ESSAYS ON ISSUES

THE FEDERAL RESERVE BANK
OF CHICAGO

AUGUST 2009
NUMBER 265

Chicago Fed Letter

Should the federal government bail out the states? Lessons from past recessions

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Like the economy in general, individual state economies are struggling in this recession. State governments face significant constraints in raising additional revenues. Most states are required to balance their budgets regardless of the economic environment. This article considers the role of the federal government in helping the states to manage their finances.

Three factors are particularly important in evaluating the effectiveness of federal antirecessionary aid to states—timing, triggers, and targeting.

State government budget woes have been much in the news. Recently, California projected a $21 billion deficit after failing to get voter approval for a series of budget balancing fiscal measures.[1] In January of this year, five prominent Democratic governors suggested that the federal government should commit $1 trillion in aid to the states over the next two years.[2] The rationale for such financial support is that states (which are generally prohibited from running deficits) need the money to maintain key programs, such as Medicaid, unemployment insurance, and work force training, for which demand rises during a recession. Also, this aid might help states avoid enacting spending cuts or tax increases that could deepen or prolong the economic downturn.

Should the federal government have a role in helping the states through a recession? In this *Chicago Fed Letter*, I review some of the issues that need to be considered when constructing an aid package that targets state governments during an economic downturn. Three factors are particularly important in evaluating the effectiveness of such federal aid to states—timing, triggers, and targeting.

The purpose and structure of aid

The idea of federal support for state (and local) governments in a downturn is hardly a new one. For example, in response to the recession of 1973–75,[3] Congress enacted the Antirecession Fiscal Assistance (ARFA) program, which was combined with general revenue sharing grants and the Local Public Works (LPW) program to provide unrestricted grants and infrastructure funding to the states. In addition, Congress had passed the Comprehensive Employment and Training Act (CETA) in 1973, and in conjunction with these other programs, it became an antirecessionary mechanism for delivering job training. More recently, in 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act, as states dealt with a slow recovery from the 2001 recession.

The purpose of such funding is primarily to stabilize fiscal behavior in the state government sector. This aid is intended to smooth the budgetary actions states would be forced to take in the face of declining revenues and increasing demands from programs such as Medicaid and unemployment insurance. The federal government sometimes adds an infrastructure element to its aid as a way of increasing demand in the construction sector and stimulating the economy. However, economic stimulus is clearly a secondary objective of this aid. If the federal government's primary purpose were to provide an economic stimulus, it would be better off simply spending the money directly rather than attempting to funnel it through the states.

Is there a right way to provide aid?

Extensive evaluations were conducted by the U.S. Department of the Treasury, the Congressional Budget Office (CBO), and the U.S. General Accounting Office (GAO)[4] to assess the federal government's aid package in response to the 1973–75 recession. In general, the reports were critical of the effectiveness of the aid programs. Specifically, the Treasury's report found that the aid to the states arrived after the recession had already bottomed out and did little to forestall states from taking budgetary actions that likely exacerbated the recession.[5] In addition, a significant portion of the aid was received during the subsequent economic recovery and may have contributed to post-recession inflationary pressures.[6] Finally, it appears that some states failed to spend the money and instead put the aid toward rebuilding state budget balances during the recovery.[7]

> In the case of the 1973–75 recession, a significant portion of federal government aid was received by the states during economic recovery and may have contributed to post-recession inflationary pressures.

Timing of aid

For federal antirecessionary aid to be effective, it must be timed to counter the economic effects associated with a decline in the business cycle.[8] This is easier said than done. Ideally, the aid should start arriving to the states shortly after the peak in the cycle and be discontinued either once a recovery has begun or when a recovery has been firmly established. In addition, there is the issue of whether the amount of aid should be scaled to reflect the severity of the downturn. Ideally, the level of aid would be recalibrated during each quarter to reflect the cyclical stress being felt by the states; this is preferable to the aid being distributed as a lump sum.

Another issue with timing is recognizing the lags in distributing the aid. Unless there is an automatic mechanism for triggering aid, the first lag is often the time it takes to secure passage of an aid bill by Congress. Consider the current circumstances: The National Bureau of Economic Research (NBER) dates the current recession as having begun in December 2007; and the aid package was enacted in February 2009.[9] So, nearly five quarters had passed before aid became available to the states. The second lag is the time it takes for the federal government to distribute the aid money to the states. Further, the states often have to set up mechanisms for channeling the funds into the necessary programs. All of this slows the process of spending the money during the recession. In the GAO's assessment of the aid programs enacted in response to the 1973–75 recession, it was found that about 50% of the federal money appropriated had actually been spent by the states, even after the recession ended.[10] The balance went to either build a surplus or reduce the state's deficit. In the case of the Jobs and Growth Tax Relief Reconciliation Act of 2003, the federal funds were first distributed 19 months after the end of the recession.[11]

Triggers for aid

In the case of the 1973–75 recession, the federal relief programs used three triggers based on unemployment. Aid under the ARFA program was provided when a jurisdiction's unemployment threshold rose above 4.5%. Aid from the LPW program was based on the total number of persons unemployed, as well as the number unemployed in excess of 6.5%, in that jurisdiction. And aid under CETA was prompted by all three triggers.[12]

The use of the unemployment rate as a trigger has a number of advantages. First, the unemployment rate is readily available at both the state and local level, so it can be used to direct aid in a more focused manner—even potentially to steer aid to specific metropolitan areas within states. Second, it is available on a monthly basis. However, in evaluating the effectiveness of the federal government's aid package of the mid-1970s, the GAO found that the structural change built into national labor markets caused this trigger to turn on well into the downturn and maintain aid well into the recovery.[13] The money was not expended for three to four quarters after the start of the recession. It is not clear whether this delay was excessive. However, the inability to turn off the trigger possibly contributed to inflation during the recovery.

If unemployment is not an optimal trigger, what other triggers might be considered? A frequent candidate is the full employment output gap (the difference between actual gross domestic product, or GDP, and potential output). The advantage of this trigger is that a decline in real GDP below its full employment level is one of the clearest indicators of a recession. However, data problems make the use of this trigger difficult. First, initial and preliminary estimates of GDP are produced with a significant lag and are subject to significant revisions. Also, subnational and metropolitan estimates are less readily available. Finally, there is something less than full consensus on how to calculate potential GDP.[14]

Other triggers that have been considered include declines in the index of industrial production and personal income. Each of these measures changes the duration of aid over the business cycle. Each one also has its drawbacks. A trigger based on industrial production tends to produce shorter durations of aid; and at least once (in 1966–67) industrial production fell because of tight monetary policy and not because of a recession. Real personal income (excluding transfer payments) appears to perform fairly well in terms of triggering aid at the onset of a recession, but has a spotty performance in terms of the duration of aid, often ending too soon. Given that neither of these alternatives is ideal, the use of the unemployment rate as a trigger does not seem to have been the worst option.

Targeting of aid

How should aid be targeted? If the principle is to provide aid on the basis of the recession's level of impact on states (and localities), the aid needs to be distributed in such a manner that the formula reflects the local severity of the downturn. In addition, the distribution needs to be adjusted to account for the local economic trend. If a state has had persistently high unemployment because of the structure of its local economy, a particular economic measure may already be above the trigger threshold, and thus, the onset of a recession might have less of an impact on the margin than in another jurisdiction where business cycle conditions have a disproportionate impact on economic activity. The goal should be to ameliorate the impact of the business cycle, not to support structural readjustment of the local economy.

> Perhaps the poorest targeting was evidenced in the 2003 aid package. Federal money was distributed to the states on a per capita basis without consideration of any local economic conditions.

The aid should also take into consideration trends in each state's budget. If the onset of a deficit is caused by a recession-related drop in revenues, supporting the state's budget through federal government aid is appropriate. However, if the state has a structural deficit caused by an inefficient tax system and/or unsupportable public spending, aid should be measured so as not to reward poor fiscal behavior. An Economic Policy Institute report suggested that an indicator of state fiscal capacity should be used, such as the state's ability to raise revenue through its taxable resource base or its relative wealth as measured by per capita gross state product.[15]

Perhaps the poorest targeting was evidenced in the 2003 aid package. Federal money was distributed on a per capita basis without consideration of any local economic conditions. As a result, 38 states received identical per capita aid amounts of $34.01. In its evaluation of the aid package, the GAO used indicators of the magnitude of the recession, such as the percentage change in nonfarm employment during the recession and the state's relative wealth as measured by per capita gross state product, to assess the level of aid provided relative to the severity of the downturn. The GAO found that Alaska, the District of Columbia, and Wyoming all experienced employment gains during the recession, and yet they received substantial fiscal relief of more than $79 per capita. Conversely, states with nonfarm employment losses above the national average of roughly 1.5%, including Colorado, Florida, Georgia, Illinois, Indiana, Massachusetts, Michigan, New York, North Carolina, Oregon, South Carolina, Tennessee, Washington, and Wisconsin, only received $34.01 per capita in aid.[16]

Using the aid

Most of the federal government's aid to counteract the effects of the 1973–75 and 2001 recessions had very few restrictions. As such, it was easy for a state to substitute federal money for own-source revenues. Whether federal money should be unrestricted or targeted depends largely on the purpose behind the federal relief funds. If the goal is to stabilize spending across the state government sector, unrestricted aid from the federal government that can be used as a state sees fit is appropriate. Unrestricted aid can also be spent faster, and the speed of getting money into the economy is often a goal of this aid. If, however, the federal government hopes to support specific types of state programs, such as Medicaid or education, categorical aid increases the accountability for the spending. Further, the federal government can provide the money on a matching funds basis that requires the state to maintain its contribution to the specific program and not allow it to simply withdraw state funding and replace it with federal dollars.

How the federal government finances the aid package must also be considered. For an aid package to be truly stimulative, the federal government needs to borrow the funds and the states need to use the money to either expand spending or avoid tax increases. It would also be feasible for the federal government to borrow the funds but have the states use the money to retire debt. While this would improve the states' balance sheets, it would not stimulate growth in the state government sector. The least optimal funding strategy would be for the federal government to reduce its expenditures or raise taxes to fund aid to the states and then for the states to use the money to retire debt. In this case, the government sector would actually contract.

Conclusion

The evaluations of the federal government's previous aid packages have suggested that there is room for improvement. In its 2004 assessment of the $10 billion dollar Jobs and Growth Tax Relief Reconciliation Act of 2003, the GAO concluded "from an economic perspective, the allocation of relief payments among the states was less than optimal."[17] The primary fault was that the aid package was ill-timed. As with most aid policies, the effectiveness ultimately lies in the details of how the aid package is implemented.

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ISSN 0895-0164

[1] Economist Newspaper Limited, 2009, "California's budget crisis: No gold in state," *Economist.com*, May 21, available at www.economist.com/displayStory.cfm?story_id=13702838.

[2] Reuters, 2009, "Governors ask Uncle Sam for $1 trillion," *CNNMoney.com*, January 2, available at http://money.cnn.com/2009/01/02/news/economy/ governors_trillion.reut/index.htm?section=money_topstories.

[3] Throughout this article, I refer to official periods of recession as identified by the National Bureau of Economic Research.

[4] In July 2004, the U.S. General Accounting Office officially changed its name to the U.S. Government Accountability Office.

[5] U.S. Department of the Treasury, 1985, *Federal–State–Local Fiscal Relations: Report to the President and the Congress*, Washington, DC, September, cited in U.S. General Accounting Office, 2004, "Federal assistance: Temporary state fiscal relief," report, No. GAO-04-736R, Washington, DC, May 7, pp. 3–4, available at www.gao.gov/products/GAO-04-736R.

[6] Ibid.

[7] Edward M. Gramlich, 1997, "State and local budgets the day after it rained: Why is the surplus so high?," in *Financing Federal Systems: The Selected Essays of Edward M. Gramlich*, Studies in Fiscal Federalism and State–Local Finance, Cheltenham, UK, and Northampton, MA: Elgar, pp. 57–80.

[8] The business cycle refers to the periodic but irregular up-and-down movements in economic activity, measured by fluctuations in real gross domestic product and other macroeconomic variables.

[9] The American Recovery and Reinvestment Act of 2009 was enacted by Congress and signed into law by President Obama on February 17, 2009.

[10] U.S. General Accounting Office, 1977, "Antirecession assistance: An evaluation," report, No. PAD-78-20, Washington, DC, November 29, pp. 6–7, available at www.gao.gov/products/PAD-78-20.

[11] U.S. General Accounting Office (2004), p. 2.

[12] Congressional Budget Office, 1978, "Countercyclical uses of federal grant programs," background paper, Washington, DC: U.S. Government Printing Office, November, p. 20, available at www.cbo.gov/ftpdocs/92xx/doc9257/78-cbo-046.pdf.

[13] U.S. General Accounting Office (1977), p. 5. Higher labor market participation rates by women were seen as keeping the unemployment rate above 6%, even as other indicators of economic recovery suggested a reasonable expansion was under way.

[14] Congressional Budget Office (1978), p. 25.

[15] Max B. Sawicky, 2003, "Altered states: How the federal government can ease the states' fiscal crisis," *EPI Issue Brief*, No. 187, February 26, available at www.epi.org/publications/entry/issuebriefs_ib187/.

[16] U.S. General Accounting Office (2004), pp. 8–9.

[17] Ibid., p. 13.