Though the effect is lagged, economic recessions constitute a threat to municipalities’ own source revenues from property taxes, too. Property taxes are also further constricted through state levy limits, present in all six states, rate limits in four states, as well as limits on assessments in Illinois and Michigan (Walczak, 2018). Revenue municipalities receive from states is similarly threatened because state budgets rely heavily on income and sales taxes for revenue, and because of this, state revenue declines can also result in decreases in intergovernmental aid. Last, while federal intergovernmental revenue has the potential for countercyclical support, it constitutes less than 5% of general municipal revenue in all but one of the states in

our analysis.

**Table 1. Revenue Sources as a Share of General Municipal Revenue in Six Great Lakes States (2017)**

State	Own-Source Revenue				Intergovernmental Revenue (IG)	
	Property Tax	General Sales Tax (Locally Imposed)	Income Tax (Locally Imposed)	All Other Own-Source Revenue	State IG	Federal IG
<b>Illinois</b>	22.6%	5.0%	0.0%	46.3%	22.1%	4.0%
<b>Indiana</b>	26.8%	0.0%	3.8%	49.8%	17.1%	2.5%
<b>Michigan</b>	27.5%	0.0%	5.9%	43.8%	16.4%	6.4%
<b>Minnesota</b>	30.1%	2.0%	0.0%	51.2%	13.8%	3.1%
<b>Ohio</b>	8.4%	0.0%	44.2%	34.8%	9.7%	2.9%
<b>Wisconsin</b>	43.5%	0.0%	0.0%	34.3%	19.8%	2.4%

Source: Authors' analysis of Census of Governments. (2017). US Census Bureau. <https://www.census.gov/data/tables/2017/econ/gov-finances/summary-tables.html>

## How Does Intergovernmental Aid Support Local Governments? How Has This Changed Over Time?

Macroeconomic events, including a national recession, can force otherwise well-managed municipalities into fiscal distress, but existing fiscal emergency programs are not designed to be an anti-recessionary policy tool or general aid programs (for a detailed discussion of fiscal emergency programs see Appendix A). The COVID crisis is unique in that it is both a public health emergency and economic downturn, and combating the two simultaneously requires an array of policy tools and programs. The federal government uniquely has extensive capacity to enact countercyclical and relief programs with its ability to deficit spend. Yet much of the authority for the implementation of social support programs and public health measures resides at the state and local

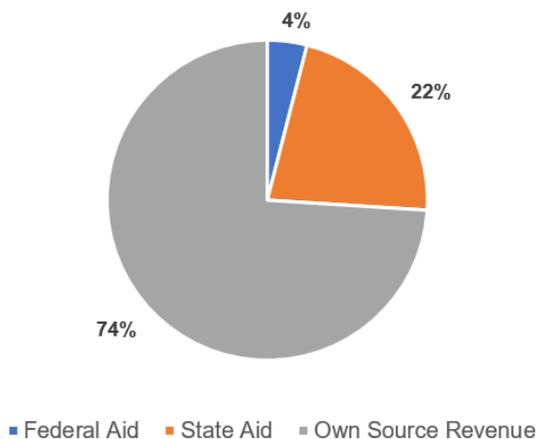
level. During the pandemic, general purpose local governments have played a particularly important role in providing emergency support for housing assistance and aid to small businesses. In doing so, they have relied on intergovernmental aid—also referred to as intergovernmental revenue, intergovernmental grants, and/or grants-in-aid—which is typically meant to “improve the operation of a federal system of government finance” (Fisher, 2018, p. 317).

Intergovernmental aid usually takes one of two broad forms: (a) categorical aid, in which aid is tied to specific programs or objectives and there are restrictions on what the funds can be used for, or (b) general aid, often known as revenue-sharing, in which the recipient government has discretion over how to use the

funds. A common example of categorical state aid is funding provided to school districts for K-12 education.

Local, general-purpose governments provide an important example of how intergovernmental aid is allocated. Across the United States, local governments' general revenue totaled \$1.7 trillion in 2017, and Figure 1 provides a breakdown of that revenue by revenue source, highlighting that local general-purpose governments (counties, municipalities and townships) generate the vast majority of their revenue from local sources.<sup>2</sup> For these governments, the property tax is an especially important revenue source, accounting for nearly 30% of total revenue in 2017.<sup>3</sup> In aggregate, federal aid accounted for about 4% of general revenue, while state aid accounted for 22%. Municipalities' reliance on state aid varies widely, however, between and within states (Kass, Pagano, and Kaap Omeyr, 2020).

**Figure 1: General Revenue by Source for Counties, Municipalities, and Townships, 2017**



Source: Authors' analysis of Census of Governments. (2017). US Census Bureau. <https://www.census.gov/data/tables/2017/econ/gov-finances/summary-tables.html>

Most of the intergovernmental aid counties, municipalities and townships receive is categorical, meaning its use is restricted to specific purposes. Local governments typically receive unrestricted (or general) aid from state governments via tax earmarking, meaning a portion of state taxes are allocated to local governments. Of the 50 states, 14 share portions of their general sales and/or income tax revenue with local governments (Kass, Pagano, and Kaap Omeyr, 2020). In some instances states allow local governments to implement their own sales tax as a substitute for revenue sharing. Some states also allow local governments to implement local income and/or sales taxes in addition to the state taxes. Overall, the financial, economic, and political parameters—or the fiscal policy space—that local governments operate under varies both within and between states (Pagano and Hoene, 2010 and 2018).

### The Rise and Fall of General Revenue Sharing

While federal aid is a small share of local governments' revenue today this has not always been the case. In the 1970s federal aid to cities increased substantially, growing from 7.5% of cities' total revenue in 1972 to nearly 14% by 1977 (Wallin, 1998, p. 5). Although most federal aid was categorical prior to the early 1970s, there was a shift to block grants (or general aid) under the Nixon administration.<sup>4</sup> The General Revenue Sharing (GRS) program was enacted in 1972, and was "widely heralded as a revolutionary change in U.S. federal aid policy" (Wallin, 1998, p. xi). The GRS played an important role in fiscal equalization, that is, it was a program designed to offset revenue raising differences among governments. Aid was primarily distributed on the basis of population, but involved complicated formulas that took into consideration income, taxing ability,

<sup>2</sup> Analysis of Census of Governments 2017 for municipal governments only. "General Revenue" is "all revenue except that classified as liquor store, utility, or insurance trust revenue" (Census of Governments, 2006, 4-3).

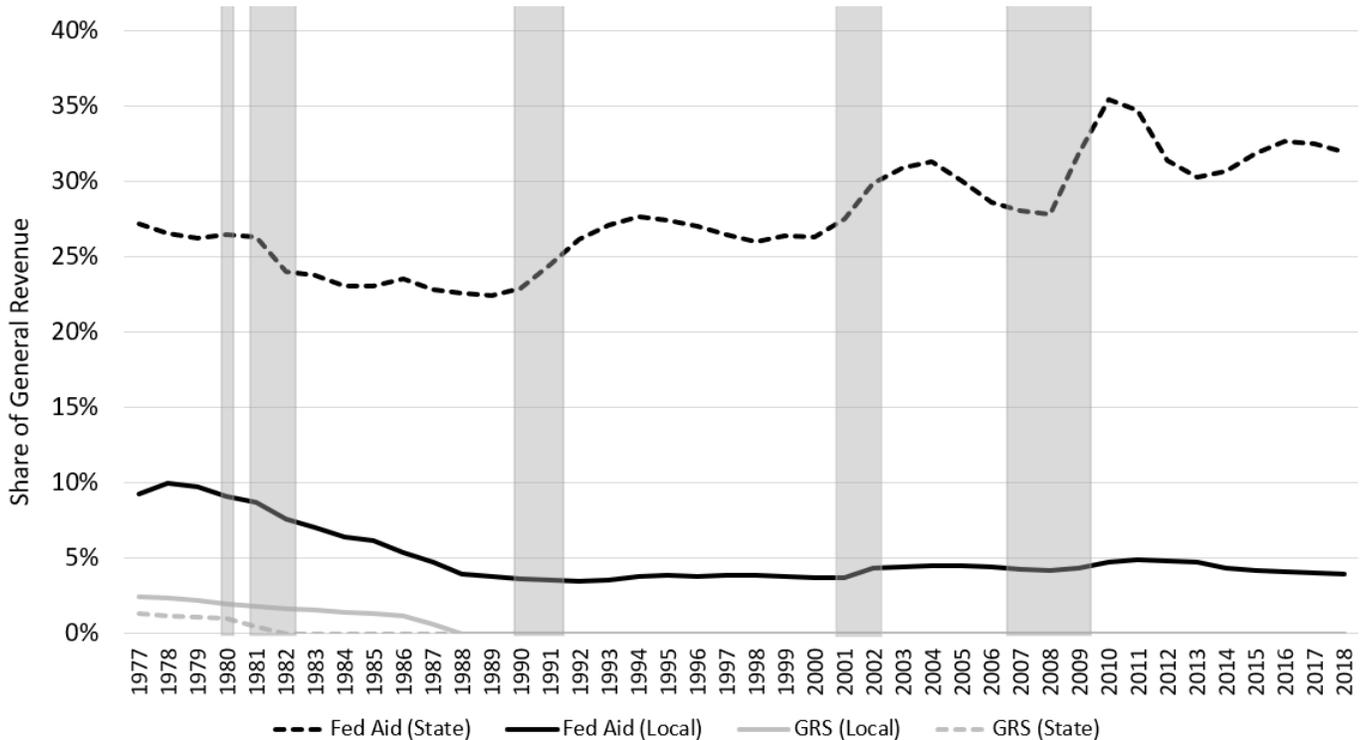
<sup>3</sup> Aggregate property tax revenue was \$121.03 billion (Census of Governments, 2017).

<sup>4</sup> While federal aid shifted to block grants in the 1970s and 80s, this form of aid was first introduced in 1966 (Wallin, 1998, p. 32).

and taxing efforts in determining the exact amounts for all units of government (Lerman, 2020; Wallin 1998). The end of the GRS and the absence of a replacement means that there is no national fiscal equalization program of equal scale in the United States for local governments, which contrasts with other major democratic countries that do have such programs (Galbraith, Lind, and Luby,

2020). As Figure 2 shows, federal aid has long constituted a higher share of state revenues than local revenues. Federal aid to states has also been more responsive than federal aid to local governments during recessionary periods. Finally, with the exception of the years where the GRS program was in effect, most federal aid distributed to state governments has restrictions on its use.

**Figure 2. Federal Aid as a Share of State and Local General Revenues, 1977–2018 (Shaded Areas Indicate Recessions)<sup>5</sup>**



Source: US Census Bureau Annual Survey of State and Local Government Finances, 1977-2018 (compiled by the Urban Institute via State and Local Finance Data: Exploring the Census of Governments; accessed 29-Mar-2021 01:10), <https://state-local-finance-data.taxpolicycenter.org>.

The GRS was created by the State and Local Fiscal Assistance Act of 1972, and authorized nearly \$6 billion (nominal dollars) to be allocated to state and local governments annually between 1972 and 1976. While the program was initially authorized for five years, it was re-authorized several times before expiring in 1986. Between 1972 and 1983, GRS funding was shared between state and

local governments, but in the final years of the program aid was only provided to local governments (Wallin, 1998, p. 47).

The political context for the creation of the GRS was tied to backlash against Great Society initiatives and growing fiscal conservatism. Thus, while the GRS initially increased federal aid to state and local

<sup>5</sup> Note that the local government figures shown in Figure 2 include aid to counties, cities, municipalities, townships, special districts, and school districts. When we exclude special districts and school districts, federal aid as a share of general revenue is essentially identical.

governments, its creation and subsequent expiration was also the start to a larger trend of devolution, decreasing federal aid, and “tax revolts” that began in earnest in the late 1970s. These developments have constrained fiscal capacity at the local level, with the tax revolts in particular limiting local governments’ revenue-raising capabilities. As federal aid decreased, state aid increased, although not in amounts sufficient to make up for the federal cuts or devolution of responsibility to lower levels of governments. In constant 1988 dollars, per capita federal aid to local governments decreased by \$63.39 between 1980 and 1988, while per capita state aid to local governments increased by only \$20.13 (Cahill and James, 1992, p. 89; “HRD-91-14 Distressed Communities”, 1991). The progression of President Reagan’s New Federalism, a second round of devolution, at the national level led to decreased federal funding to states and local governments at the same time that the responsibilities of lower units of government were expanding due to, among other things, unfunded mandates.

### **State Aid Programs and the Challenge of Policy Drift**

In addition to the disappearance of the GRS, local governments have faced added pressure from changes to and deficiencies in state

aid programs. In many places, the dominant source of unrestricted state aid is income tax revenue. The elasticity of income tax revenue depends on the design of the tax system, and ones that are highly elastic mean the percentage change in income tax receipts is greater than the percentage change in economic growth. During periods of economic growth, the increase in income tax receipts, on a percentage basis, is greater than the percentage increase in economic growth; and during periods of economic contraction, the decrease in income tax receipts is greater than the decrease in economic growth. Yet, tying unrestricted state aid to state income tax revenue means that aid, by design, will decline during economic downturns, which is the exact moment local governments may most need such aid. This dynamic is best described as a case of policy drift, in which programs fail to update to address changing economic conditions (Hacker, 2004).

To explore how local governments fare under current state funding programs, we can consider state aid programs for the six Great Lakes states. Table 2 shows total state aid and the portions that are restricted and unrestricted aid.

**Table 2: Restricted and Unrestricted State Aid to Municipalities, for Great Lakes States**

State	Total State Aid as Share of Municipal Revenue (2017)	Total State Aid, \$ Billions (2017)	Portion of Aid Restricted (2017)	Portion of Aid Unrestricted (2017)
Illinois	22.1%	\$4.38	16.8%	83.2%
Indiana	17.1%	\$1.35	92.5%	7.5%
Michigan	16.4%	\$1.50	53.8%	46.2%
Minnesota	13.8%	\$1.01	45.6%	54.4%
Ohio	9.7%	\$1.20	79.0%	21.0%
Wisconsin	19.8%	\$1.19	38.8%	61.2%

Source: Authors' analysis of Census of Governments. (2017). US Census Bureau. <https://www.census.gov/data/tables/2017/econ/gov-finances/summary-tables.html><sup>6</sup>

As Table 2 highlights, the significance of state aid as a revenue source varies across the six Great Lakes states, accounting for 22% of municipal revenue in Illinois, but less than 10% in Ohio. In dollar amounts, Illinois provides municipal governments with the greatest amount of state aid, while Minnesota provides the least. There is also variation in whether states primarily provide restricted or unrestricted aid. In Illinois the vast majority of state aid is unrestricted, whereas the opposite is true in Indiana and Ohio. The portion of local aid that is restricted varies as well, ranging from nearly 17% in Illinois to more than 90% in Indiana. Many states offer aid restricted for transportation funding: Illinois shares a portion of the motor fuel tax; Indiana provides a motor vehicle excise tax replacement, motor vehicle highway distribution, and a local

road and street distribution; Ohio provides a local government highway distribution; and Wisconsin provides grants for local transportation projects. The other common form of restricted aid is for public safety. Illinois shares a portion of gaming taxes restricted for public safety spending and Minnesota offers aid to local governments specifically for local police and fire pension liabilities.

Table 3 shows the amount of unrestricted state aid, change in unrestricted aid between 2007 and 2012, and the main source of unrestricted aid for each of the six Great Lakes states.

<sup>6</sup> The Census of Governments classifies intergovernmental revenue from state governments using twelve codes. Code "C30" is for general local government support, and is the only designation for aid in which the money can be used "at the discretion of the receiving government to any of its basic functions" (Census of Governments 2006, 4-25). All of the other codes for state aid to local governments are for aid in which the revenue is for a specific activity/purpose; for example, code "C21" is for education spending. We consider state aid coded as "C30" as unrestricted aid, and all other aid as restricted.

Table 3: Characteristics and Trends in Unrestricted Aid for Great Lakes States

State	Unrestricted Aid (2017, \$ Millions)	Per-Capita Unrestricted Aid (2017)	Unrestricted State Aid as Share of Municipal Revenue (2017)	% Change in Real per Capita Unrestricted State Aid (07-17) <sup>7</sup>	Main Source of Unrestricted Aid
Illinois	\$3,647.5	\$285.27	18.4%	-4.2%	Tax Earmarking—General Sales + Income
Indiana	\$100.5	\$15.10	1.3%	-85.6%	Tax Earmarking—Gallonage + Gaming
Michigan	\$695.1	\$69.68	7.6%	-34.2%	Tax Earmarking—General Sales
Minnesota	\$547.5	\$98.33	7.5%	-23.1%	Lump Sum—Local Government Aid
Ohio	\$252.3	\$21.63	2.0%	-64.2%	Tax Earmarking—General Fund Revenue
Wisconsin	\$726.2	\$125.37	12.1%	-35.3%	Lump Sum—County and Municipal Aid

Source: Authors' analysis Census of Governments. (2017). US Census Bureau. <https://www.census.gov/data/tables/2017/econ/gov-finances/summary-tables.html>

As shown in Table 3, Illinois, Indiana, and Michigan use tax earmarking for the bulk of their unrestricted aid programs for local governments. Illinois shares portions of the income and general sales taxes, Indiana shares portions of the gallonage and gaming taxes, and Michigan shares a portion of the general sales tax. The extent to which tax earmarking fluctuates with tax collections is different in some states than others. In Illinois, the funds available for municipalities fluctuates according to tax collections, but the state

legislature has also changed the portion of the income tax dedicated to local government four times since 2011 (“LGDF,” 2020), which has resulted in swings in funding levels separate from tax collection cycles.

Ohio’s general aid program is tied to tax collections; however, unlike other states it does not earmark portions of specific taxes. Instead, tax revenue is deposited into the state General Fund, and then a portion of all revenue (regardless of source)

<sup>7</sup> 2007 figures inflation-adjusted to 2017 dollars using the Bureau of Economic Analysis’s Implicit Price Deflators for Gross Domestic Product, “Government consumption expenditures and gross investment” for state and local governments.

is transferred to local governments via the Local Government Fund. The amount of aid municipalities can receive is capped however, as they cannot receive more than the nominal dollar amounts they received from the state in 2007. Therefore, municipalities only see a change in funding level if state tax collections are insufficient to fund the program at the 2007 level. By design, Ohio's aid program provides local governments with less revenue over time when accounting for inflation. In addition, state lawmakers actively cut the general aid program in an effort to balance the state budget in the aftermath of the Great Recession (Cooper, 2011).

Instead of tax earmarking, Minnesota and Wisconsin opt for lump-sum aid programs in which individual municipalities' aid amounts are determined using statutorily imposed formulas. Minnesota distributes local aid using a need-based formula, but the total amount of funding for the program is the same nominal dollar amount each year. Wisconsin's municipal aid program technically expired in 2012, but each municipality that received a payment in 2012 receives the same amount each year thereafter. For both programs the base funding amount is only guaranteed in the event that state resources are adequate to fully fund the programs. Data from Wisconsin's Legislative Fiscal Bureau suggest that state

aid to local governments fell by 40.9% between 1998 and 2018. Over the same period, the share of the state's general fund allocated to local aids was cut in half. There are multiple reasons for this decline, including changes in the state's school funding formula, the growth of the state's prison system, the gradual expansion of Medicaid eligibility, and a series of tax cuts (Murray, Stein, and Henken, 2019).

Regardless of whether the state uses a tax earmarking program, a lump sum program, or partially guarantees a base level of funding, real per capita unrestricted state aid for each of the six Great Lakes states declined in the wake of the Great Recession, ranging from a 4.2% decrease in Illinois and to an 85.6% decrease in Indiana. Importantly, none of the six states have a countercyclical component to their unrestricted aid programs. For all six states, general aid declines when the state government experiences fiscal stress, albeit to varying degrees. This is true of most state and local aid relationships. Following the Great Recession, state aid to localities decreased because of declines in state tax collections and legislative cuts to general aid programs. These reductions were long lasting, with local governments in 26 states receiving less aid in 2016 than in 2008 (Rosewicz, 2019).

## How Can State Aid Programs Be Enhanced to Support Local Governments?

States could augment existing programs or create a new program that is specifically meant to provide aid to local governments during economic downturns or crises and, rather than being discretionary, is automatically triggered. Depending on the design of the state's current general-aid program, this could take one of several forms. While creating a new program with an automatic trigger may be optimal, state and local governments both experience fiscal stress during downturns, and states inability to deficit spend hinders their ability to increase

aid to local governments without sacrificing other, important functions. We thus focus on ways states could augment their existing aid programs. First, states that currently provide local aid through lump-sum programs, like Minnesota and Wisconsin, could at a minimum 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.

Second, in states like Illinois, where local revenue sharing is tied to income and/or sales taxes, there are several potential options for reform. This could include 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 addition, it might include writing minimum aid amounts (linked to inflation) into the state code to ensure that aid does not fall below a reasonable threshold. Even with these changes, however, lawmakers could cut general aid programs in an effort to balance state budgets, as happened in some states after the wake of the Great Recession. In Wisconsin, for example, aid to counties and municipalities was cut by 9.2% in 2012 and has been relatively flat in nominal dollars ever since (“Shared Revenue Program”, 2021, p. 2)

Third, in general, states could improve the diversity of the revenue mix for tax earmarking 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 (Carroll, 2009; Gentry and Ladd, 1994; Schunk & Porca, 2004). Current earmarking 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, for example, does this; however, other design elements of its general aid program essentially cap the amount of aid municipalities can receive.

Last, states may consider setting aside a dedicated portion of their rainy day funds (also known as budget stabilization funds) for local governments to tap into during economic crises to maintain service levels. This proposal would effectively separate a state’s single rainy day fund that is set aside just for state services into two funds, one for the state and

the other for local governments. While all fifty states currently have some form of rainy day fund, the structure of these accounts varies widely and the balances change frequently, making it hard to paint a broad picture of common practices. See Appendix B for discussion of rainy day funds and detailed description of rainy day funds in the six Great Lakes states.

Nevertheless, it is important to be clear about the limits of rainy day funds. Research suggests that rainy day funds can be effective in recessionary periods to maintain existing service levels, but they are an insufficient tool alone. This is in part because rainy day funds are usually exhausted at the very beginning of a recessionary period, providing one-time revenue rather than lasting relief (Shi, 2016). Fiscal and political challenges also hinder some states’ ability to build up a robust rainy day fund. Illinois has had a rainy day fund since 2000, but the state has never transferred significant resources to the fund. The small sums that have been deposited into Illinois’ rainy day fund over the years have been used to cover budget gaps caused by the state’s fiscal woes (Singh, 2020). Moreover, while most states added to their rainy day funds over the past decade, the median balance across all fifty states at the start of 2020 was about 8% of general fund spending, which amounts to about one month of spending (The Fiscal Survey of States, 2020). Studies also find that the impact of a rainy day fund on a state’s fiscal stability depends on the requirements surrounding adding money to the fund. Rainy day funds are most effective when deposits are required during expansionary periods, and absent strong deposit procedures or political will, a rainy day fund may not be helpful in any measurable way (Sobel and Holcombe, 1996; Douglas and Gaddie, 2002; Denison, 2019). Hence, while rainy day funds can be an important component of a countercyclical state plan, they require stringent maintenance and are ultimately insufficient tools in isolation for long-term fiscal stability.

In sum, there is a need to revise state aid

programs that support county and municipal governments, yet 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, procyclical. Nor can they alter the reality of state fiscal rules that essentially preempt strong countercyclical action. The next sections consider alternatives that may be able to provide this sort of support.

## How Could an Automatic Aid Program Support Local Governments During Economic Crises?

Given the limitations and shortfalls of existing state aid programs, what can state governments do to provide fiscal support to local governments during economic downturns? Balanced budget requirements and states' own fiscal pressures limit what states alone can do. As previously discussed, while there are modest ways to augment existing state aid programs, we believe that the optimal solution is the creation of a new federal program that automatically provides fiscal support to both state and local governments during economic downturns and crises. States too could create new automatic stabilizer programs; however, funding such programs given states' fiscal and political realities is an unresolved challenge.

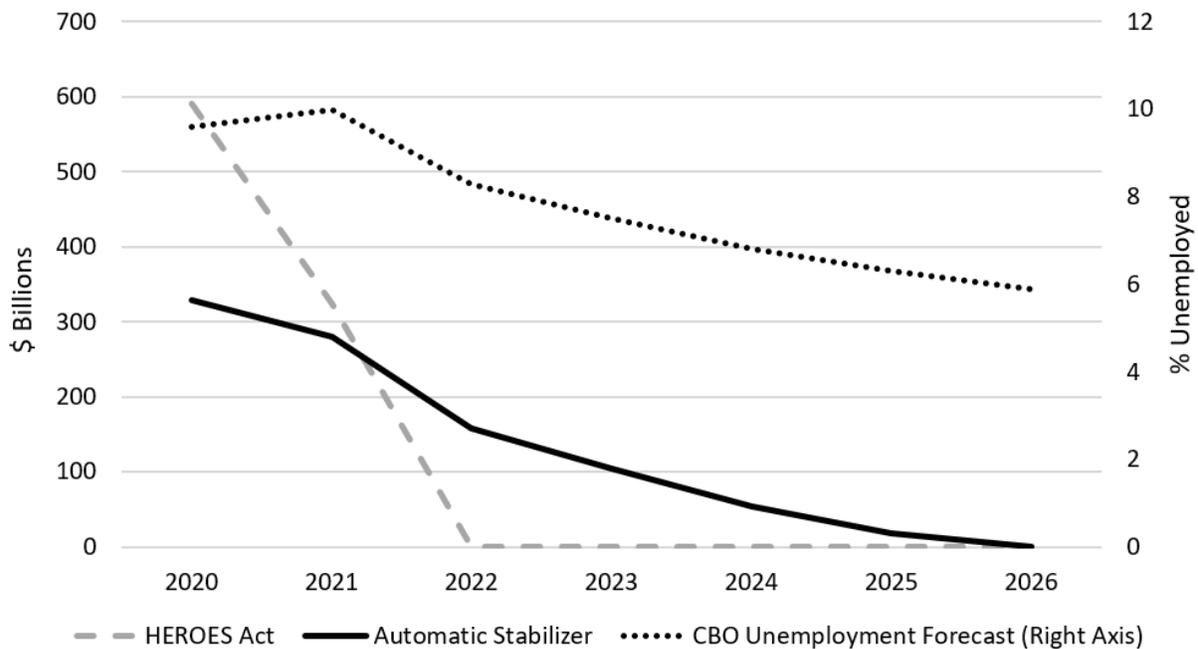
### Automatic Aid at the Federal Level and Lessons for States

As noted above, automatic stabilizers are one way to take better advantage of the federal government's countercyclical policy capacity (ACIR, 1978). A key benefit of automatic stabilizers is their ability to adapt to fluctuations in economic conditions rather than dropping off abruptly when the legislation sunsets. To see the value of this approach, consider the following comparison. In May 2020, House Democrats passed the Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act, which authorized up to \$915 billion in aid to state and local governments and the District of Columbia. Figure 3 depicts projected federal outlays under this proposal with the gray dashed line and shows that HEROES would have front

loaded the money in the first two years, but before a substantial decrease in forecasted unemployment (shown by the black, short-dash line). Notably, unlike the Coronavirus Aid, Relief, and Economic Security (CARES) Act—whose state and local relief funds initially had to be spent by recipient governments before the end of calendar year 2020—the proposed HEROES funds would be available to state and local governments until expended. Thus state and local governments could presumably draw on these funds in later fiscal years. Nevertheless, the congressional allocation under HEROES would not increase or decrease in line with unemployment.

By contrast, consider a proposal for a federal aid program that kicks in whenever national unemployment exceeds 6% and provides grants for each percentage point in unemployment which exceeds that threshold (Bartik, 2020a). As the graph shows, while the automatic aid proposal (depicted by the solid black line) is more modest in the initial years, it is spread out over the course of the recession, which may exceed the period of time in which Congress is attentive to, or capable of responding to, state and local fiscal needs. Such a structure could be especially useful for local governments because the impact of a recession on property taxes often lags a formal recession. The depth of local governments' revenue declines tied to the Great Recession, for example, did not occur until six years after that recession began (McFarland and Pagano, 2020, p. 19).

**Figure 3. Federal Aid to State and Local Governments: Estimated Outlays in HEROES Act versus Automatic Stabilizers**



Sources: Modified by authors from Bartik (2020a); CBO (2020)

Were a federal program of automatic state and local aid to be enacted, it would not be the first of its kind. 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. While 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 (ARFA) program, which was created by Title II of the 1976 Public Works Employment Act. Under that program, the federal government provided emergency assistance “in the form of unrestricted grants” to state and local governments that were “adversely affected by sustained periods of high unemployment” (ACIR, 1978, p. 16). ARFA allocated aid to state and local governments when the national unemployment rate exceeded 6%, with specific state and local dollar amounts contingent on state or local

unemployment rates. Only governments with unemployment rates in excess of 4.5% were eligible to receive funds. Between July 1, 1976 and March 31, 1978, \$2.5 billion (or about \$10 billion in 2020 dollars) was paid to recipient governments from this program.

While automatic stabilizers have gained increasing traction among scholars and policymakers alike, it is worth addressing several arguments against them. A first argument suggests that automatic stabilizers induce “moral hazards”, encouraging state and local governments to make irresponsible fiscal decisions with the knowledge that the federal (or state) government will bail them out. Yet this argument relies on the implausible assumption that subnational officials are responsible for fiscal dilemmas that emerge only as the result of economic crises. Given the procyclical nature of their revenue streams, crises present subnational governments with a capital structure trap, which can only be resolved by the federal government.

A second argument essentially concerns pragmatic politics, asserting that because automatic stabilizers switch on and off autonomously of discretionary actions, they prevent ambitious elected officials from claiming credit for policy gains. This view ignores the fact that elected officials already *routinely* claim credit for the successful operation of programs which contain automatic stabilizers, including Medicaid and SNAP. It also presumes, incorrectly, that crises will not necessitate additional discretionary programs (e.g. increases to the FMAP rate or extensions of UI) that generate credit-claiming opportunities.

A third argument suggests that the simplification of fiscal reality required for crafting automatic stabilizer programs (the use of simple formulas and highly reductive unemployment statistics) will lead to policy outcomes that are poorly targeted to state and local fiscal needs. This is likely true. Yet it is the reason that automatic stabilizers should be seen as complementing rather than fully substituting for discretionary fiscal policies. Even if automatic stabilizers had been in place prior to the COVID-19 pandemic, additional discretionary policies to deal with the public health needs and unexpected state and local fiscal needs would have been essential.

When designing an automatic stabilizer program for state and local aid, there are five key considerations.

1. *Trigger:* In contrast to discretionary policy, automatic stabilizers go into effect when economic conditions signal a recession. For example, recent work by Sahm (2019) suggests a recession begins when the three-month moving average of unemployment (U3) rises half a percentage point relative to its low in the past 12 months. While there are other potential recession indicators, the “Sahm rule”—published by the St. Louis Federal Reserve Bank—has two desirable properties. First, unlike the National Bureau of Economic Research’s indicator which analyzes turning points in business cycles after a recession has occurred, the Sahm rule is a prospective measure which can be implemented at the beginning of a recession. Second, the Sahm rule produces a far lower number of false positives when compared to other indicators, such as the inverted yield curve. The program could incorporate the Sahm rule based on changes in national unemployment. Alternatively, it could incorporate the Sahm rule based on changes in unemployment at the state level, relying on Local Area Unemployment Statistics rather than the national unemployment rate. This latter approach involves additional complexities where authorization and program formulas are concerned (Williams, 2020).
2. *Authorization:* A second consideration is the size of the base-level spending authorization for the program and how the program should scale up as economic conditions worsen. If the trigger relies on changes in national unemployment, one starting point for a base authorization would be to examine the relationship between unemployment and subnational tax revenues. According to one analysis, a one percentage point increase in the unemployment rate coincides with a \$45 billion reduction in annual state revenues and a \$22 billion reduction in local revenues (Bartik, 2020b). Hence the program could include a base annual authorization of \$67 billion, with an additional \$67 billion for each additional one percentage point increase in unemployment. To avoid policy drift, these amounts should be indexed to inflation. Alternatively, were the program to be triggered through changes in state unemployment, Congress could authorize such sums as are necessary with dollar amounts pegged to a multiple (e.g. 3%) of state and local tax receipts in the most recent fiscal year (Williams, 2020).

3. *Formula:* Key questions when designing an antirecession aid program is which units of government should receive aid and how to design program formulas to ensure that aid is targeted to respond to variation in economic conditions. Given substantial differences in the fiscal needs of state and local governments during economic downturns, the program would likely need to contain four separate funds: one for state governments, one for general-purpose local governments, one for territorial governments, and one for tribal governments. In each fund, appropriations would be allocated based on annual revenue collections for each unit of government.
  4. *Data Availability, Simplicity, and Certainty:* Automatic stabilizers, as the name suggests, are intended to provide a nearly immediate response to economic crises. Immediacy hinges on the availability of reliable economic indicators which can be produced with little delay. While unemployment data largely serve this purpose well, there are several issues to consider. First, the U3 measure of unemployment is easily available and widely used, yet it has provided only a limited picture of unemployment during the COVID-19 crisis. This is especially true given its inability to capture labor market exits and workers whose employment status is misclassified. At a minimum this suggests the need to model the effects of using alternative measures (e.g. U6) to determine base authorizations for the legislation. Second, given variations in state and local tax structure, unemployment itself does not have a uniform effect on revenues. This may raise concerns about the appropriateness of subnational unemployment rates as a trigger. The potential for the over- and under-provision of aid to particular jurisdictions is unavoidable when creating such a national program. Nevertheless, this issue should be examined in the course of policy implementation. Third, while revenue figures provide a simple and usable benchmark for aid, lost revenues alone do not constitute the entire picture of state and local needs, especially when it comes to unmet demands (Kass and Rocco, 2021). Indeed, because there is no standard means of reporting these needs, policymakers must rely on a patchwork of survey data from intergovernmental organizations. At a minimum, this suggests the potential value of a common data source—such as a quarterly survey conducted by the Census Bureau’s Government Divisions that could be modeled off the Census Bureau’s recent pulse surveys—which strives to represent a fuller picture of state and local needs.
  5. *Timing of spending and flexibility:* A final consideration when designing a program of antirecession aid is the extent to which state and local governments are able to both receive and spend funds in a timely manner. Following the trigger, aid should be allocated on a quarterly basis for the duration of the recession. To ensure timely spending of the funds, regulations on the use of aid should be limited to standard program integrity and reporting requirements articulated by the Department of the Treasury.
- It is worth noting that these same considerations for the development of a federal aid program would apply to the development of state-level emergency stabilizer programs for local governments. If enacted, this idea would represent a bold innovation in state policy. It would also be a bold statement about the priorities of the state which would favor local governments. Yet there are some added complexities. As with a federal program, state programs would have to contain a trigger that provides a reasonably accurate signal of when a recession is beginning. Yet this trigger would likely be based on application of the Sahm rule to state-level unemployment

data rather than national unemployment data. Similarly, state officials would have to make additional choices regarding base allocations and program formulas, including how to incorporate measures of local fiscal distress or need (“State Strategies”, 2016). Last, it bears repeating that as noted above, state aid formulas are inherently limited by the procyclical nature of state revenues. To be sure, these automatic payments still would protect against cuts to state aid that often accompany recessions. At the same time, a state program of automatic aid to local governments would—during a recession—have to be offset by cuts to other state programs or tax hikes, which are politically problematic during a recession. These and other unintended consequences of ‘automating’ state aid to local governments during a recession warrant greater consideration. If, however, the purpose for creating automatic stabilizers is to intentionally prioritize local governments, then the policy would be intentional and reflective of state priorities.

### **Why Discretionary Aid Will Remain Essential**

The purpose of automatic aid programs like the one characterized above is to shorten the length of recessions and to provide reliable support to state and local governments as economic conditions worsen. Yet because the formulas used in these programs are fairly rigid, they are ill-equipped to respond to crises that create fiscal needs that must be resolved quickly and cannot be easily captured in indices of revenue loss or planned spending.

The COVID-19 pandemic is a perfect example of why discretionary aid is an important tool for responding flexibly to unforeseen emergencies. While the absence of automatic aid has created vulnerabilities for local governments in the pandemic, discretionary support from Congress has been essential in responding quickly to new spending needs that emerged in the early days of the crisis. The importance of federal aid in response to these needs is revealed by survey evidence on how cities used funds from the CARES Act. As of December, 2020, 70% of cities reported

using CARES Act funds to purchase personal protective equipment and other cleaning supplies, 30% reported leveraging the aid to fund local businesses, and 12% reported using the funding to provide housing assistance (Vadavalli, Pine, and Wagner, 2020).

Nevertheless, the same survey revealed that cities across the country remained in need of additional federal support to deal with revenue shortfalls and spending needs. This suggests that discretionary and automatic aid programs should be seen as complementary approaches to stabilizing local government functions during crises. In addition, it suggests that one design improvement that can be made on discretionary aid programs—found in the House-approved HEROES Act—is to ensure that state and local fiscal aid funds remain “available until expended” rather than sunseting at the end of the fiscal year.

### **The Unsolved Challenge of Fiscal Equalization**

While automatic aid programs would be an important first step at modernizing fiscal federalism, they will not on their own deal with stark disparities in fiscal capacity across state and local governments. Even during normal economic times, numerous states lack the revenue capacity to meet planned expenditure needs (Gordon, Auxier, and Iselin, 2016). The problem grows worse when we consider that quantitative measures of fiscal capacity often fail to consider outstanding expenditure needs that have not been budgeted (Kass and Rocco 2021).

Yet the United States is unique among mature federations for lacking a formal program of fiscal equalization (Béland and Lecours, 2014). Moreover, federal aid program formulas often fail to play an equalizing role. Notably, the federal medical assistance percentage (FMAP) formula ignores disparities in state need, fiscal capacity, and the cost of medical care (Gordon, 2018). Earlier attempts at general fiscal equalization among states and cities, such as the General Revenue Sharing program, often failed to play an equalizing role, as they were designed to simultaneously mitigate differences in

fiscal capacity while rewarding revenue effort. Clearly, however, any effort to strengthen state and local finances will need to consider how to solve the unmet challenge of equalization. This will require drawing lessons not only

of prior federal efforts at equalization but ongoing attempts at equalization in the states, particularly where elementary and secondary education is concerned (Skinner, 2019; “Fully Funding”, 2021).

## Conclusions

The COVID-19 pandemic and its attendant economic effects should cause policymakers to carefully evaluate the adequacy of existing institutional arrangements to support state and local governments in the midst of economic turmoil. While Congress did manage to deliver an unprecedented level of discretionary aid via the CARES Act (and more recent American Rescue Plan Act), both the vagaries of the legislative process and the strings attached to the aid ultimately created a level of uncertainty and complexity for subnational officials, hampering effective, timely decision-making. Although rainy day funds help to insulate states from some economic effects of the pandemic, they are limited to maintaining pre-crisis service levels. Moreover, limitations on spending and borrowing have effectively forced state and local governments to respond to revenue shortfalls by making deep spending cuts, laying off millions of employees, and delaying or cancelling vital infrastructure projects.

This is not the last pandemic, and it is not the last economic crisis. The experience of COVID-19 should inform how we think about the necessary policies to local governments’ fiscal stability, especially given the effect of local spending on the health of the economy writ large. There are, as we have shown, a variety of potential reform options. The most impactful reform at present would be the creation of a federal automatic intergovernmental stabilizer program that would expand unrestricted aid to state and local governments during recessions and would gradually contract as the economy recovers. Yet state governments can

also recognize the profoundly important economic role of municipalities by revising intergovernmental aid programs to better support local fiscal needs. As we note above, there are several basic reforms to state-local aid programs that can strengthen local revenues during crises. Additionally, states may consider developing an automatic stabilizer component of their local aid programs, though there are a number of potentially unintended consequences—such as sharp cuts to other state programs—that would have to be considered.

These are not the sorts of reform proposals that typically attract national attention. At the depths of the Great Recession, news stories about state and local government occupied but a tiny fraction of total media coverage. And by the time that states, cities, and counties faced the brunt of the recession’s effects, they were barely visible in major media outlets. Whatever happens, re-tooling fiscal federalism will require attention to the problem before the next crisis arrives.

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## Appendix A: Fiscal Emergency Programs

### The Promise and Limits of Fiscal Emergency Laws and Programs

In addition to general aid programs, many states also have fiscal emergency programs in the event of local fiscal distress. These programs 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. While a government's fiscal health is multidimensional, including long-term service needs, many emergency programs narrowly concern a government's short-term ability to meet its financial obligations and pay external creditors. This is in part because historical development of fiscal emergency programs has been closely tied to issues surrounding municipal bankruptcy, and bond debt plays a particularly important role in many fiscal distress programs. States have their own fiscal emergency programs applicable to local governments, and at the federal level there is Chapter 9 bankruptcy.

Since local governments are creatures of the state, it is state laws that govern whether municipalities can file for federal, Chapter 9 bankruptcy and, more generally, what happens to municipalities that experience fiscal distress. Local governments are permitted to file for bankruptcy in only 12 states (Spiotto et al., 2016, p 131). In those states, municipalities that have run out of options to pay outstanding obligations may seek to file for Chapter 9 bankruptcy, a federal mechanism that provides protection from creditors and affords the government time to develop a long-term plan to pay off debts. The remaining 38 states and the District of Columbia restrict or prohibit municipalities' ability to access Chapter 9. Thus, fiscal distress can materialize and municipalities can default on debt even if they do not—or legally cannot—file for bankruptcy. While some fiscal distress programs are narrowly designed to help municipalities avoid default

on bond debt or Chapter 9 bankruptcy, others go further, attempting to maintain local service levels, curb local tax burden, or correct local mismanagement.

States vary in terms of how much the state government monitors and regulates the finances of local governments. More than 20 states have adopted fiscal emergency mechanisms to intervene when a municipality reaches distress or emergency (Spiotto et. al., 2016). Louisiana, Pennsylvania, Rhode Island, and Texas allow for a court appointed municipal receiver. Similarly, at least 13 states (like 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 (Spiotto et. al., 2016, pp. 92-94).

State fiscal emergency programs have, however, numerous design flaws. Jacob and Hendrick (2013) argue that while many symptoms of fiscal distress may be the outcome of decisions made by local managers, such decisions are made within the context of fiscal and political environments that are somewhat beyond managers' control. They go on to note that state statute, local tax base, and political context can produce opportunities or constraints, meaning some communities are more or less likely to experience fiscal stress regardless of local managers' decisions. This concept relates to Pagano and Hoene's (2018) "fiscal policy space" framework, which considers state-

local policy, economic and fiscal tax base alignment, and the local demand for services to explain the real policy challenges faced by a unit government. Because fiscal policy space varies between states and between cities in the same state, the real policy options available also vary. This is problematic because 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 (Cahill and James, 1992). Ward and Davidson (2020) highlight the importance of macroeconomic trends in determining local fiscal distress within the context of COVID-19. They point out that even otherwise fiscally healthy cities are facing “significant changes to staffing and services” in the wake of the COVID-19 pandemic (n.p.). Last, Gillette (2012) notes that states may not be the most appropriate source of aid in emergencies for several reasons, including that states may be in fiscal distress in their own right. In other words, both states and municipalities suffer fiscal downturns during a national recession, putting both types of governments in precarious fiscal positions. 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.

### **State Fiscal Emergency Program(s) in Great Lakes States**

This subsection describes the fiscal emergency programs in the six Great Lakes states. Our discussion of fiscal emergency programs is meant to offer an overview of existing programs, not to endorse or evaluate specific characteristics. The pros and cons of emergency managers, loan programs, oversight boards, and fiscal emergency

programs are both nuanced and context-specific, see Stanley (2016) and Kossis (2012) for critical discussion.

Minnesota and Wisconsin have very little 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. In Minnesota, a municipality must report if it will not be able to make a principal or interest payment on an outstanding debt obligation to the state auditor. After verification, the auditor may grant a loan to cover the payment (Spiotto et. al., 2016). Wisconsin provides municipalities some protection when issuing public improvement bonds. If there is an expected deficiency for the next calendar year, the municipality is required to make up that deficiency, but only amounting to a sum which does not cause the municipality to exceed its debt limits (66 Wisc. § 0619(6)(a)).

Indiana and Illinois offer support to municipalities in fiscal distress, but the municipality must request assistance. Indiana municipalities may file a petition with the Distressed Unit Appeal Board requesting designation as a distressed government, after which the Board can appoint an emergency manager (Spiotto et. al., 2016). The state of Illinois’ Financially Distressed City Law allows for financial assistance from the Illinois Finance Authority for a financially distressed city (Spiotto et. al., 2016). However, the threshold for qualifying as a financially distressed city in Illinois is high.<sup>8</sup> Since 1990, when Illinois’ law went into effect, only East St. Louis has been designated a financially distressed city (Spiotto, 2017). In Indiana and Illinois, the programs are narrow in scope and meant only for highly distressed cities. Last, the states do not proactively monitor and intervene in municipal finances. This program

<sup>8</sup> To be considered a financially distressed city in Illinois, a municipality must (1) be home-rule, (2) be certified by the Illinois Department of Revenue to be in the highest 5% of home-rule municipalities for percent of all taxes levied and to be in the lowest 5% of home-rule municipalities for per capita tax yield, and (3) be designated as financially distressed by a joint resolution of the state General Assembly (65 Ill. Comp. Stat. 5/8-12-3).

design means that in Indiana and Illinois, fiscal emergency programs only kick in once a problem materializes and hinges on local governments requesting assistance from the state. This contrasts with programs in other states that aim at intervening before fiscal problems become severe.

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. If a municipality is deemed to be in fiscal emergency, it must enter into a consent decree with the state, allow an emergency manager to be appointed, enter into a neutral evaluation process, or file a Chapter 9 bankruptcy petition (Spiotto et. al., 2016). Emergency managers in Michigan have broad powers over municipalities, especially regarding receivership. They effectively take over the role of the governing body and chief administrative officer, and local elected officials are severely limited in their ability to perform regular duties (436 Mich. § 141.1549). The emergency manager's role is largely technocratic, with a focus on bringing spending in line with a community's revenue, rather than the state providing direct fiscal support (through increasing state aid to the applicable municipality and/or taking over some duties). Emergency managers do not always resolve communities' challenges though, and decisions to address fiscal problems can have destructive results, as evidenced by the Flint water crisis (Stanley, 2017).

Ohio's fiscal distress programs are the most comprehensive of the states examined, 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. The program has three levels—fiscal caution, fiscal watch, and fiscal emergency. This ordinal system ties the level of aid and oversight to the relative fiscal condition of the community. A municipality under fiscal caution or fiscal watch must submit a proposal for correction and may receive technical assistance from the auditor. Municipalities under fiscal emergency come under the supervision of a financial planning commission, which has the authority to require the government to establish monthly levels of expenditures and encumbrances consistent with the financial plan, approve the amount and purpose of any debt issues, make and enter into all contracts and agreements necessary to the performance of its duties, and make recommendations for cost reductions or revenue increases to carry out the financial plan ("Local Governments & Fiscal Distress," n.d.). In addition to the fiscal distress program, the State of Ohio also uses a Fiscal Health Indicator (FHI) program to track the financial stability of all municipalities in the state. FHI reports are generated automatically by testing the annual financial data localities submit to the Auditor of State in the required annual audit against 17 fiscal health indicators. Entities are given a positive, cautionary, or critical outlook for each indicator. This system is loosely connected to the fiscal distress system in that local governments with six or more critical indicators or eight or more cautionary indicators are encouraged to contact the Ohio Local Government Services to determine if they meet any of the state criteria for fiscal distress (Scorsone and Pruet, 2020). If local governments do not voluntarily reach out, the state auditor may initiate a review.

## Appendix B: Rainy Day Funds

### Great Lakes States' Rainy Day Funds

The following Appendix describes the rainy day funds in the Great Lakes states, and Table B1 summarizes the characteristics of these rainy day funds.

The State of Illinois allows for deposits into the rainy day fund if the state legislature appropriates less than 99% of projected revenues in a fiscal year's budget. In effect, this makes the threshold for depositing funds into the rainy day fund high, because the legislature rarely budgets less than 99% of projected revenues, meaning the statutory deposit into the rainy day fund is often \$0. What little amounts the state has deposited into its rainy day fund have been drawn down to fill budget gaps. Historically, Illinois has not replenished spent rainy day funds, as required by statute. Similarly, Wisconsin requires revenues to outperform projections before funds can be deposited in the rainy day fund. Minnesota also calculates rainy day fund deposits based on unrestricted

general fund balance. Notably, Minnesota's fund exists as an account within the General Fund, rather than as a separate fund. In contrast, deposits to Indiana's and Michigan's funds face a lower threshold and are essentially automated. In Ohio, the governor appropriates an amount for the rainy day fund in their proposed budget.

Illinois and Wisconsin began the pandemic with relatively little in their rainy day funds. At the beginning of calendar year 2020, Wisconsin had enough in its rainy day fund to cover 3.6% of its annual General Fund expenditures. Illinois had a meager \$4 million in its rainy day fund, representing 0.0% of General Fund expenditures. Indiana, Michigan, Minnesota, and Ohio were somewhat better off, with rainy day fund balances equaling 8.6%, 11%, 10.4%, and 7.7% of general funds expenditures, respectively (Cammenga, 2020). So far, Indiana and Michigan have tapped their rainy day funds to plug COVID-19 related budget gaps (Cantlon, 2021).

**Table B1: Rainy Day Funds in the Great Lakes States**

State	Fund Name and Statute	Annual Deposit Procedure	Balance Target	Statutory Maximum	Drawdown Procedure	Beginning of 2020 Balance (as % of General Fund Expenditures)
Illinois	Budget Stabilization Fund  30 Ill. § 122 (2004)	If legislature appropriates less than 99% of estimated general fund revenues for the year, a portion of estimated revenues can be transferred to the Fund	5% of general fund revenues		Funds may be used by the Comptroller to cover cashflow issues, but must be returned before the end of the fiscal year	0.0%
Indiana	Economic Stabilization Fund*  4 Ind. § 18-1 (2013)	Determined by any positive change in annual growth rate of personal income			Transferred to the general fund based on negative change in annual growth rate of personal income	8.6%
Michigan	Counter-cyclical Budget and Economic Stabilization Fund  30 Mich. (1978)	Growth of more than 2% in personal income in previous year triggers a calculated pay-in		10% of combined general funds revenues and school aid fund revenue	Legislative action	11.0%***
Minnesota	Budget Reserve Account**  Minn. 16A.152 (2020)	1/3 of unrestricted general fund balance, calculated biannually		Maximum calculated biannually, based on general fund revenues and volatility of tax revenue	Joint action by commissioner of management and budget, Governor, and Legislative Advisory Commission	10.4%

Ohio	Budget Stabilization Fund*	Governor includes appropriation in budget proposal	8.5% of general fund revenues		Legislative action	7.7%
	Ohio R.C. §131.43 (2015)					
Wisconsin	Budget Stabilization Fund	50% of any unexpected general tax revenue		5% of general fund expenditures	Legislative action	3.6%***
	25 Wisc. § 60 (2012)					

\* Indiana also has a Medicaid Contingency and Reserve Account and a State Tuition Reserve Account that are used as area-specific rainy day funds. Ohio also has a Medicaid Reserve Fund.

\*\* Exists as an account within the General Fund.

\*\*\* Figures are for 2019, due to data availability.

Sources: Budget and Cashflow Accounts, Minn. 16A.152 (2020); Budget Stabilization Act, 30 Ill. § 122 (2004); "Budget Stabilization Fund." (2020, April 28). Michigan Senate Fiscal Agency. <https://www.senate.michigan.gov/sfa/Revenue/BudgetStabilizationFundBackground.PDF>; "Budget Stabilization Fund and General Fund Reserve Requirements." (2019). Wisconsin Legislative Fiscal Bureau. [https://docs.legis.wisconsin.gov/misc/lfb/informational\\_papers/january\\_2019/0075\\_budget\\_stabilization\\_fund\\_and\\_general\\_fund\\_reserve\\_requirements\\_informational\\_paper\\_75.pdf](https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2019/0075_budget_stabilization_fund_and_general_fund_reserve_requirements_informational_paper_75.pdf); Budget Stabilization Fund, Ohio R.C. §131.43 (2015); Cammenga, J. (2020, April 1). How Healthy is Your State's Rainy Day Fund? Tax Foundation. <https://taxfoundation.org/2020-state-rainy-day-funds/>; State Offices and Administration, 4 Ind. § 18-1 (2013).