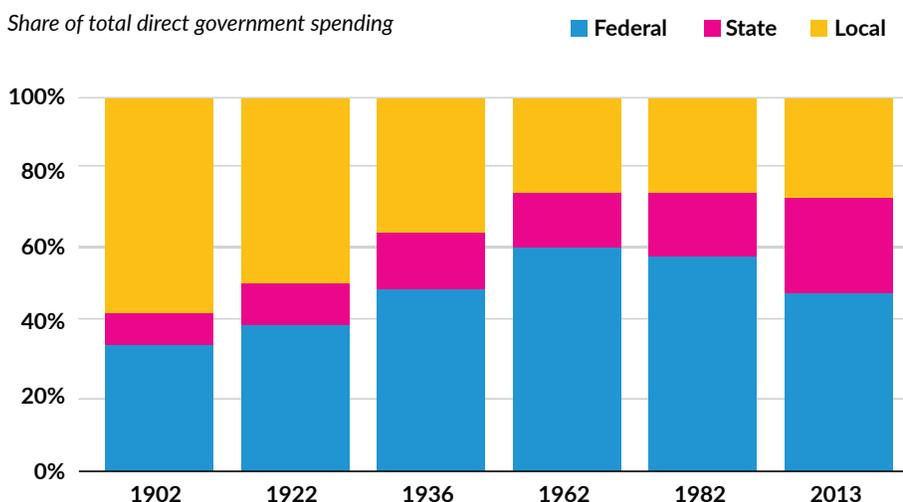


Federal Aid to Local Governments

Megan Randall, Sarah Gault, and Tracy Gordon
September 2016

Cities and metropolitan areas generate nearly 90 percent of US economic activity, but they also face distinct fiscal challenges. Those challenges were laid bare during the Great Recession, when property tax revenue, the mainstay of local government finance, fell sharply, and states made cuts to local aid. In the wake of the Great Recession, researchers, policymakers, credit analysts, investors, and citizens are calling for better ways to measure and predict municipal fiscal distress. Here, we examine the evolving relationship between the federal government and localities to provide insight into what city financial futures might look like.

HISTORICAL FEDERAL, STATE, AND LOCAL GOVERNMENT EXPENDITURES (1902-2013)



HISTORY OF FEDERAL AID

For most of American history, states and localities were the main providers of public goods and services; the federal government focused on national defense, foreign relations, courts, and the postal service. But that relationship shifted during the Great Depression and World War II, when the federal government introduced spending programs, such as Social Security, and grew its military. Even then, however, the federal government relied on states and localities to administer many public programs, especially in infrastructure and public welfare.

In addition to relying on states and local governments as service providers, the federal government has sought to provide assistance to improve local conditions. Many of these programs provide grants to states, which then pass funds through to local governments. Among the first direct federal-local assistance efforts were emergency economic relief programs, authorized under the Federal Emergency Relief Act of 1933. Soon after, the federal government began to establish broader aid programs to address longer-term disinvestment and structural economic decline in regions, cities, and neighborhoods.

SOURCE:

US Census Bureau, Government Finance Statistics 2009-2013 and Database on Historical Finances of Federal, State, and Local Governments; US Office of Management and Budget, Historical Tables 1.1 and 12.1.

TYPES OF FEDERAL AID

Federal aid to local governments comes in three main forms:

1. **Categorical grants**, which are awarded either based on a formula or through a competitive, project-based application process, restrict funding to specific programs or activities. Project-based grants have been criticized for reinforcing poor coordination among federal agencies, demanding increased capacity from local governments that have to prepare and submit grant applications, and funneling resources away from local needs.
2. **Block grants**, which are allocated based on a formula, restrict funding to broad goals but allow localities to decide how to spend the money to meet those goals. Two block-grant programs established in the 1970s, the Comprehensive Employment and Training Assistance Block Grant and the Community Development Block Grant, consolidated a large number of separate categorical grant programs.
3. **General revenue sharing**, which directs largely unrestricted funds from federal or state governments to localities based on a formula. The federal government established general revenue sharing with local governments in 1972, but the program ended in 1986. Despite the end of the federal program, many states continue to share general revenue with local governments.

The federal government also subsidizes state and local governments by allowing those who pay federal income tax to deduct state and local taxes already paid and by excluding bond interest from taxable income. The value of these subsidies has been estimated at \$134 billion in foregone dollars to the US Treasury in fiscal year 2016.ⁱ

THE PRESENT AND FUTURE OF FEDERAL AID

Though the federal government has reduced direct per capita aid to local governments since the 1980s, the Catalog of Federal Domestic Assistance identifies 824 programs with local governments or communities as beneficiaries. Roughly 80 percent of the programs are categorical and project-based, and review criteria are often based on measures of economic distress.

In 2015, the Government Accountability Office (GAO) found that cities in economic distress lacked the financial and human resources to manage and seek grants.ⁱⁱ Based on these findings, the GAO has urged the federal government to proactively coordinate among programs and share solutions from working with cities in distress. In particular, it recommended that the Office of Management and Budget and the White House Working Group on Detroit share findings from their recent capacity-building efforts in Detroit. The 2015 GAO report supports previous findings that competitive grant processes can disadvantage high-need, low-capacity jurisdictions.ⁱⁱⁱ

ANTIRECESSIONARY FISCAL RELIEF

In the 1970s, the federal government experimented with jump-starting the economy by sending additional dollars to state and local governments. But the first few programs were limited, and independent evaluations suggested aid was often poorly targeted, slow to arrive, and not spent quickly.^{iv}

After the 1970s, the federal government largely avoided countercyclical state and local aid, although it did increase grants for job training and transportation during recessions in the 1980s and 1990s. This pattern changed in the early 2000s. The Jobs and Growth Tax Relief Reconciliation Act of 2003 appropriated \$10 billion in one-time, population-based grants to states and authorized \$10 billion in additional Medicaid spending.^v It was criticized, however, for slow delivery and grants that didn't reflect economic conditions or state fiscal capacity.

The American Recovery and Reinvestment Act of 2009 (ARRA) deviated from previous efforts in scale and structure. ARRA directed nearly \$280 billion to the nation's state and local governments and made substantial federal resources (roughly \$150 billion) available to states and localities as general fiscal relief or with few federal strings attached.

But did it work? Most evaluations, whether by government agencies or private forecasters, have found that ARRA helped the economy compared to a world in which policymakers did nothing. Evaluations of the state aid portion, however, have been mixed. Some authors, for example, have found that states saved rather than spent a considerable portion of federal stimulus aid.^{vi}

i. See table 14.1, "Estimates of Total Income Tax Expenditures for Fiscal Years 2014–2024," of Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2016* (Washington, DC: Executive Office of the President of the United States, 2015). <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/spec.pdf>.

ii. Government Accountability Office, *Municipalities in Fiscal Crisis: Federal Agencies Monitored Grants and Assisted Grantees, but More Could Be Done to Share Lessons Learned* (Washington, DC: Government Accountability Office, 2015). <http://www.gao.gov/assets/670/669134.pdf>.

iii. Government Accountability Office, *Municipalities in Fiscal Crisis*; Jeremy L. Hall, "The Distribution of Federal Economic Development Grant Funds: A Consideration of Need and the Urban/Rural Divide," *Economic Development Quarterly* 24, no. 4 (2010): 311–24.

iv. US Advisory Commission on Intergovernmental Relations, *Countercyclical Aid and Economic Stabilization* (Washington, DC: US Advisory Commission on Intergovernmental Relations, 1978). <http://digital.library.unt.edu/ark:/67531/metadc1350/m1/1>.

v. The Jobs and Growth Tax Relief Reconciliation Act of 2003 also included a "hold harmless" provision or prohibition against normal decreases in matching rates based on improvements in state personal income per capita. Federal policymakers had previously altered federal Medicaid matching formulas to hold states harmless after an influx of Hurricane Katrina evacuees and to provide relief in other natural disasters. See Evelyn P. Baumrucker, *Medicaid: The Federal Medical Assistance Percentage (FMAP)*, RL 32950 (Washington, DC: Congressional Research Service, 2010).

vi. Gerald Carlino and Robert P. Inman, "Fiscal Stimulus in Economic Unions: What Role for States?" Working paper 21680 (Cambridge, MA: National Bureau of Economic Research, 2015).