INSIGHT

State and Local Fiscal Conditions and Economic Shocks

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Policymaker attention to the COVID-19 economic shock has included its potential effect on state and local governments. This Insight summarizes the underlying forces affecting state and local finances following a negative economic shock, examines tools available to them in response to such forces, and briefly discusses federal assistance offered in recent recessions.

State and Local Finances and Economic Shocks

State and local governments are an integral part of U.S. economic activity, with $3.7 trillion in 2017 spending (19% of GDP). Federal, state, and local government revenues tend to increase when the economy is growing (as taxes are paid on increased economic output) and decrease when the economy is not growing. Unlike at the federal level, state and local governments must routinely balance their operating budgets, typically every one or two years. All else equal, state and local governments therefore must offset reductions in revenues caused by negative economic shocks with increases in revenues, reductions in spending, or a combination of the two.

Balanced budget requirements can limit state and local ability to meet increased spending program demands during economic downturns. In contrast, the federal government has typically enacted larger spending increases in response to economic shocks. **Table 1** shows federal, state, and local spending levels in the years leading up to and during the Great Recession. Measured as a share of economic output, federal outlays were 21% larger during the period FY2009 through FY2011 than during the FY2006-FY2008 period. State and local operating expenditures rose by 8% over the same timeframe.

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Table 1. Government Spending Before and During the Great Recession, FY2006-FY2011

(as a percentage of GDP)

	FY2006-FY2008	FY2009-FY2011
State and Local Operating Expenditures	13.9	15.0
Federal Expenditures	19.6	23.7

Source: U.S. Census Bureau and Office of Management and Budget.

The timing of economic effects can prove to be an additional challenge for state and local financing. About 70% of state and local government spending is devoted to education, general welfare, health, and infrastructure programs, for which demand tends to increase shortly after a negative economic shock occurs. A substantial portion of state and local revenues, meanwhile, are collected from taxes on income and property, which can see more lagged effects from an economic downturn. For state and local policymakers, this means that any early action taken to address spending needs may need to be supplemented later on if there is a lagged reduction in revenues, all while working within budgetary restrictions.

Responding to Economic Shocks

There are a few sources of assistance available to state and local governments to address budget shortfalls that do not require outside intervention. Rainy day funds are budget accounts that are designed to assist in closing funding gaps when revenues are insufficient to meet spending demands. All 50 state governments have at least one rainy day fund, and recent estimates projected there to be roughly $62 billion (or 2.5% to 3.0% of annual state government spending) in those funds at the end of 2019. However, use of rainy day funds alone would likely be insufficient to bridge state financing gaps from a moderate or severe recession. Moreover, there is scant evidence of rainy day fund use at the local level.

State and local governments may also consider increasing the relative amount of resources they devote to their capital budgets, which are not typically subject to the balancing restrictions of operating accounts. Capital budgets are generally restricted to funding projects related to infrastructure and land maintenance and construction, and research has found limited practical ability to move projects from operating to capital accounts. Capital projects typically involve substantial levels of government borrowing, for which costs may increase in recessions due to an increase in the perceived credit risk of state and local government bonds.

The potential for automatic increased federal support of state and local governments undergoing poor economic circumstances is limited. Federal government transfers are the single largest source of state and local government revenue, and the federal contribution for some of those programs is set by formula under current law. For many of the largest transfer programs, however, federal contributions either have increased only in cases of unique economic harm to the state or locality (as has been the case in the past with Medicaid) or are insensitive to economic conditions (as is true for TANF).

Additional Federal Support

The federal government may intervene to provide fiscal support to state and local governments in times of economic hardship. Assistance may be offered in the form of increased support for established programs or through the creation of new programs. The American Recovery and Reinvestment Act of 2009 (P.L. 111-5), passed during the Great Recession, provided $192 billion in direct state and local government transfers, which included increased Medicaid payments to states through a temporary increase in the Medicaid federal matching assistance percentage, or FMAP (i.e., federal matching rate); the creation of an emergency contingency fund for TANF and a state fiscal stabilization fund; and increased funding for

SNAP administrative costs. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), enacted following the recession in the early 2000s, provided a total of $20 billion through a combination of FMAP increases and general state and local fiscal assistance.

The Families First Coronavirus Response Act (H.R. 6201), enacted on March 18, 2020, included direct state and local government assistance in the forms of a temporary FMAP increase as well as increased funding and new authorities for SNAP and other domestic food assistance programs.

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