

**STRENGTHENING THE FEDERAL-STATE-LOCAL PARTNERSHIP
IN RECESSION AND RECOVERY**

**Statement of
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**before the
Committee on the Budget,
United States House of Representatives**

**WHY FEDERAL INVESTMENTS MATTER:
STABILITY FROM CONGRESS TO STATE CAPITALS**

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* The views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

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Chairman Yarmuth, Ranking Member Womack, and members of the committee, thank you for having me here today to talk about the importance of the federal budget to state and local governments. The views I am going to express today are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

In this short testimony, I'd like to make three main points:

1. States and localities are key economic players and service providers.
2. Both these roles are severely tested in recessions and other economic shocks.
3. The federal government often steps in to help states and localities, but it could do more.

States and Localities Power Much of the American Economy and Public Sector

The nation's 50 states and more than 90,000 local governments (counties, cities, towns, school districts and special-purpose districts such as water or transit authorities) spend nearly \$3 trillion a year on goods, services, and transfers.¹ They employ one of every seven workers—more than any other industry including health care, retail trade, and manufacturing and seven times as many as the federal government.² Since World War II, they have contributed an average of 0.3 percentage points to real annual GDP growth.³

States and localities fund more than 90 percent of and deliver nearly all public elementary and secondary education.⁴ They administer public colleges and universities, which enroll three-quarters of the nation's higher education students.⁵ States and localities undertake nearly 80 percent of all government spending on roads, bridges, water utilities, and other infrastructure—excluding their spending from federal grants or subsidized loans.⁶

Together with the federal government, states and localities provide subsidized health insurance to low-income individuals and families and cover about half of all long-term care expenses through the joint-

¹ "Table 3.3, State and Local Government Current Receipts and Expenditures," National Income and Product Accounts (NIPA), US Bureau of Economic Analysis (BEA), last updated December 20, 2019, https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=3&isuri=1&nipa_table_list=5&categories=survey%20-%20reqid=19&step=3&isuri=1&nipa_table_list=5&categories=survey.

² "Table B-1a. Employees on Nonfarm Payrolls by Industry Sector and Selected Industry Detail, Seasonally Adjusted," Current Employment Statistics—CES (National), US Bureau of Labor Statistics, last updated December 6, 2019, <https://www.bls.gov/web/empsit/cese1a.htm>.

³ "Table 1.1.2, Contributions to Percent Change in Real Gross Domestic Product," NIPA, BEA, last updated December 20, 2019, http://apps.bea.gov/iTable/iTableHtml.cfm?reqid=19&step=3&isuri=1&Select_all_years=0&NIPA_Table_List=2&SERIES=A&FIRST_YEAR=1945&Scale=-99&LAST_YEAR=2019&Categories=survey&TheTable.

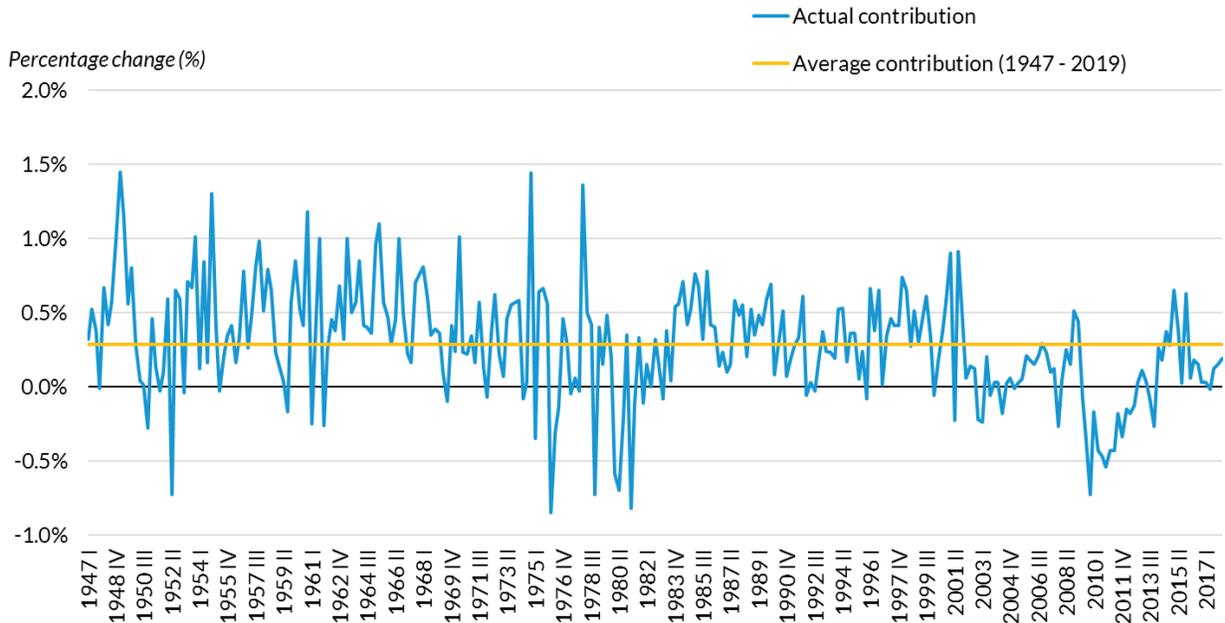
⁴ Stephen Q. Cornman, Lei Zhou, Malia R. Howell, and Jumaane Young, *Revenues and Expenditures for Public Elementary and Secondary Education: School Year 2015–16 (Fiscal Year 2016)* (Washington, DC: US Department of Education, National Center for Education Statistics, 2018).

⁵ "Table 303.10. Total Fall Enrollment in Degree-Granting Postsecondary Institutions, by Attendance Status, Sex of Student, and Control of Institution: Selected Years, 1947 through 2028," Digest of Education Statistics, US Department of Education, National Center for Education Statistics, Institute of Education Sciences, accessed January 11, 2020, https://nces.ed.gov/programs/digest/d18/tables/dt18_303.10.asp?current=yes.

⁶ Nathan Musick, *Public Spending on Transportation and Water Infrastructure, 1956 to 2017* (Washington, DC: Congressional Budget Office, 2018).

federal-state Medicaid program.⁷ They administer critical parts of the social safety net including unemployment insurance, Temporary Assistance to Needy Families (TANF), the Supplemental Nutrition Assistance Program (SNAP, formerly known as the Food Stamp Program), and public housing.

State and Local Government Contribution to Real GDP Growth



Source: Bureau of Economic Analysis

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States and Local Governments Are Often Hard Hit in Recessions

States and localities get roughly half their combined general revenue from taxes, another quarter from federal grants (mostly Medicaid), and the remainder from charges (including public college and university tuition, parking meter fees, public hospital payments, and highway tolls) and other sources.⁸

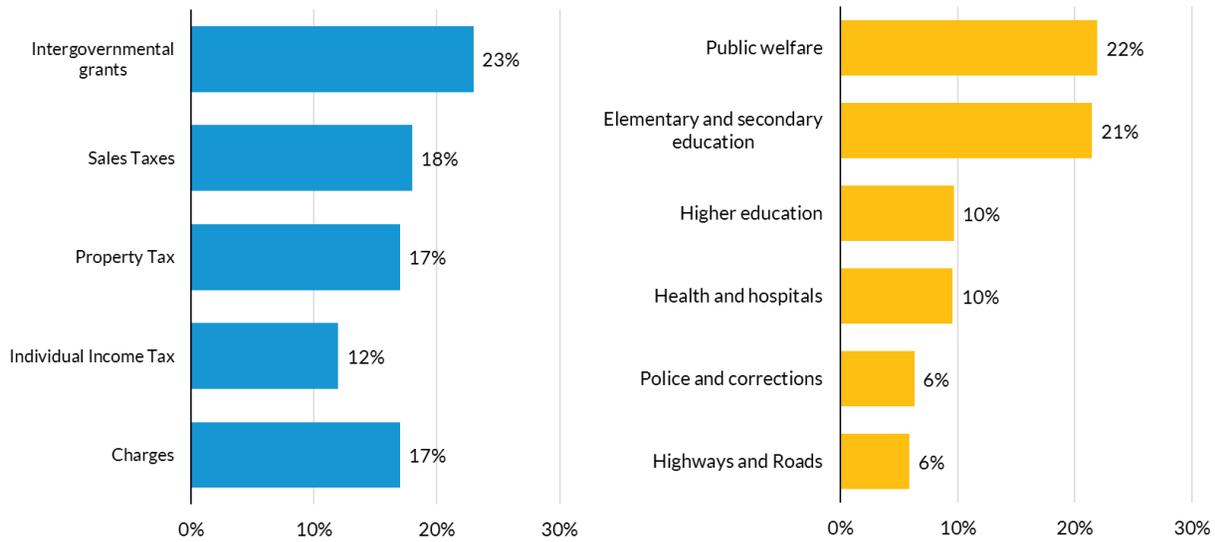
Sales taxes, including business gross receipts taxes and separate taxes on motor fuel, cigarettes, and alcohol, are the single largest source of state and local tax revenue (18 percent of general revenue), followed by property taxes (17 percent) and individual income taxes (12 percent).

State and local governments spend roughly two-thirds of their budgets on programs in education, health, and public welfare (a broad functional category defined by the US Census Bureau that includes Medicaid as well as TANF and other cash assistance and services for low-income residents).

⁷ Marybeth Musumeci, Priya Chidambaram, and Molly O'Malley Watts, "Medicaid Home and Community-Based Services Enrollment and Spending" (San Francisco: Kaiser Family Foundation, 2019).

⁸ Federal grants are a higher share of state (33 percent) than local general revenue (4 percent), although local governments receive a substantial share (36 percent) of funds from states that pass through federal grants. See Megan Randall, Tracy Gordon, Solomon Greene, and Erin Huffer, *Follow the Money: How to Track Federal Funding to Local Governments* (Washington, DC: Urban Institute, 2018).

State and Local Government General Revenue by Source and Direct Expenditure by Function
Share of total, 2017



Source: State & Local Government Finance Data Query System. <http://www.taxpolicycenter.org/slf-dqs/pages.cfm>. The Urban Institute-Brookings Institution Tax Policy Center. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments. Date of Access: (09-Jan-20 4:30 PM).

Note: Sales taxes include selective sales taxes (e.g., cigarette taxes). Expenditures excludes spending on government-run liquor stores, utilities, and insurance trusts. Medicaid spending is divided between the public welfare and health and hospitals functional categories, with the majority allocated to the former.

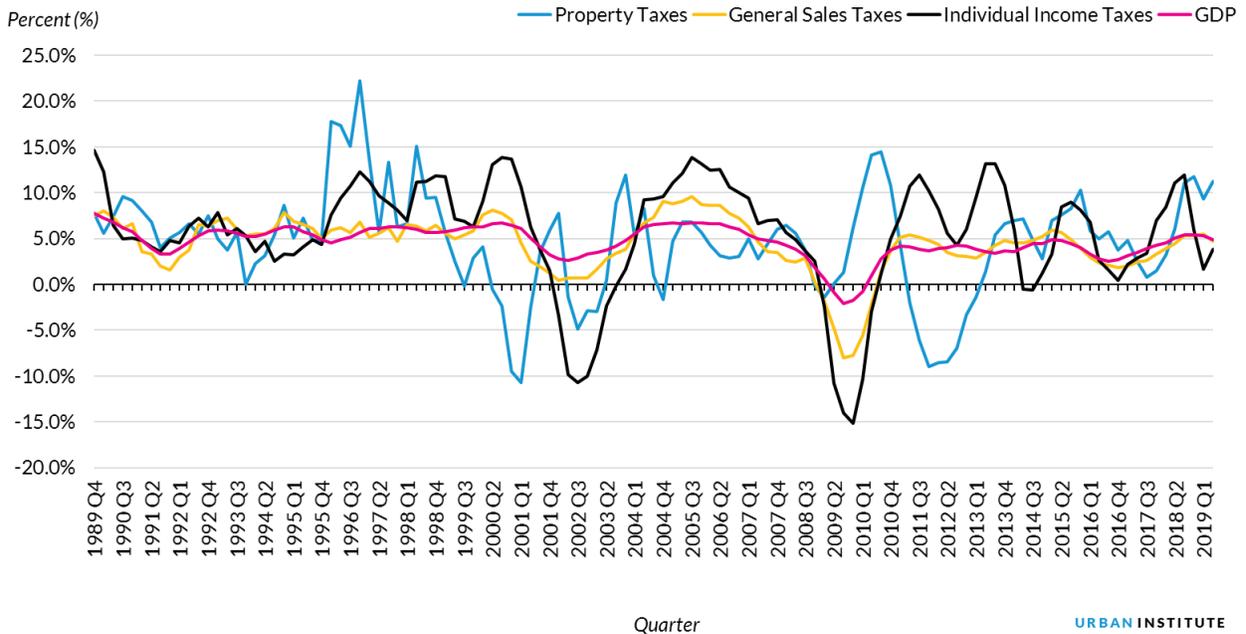
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States in particular tend to rely on procyclical revenues—ones that rise and fall with the economy. However, their spending is countercyclical, meaning that it generally rises in a downturn because of greater demands for public programs, especially those targeted to people who are low income or unemployed.⁹

⁹ Glenn Follette and Byron Lutz, “Fiscal Policy in the United States: Automatic Stabilizers, Discretionary Fiscal Policy Actions, and the Economy” (Washington, DC: Federal Reserve Board, 2010); US Government Accountability Office (GAO), “Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance” (Washington, DC: GAO, 2011).

State Government Revenue

Four-quarter moving average of year-over-year percent change



Source: Bureau of Economic Analysis: National Income and Product Accounts

This potential mismatch between revenues and spending in their responsiveness to the business cycle creates problems for state and local elected officials, who must generally balance their budgets each year.¹⁰ It also poses problems for the larger economy because tax increases and spending cuts undertaken to close projected budget deficits can undermine a national economic recovery.

Economists have long noted the potential for such “fiscal perversity” at the state and local level, blaming it for prolonging the Great Depression and Japan’s Lost Decade of the 1990s, among other episodes.¹¹ A related concern is regional downturns, such as the oil price shocks of the late 1970s, which may not be highly or even positively correlated with each other or national economic conditions.¹²

Federal Policymakers Have Long Recognized Potential Harms from State and Local Belt Tightening

In the 1970s federal policymakers experimented with various forms of countercyclical state and local fiscal assistance starting with the Local Public Works Capital Development and Investment Act of 1976 and

¹⁰ Kim Rueben and Megan Randall, “Balanced Budget Requirements: How States Limit Deficit Spending” (Washington, DC: Urban Institute, 2017).

¹¹ Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (New York: W. Norton & Co., 1944); E. Cary Brown, “Fiscal Policy in the 1930s: A Reappraisal,” *American Economic Review* 46 (December 1956): 857–79; Kenneth N. Kuttner and Adam S. Posen, “The Great Recession: Lessons for Macroeconomic Policy from Japan,” *Brookings Papers on Economic Activity* 32 (2001): 93–186.

¹² Edward M. Gramlich, “Subnational Fiscal Policy,” in *Perspectives on Local Public Finance and Public Policy* edited by John M. Quigley, 3–27 (Greenwich, CT: JAI Press, 1987).

continuing through to extensions to the Comprehensive Employment and Training Act of 1973 and the Antirecession Fiscal Assistance program. However, aid was often poorly targeted, slow to arrive, and not spent quickly.¹³

Countercyclical fiscal assistance then fell out of favor until the early 2000s, when the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) appropriated \$10 billion in one-time, population-based grants to states as well as \$10 billion in Medicaid funds through a temporary increase in the federal matching rate. This aid was also criticized for slow delivery and grants that failed to reflect current economic conditions or underlying state fiscal capacity.¹⁴

The American Recovery and Reinvestment Act (ARRA) of 2009 was the next major experiment with countercyclical fiscal assistance, directing nearly \$290 billion to the nation’s state and local governments. In all, nearly half of ARRA spending dollars would flow through state capitols, city halls, county seats, school districts, and other local entities.¹⁵ ARRA also made substantial resources available to states and localities as general fiscal relief, or with few federal strings attached.

TABLE 1
Federal Outlays for Recovery Act Provisions Affecting State and Local Governments
Billions of dollars



	2009	2010	2011	2012	2013	2014	2015-2019	Total
Flexible fiscal relief								
State Fiscal Relief (Medicaid FMAP)	33.9	43.9	11.8	0.1	0.0	0.0	0.3	90.0
State Fiscal Stabilization Fund	6.5	28.4	16.1	2.4	0.3	0.0	0.0	53.6
Other non-infrastructure purposes								
Education (beyond SFSP)	2.0	13.3	11.8	1.6	0.2	0.0	0.0	28.9
Economic recovery payments, TANF, and child support	14.9	2.1	0.7	0.2	0.0	0.0	0.0	18.0
Unemployment compensation	17.0	20.5	0.5	0.3	0.1	0.1	0.8	39.2
State and local law enforcement	0.4	0.8	0.6	0.4	0.6	0.0	0.0	2.8
Infrastructure								
Highway construction & other transportation	5.0	9.4	8.8	7.0	6.1	5.4	6.4	48.1
Clean water drinking water revolving fund	0.2	1.4	1.8	1.2	0.6	0.3	0.3	5.8
Public housing capital fund	0.1	1.2	1.2	0.8	0.6	0.0	0.0	4.0
Total	80.0	121.0	53.2	14.0	8.4	6.0	7.7	290.4

Source: Congressional Budget Office, 2009.

Note: "Other" education sums include funds for Facilities Modernization, Renovation, and Repair, Other Education, and Other as classified by the CBO.

ARRA worked faster than JGTRRA and many would argue it was more effective. Aid started to flow in the first quarter of 2009, retroactive to six months earlier. With JGTRRA, aid did not start until after the

¹³ Advisory Commission on Intergovernmental Relations (ACIR), *Countercyclical Aid and Economic Stabilization* (Washington, DC: ACIR, 1978); GAO, "Antirecession Assistance: An Evaluation" (Washington, DC: GAO, 1977).

¹⁴ GAO, "Federal Assistance: Temporary State Fiscal Relief" (Washington, DC: GAO, 2004).

¹⁵ ARRA created individual income tax credits, expanded business tax incentives, and launched federal initiatives in high speed rail, health information technology, and an energy "smart grid." At its peak (2009–12), it provided a fiscal impulse of about \$700 billion (excluding the so-called "AMT patch," which is best thought of as continuation of long-standing policy).

recession was already over—because of delays enacting the legislation, but also because the 2001 recession was relatively brief. In addition, ARRA was better targeted to places affected in the downturn.¹⁶

The Federal Government Should Do More to Prepare for State and Regional Economic Shocks and Help Places Left Behind in the Current Recovery

The federal government allocates roughly \$700 billion, or 3.5 percent of GDP, annually to states and localities using a combination of formula grants and competitive awards. The federal government also helps states and localities through the tax code—by allowing federal taxpayers to deduct state and local property and income or sales taxes (up to a \$10,000 annual limit after the Tax Cuts and Jobs Act). In addition, the federal income tax generally excludes state and local municipal bond interest payments from individual taxable income.¹⁷

Federal money isn't a bailout; it's a quid pro quo. The federal government recognizes that state and local governments have certain advantages when it comes to tailoring programs to their populations, geographies, and costs. It wants to encourage them to spend more on valued goods and services whose benefits may extend across jurisdictional lines. Examples include roads, bridges, and investments in human capital or help for struggling families.

Another consideration is equity or fairness. Some states and localities may start out with less income, wealth, and other resources to tax. Alternatively, they may have populations that are older, sicker, geographically dispersed, or otherwise more expensive to serve at a given level of quality.¹⁸ Americans who care about providing struggling families with a basic level of assistance might be willing to subsidize these states and localities to do more.

The federal government has long distributed grants and had state and local governments provide goods and services using these funds, almost always with strings attached. However, the US intergovernmental grant system falls short in both static and dynamic terms. In the static sense, federal grants do a poor job responding to divergent regional economic and fiscal fortunes and in equalizing differences in fiscal and economic capacity. In a dynamic sense, federal grants typically are not as responsive as they could be to the regional effects of economic shocks or recessions.

To make grants better economic equalizers, federal policymakers should reexamine funding formulas that may be out of step with current economic and social conditions. Federal highway grants should be based on need and performance rather than only highway lane miles, vehicle miles traveled, population, and

¹⁶ However, unemployment was a better indicator of Medicaid enrollment pressures than the across-the-board FMAP increase or hold-harmless provision. See Tracy Gordon, "Harnessing the U.S. Intergovernmental Grant System for Place-Based Assistance in Recession and Recovery," Hamilton Project Policy Proposal 2018-12 (Washington, DC: Brookings Institution, 2018).

¹⁷ "What Types of Federal Grants Are Made to State and Local Governments, and How Do They Work?" Tax Policy Center Briefing Book, Urban-Brookings Tax Policy Center, accessed January 10, 2020, <https://www.taxpolicycenter.org/briefing-book/what-types-federal-grants-are-made-state-and-local-governments-and-how-do-they-work>.

¹⁸ See Tracy Gordon, Richard Auxier, and John Iselin, *Assessing Fiscal Capacities of States a Representative Revenue System—Representative Expenditure System Approach Fiscal Year 2012* (Washington, DC: Urban Institute, 2016).

tax payments to the federal Highway Trust.¹⁹ Medicaid, Title I education, and Community Development Block Grant formulas should also be better targeted to local need, capacity, and cost.²⁰ Where possible, the federal government should reexamine hold-harmless provisions, caps, and small-state minimums and other floors and ceilings that limit responsiveness to local economic conditions.²¹

To make federal grants better economic shock absorbers, policymakers ought to consider making permanent and automatic a feature of ARRA that allocates more money to places experiencing large drops in employment.²² Beyond Medicaid, federal highway grants are another good candidate for restructuring to address regional economic decline. As it did with ARRA, the federal government could attach conditions for states to spend infrastructure funds quickly and emphasize “state of good repair” improvements over system expansion in awarding funds.²³

At a minimum, the federal government could help states and localities by reducing uncertainty associated with late federal appropriations, short continuing resolutions, and threatened shutdowns.²⁴ It could also minimize the use of expiring tax provisions that complicate efforts at federal income tax conformity and that provide less effective incentives for desired behaviors than permanent policy.²⁵

In summary, the US federal-state-local partnership did not come easily. It evolved over 200 years that included defaults, bailouts, a civil war, the introduction of new revenue sources and social insurance programs, and lots of trial and error. It is an enduring and robust partnership, but it is a work in progress. There are several ways in which the US federalist system can be made stronger, especially in an economic crisis. Thank you for the opportunity to share these three points with you. I welcome the opportunity to take questions and to continue to work with you in the future.

¹⁹ See Robert Puentes, *A Bridge to Somewhere: Rethinking American Transportation for the 21st Century* (Washington, DC: Brookings Institution, Metropolitan Policy Program, 2008); and Congressional Budget Office, “Approaches to Making Federal Highway Spending More Productive” (Washington, DC: Congressional Budget Office, 2016).

²⁰ Thomas B. Jabine, Thomas A. Louis, and Allen L. Schirm, “Case Studies,” in *Choosing the Right Formula: Initial Report*, 12–36 (Washington, DC: The National Academies Press, 2001); GAO, “Community Development Block Grant Formula: Targeting Assistance to High-Need Communities Could Be Enhanced” (Washington, DC: GAO, 2005).

²¹ GAO, “Formula Grants: Funding for the Largest Federal Assistance Programs Is Based on Census-Related Data and Other Factors” (Washington, DC: GAO, 2009).

²² See, for example, Matthew Fiedler, Jason Furman, and Wilson Powell III, “Increasing Federal Support for State Medicaid and CHIP Programs in Response to Economic Downturns,” in *Recession Ready: Fiscal Policies to Stabilize the American Economy*, 93–127 (Washington, DC: Brookings Institution, The Hamilton Project, 2019); and Gordon, “Harnessing the U.S. Intergovernmental Grant System.”

²³ Therese J. McGuire, Jay Alexander, William D. Dupor, Randall W. Eberts, Ronald L. Epstein, Andrew Haughwout, Benjamin F. Jones, Nancy Richardson, and Jay C. Shambaugh, *Transportation Investments in Response to Economic Downturns* (Washington, DC: The National Academies Press, 2014). As noted in McGuire and colleagues (2014, 43), some discretionary funds (e.g., TIGER and \$750 million in an existing discretionary transit capital grant program) were awarded to projects judged capable of spending additional funds quickly. See also Andrew Haughwout, “Infrastructure Investment as an Automatic Stabilizer,” in *Recession Ready: Fiscal Policies to Stabilize the American Economy*, 129–52 (Washington, DC: Brookings Institution, The Hamilton Project, 2019).

²⁴ Philip G. Joyce, *The Costs of Budget Uncertainty: Analyzing the Impact of Late Appropriations* (Washington, DC: IBM Center for the Business or Government, 2012).

²⁵ See, for example, Richard Auxier and Frank Sammartino, *Tax Debate Moves to the States: The Tax Cuts and Jobs Act Creates Many Questions for States That Link to Federal Income Tax Rules* (Washington, DC: Urban-Brookings Tax Policy Center, 2018).