

Harnessing the U.S. Intergovernmental Grant System for Place-Based Assistance in Recession and Recovery

Tracy Gordon



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Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

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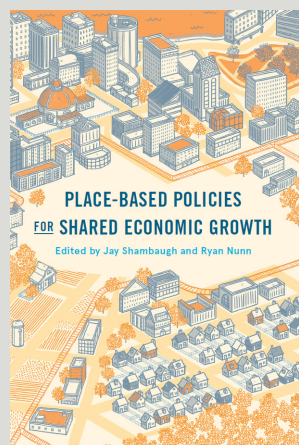


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A CHAPTER IN THE HAMILTON PROJECT BOOK



Place-Based Policies for Shared Economic Growth

For a century, the progress our nation made toward realizing broadly shared economic growth gave our economy much of its unparalleled strength. However, for the last several decades, that progress has seemed to stall. On critical measures such as household income, poverty, employment rates, and life expectancy, there exist yawning, persistent gaps between the best- and worst-performing communities. These conditions demand a reconsideration of place-based policies. The evidence-based proposals contained in this volume can help restore the conditions of inclusive growth that make it possible for individuals from any part of the country to benefit from economic opportunity.

BROOKINGS

Abstract

American places are pulling apart from one another—economically, socially, and politically. Declining regional income convergence, increasing geographic concentration of joblessness, and an increasing awareness of the social costs of long-term joblessness and economic isolation have led many economists to question their traditional skepticism of policies that aim to revitalize distressed areas. Arguments in this vein typically focus on evaluating past programs and identifying conditions under which place-based assistance can be effective. Often overlooked in these discussions, however, is that the federal government already injects about \$700 billion annually (3.5 percent of GDP) into state and local economies through intergovernmental grants. This chapter examines how the federal government could adapt the existing grant apparatus to perform better as a shock absorber in recession and an economic equalizer in recovery. After reviewing the existing system, it proposes changes to help federal grants offset differences in underlying state fiscal capacity and respond more quickly to regional economic downturns and national recessions.

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Introduction

America's regions are pulling apart from one another—economically, socially, and politically. While globally connected metropolitan areas prosper, small- and mid-size cities are often left behind (Badger 2017). Places without diversified economies, colleges and universities, or new immigrants are especially at risk (Austin 2017).

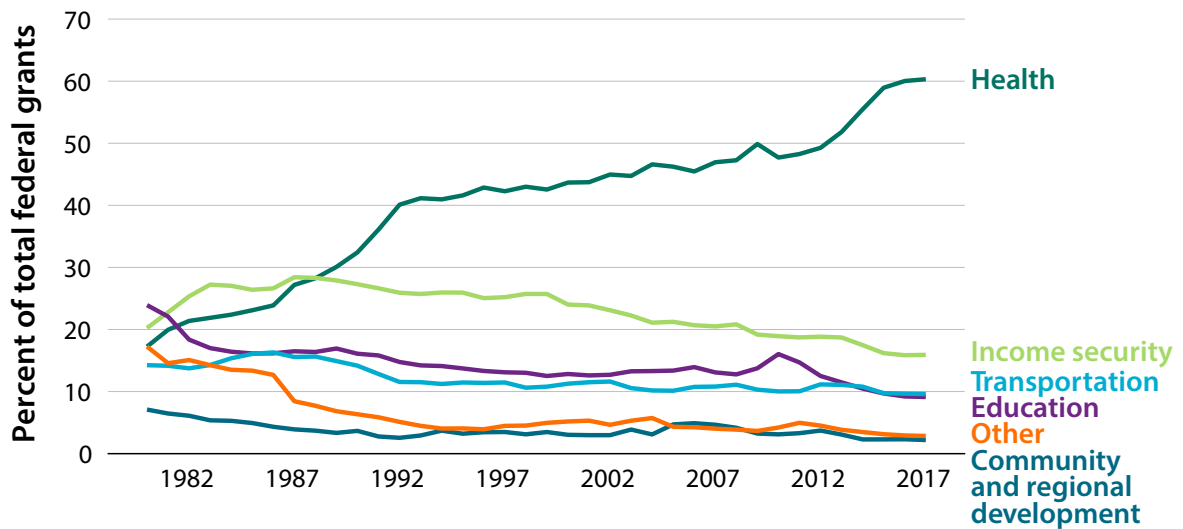
Economists have traditionally taken a dim view of place-based policies (Glaeser and Gottlieb 2008). However, recent evidence suggests that well-designed strategies can be effective (Austin, Glaeser, and Summers, forthcoming; Busso, Gregory, and Kline 2013). Many economists are also recognizing that the social costs of protracted regional decline and individual joblessness may necessitate reexamining the traditional view (Avent 2016).

Often overlooked in these arguments is that the federal government already injects about \$700 billion (3.5 percent

of GDP) into state and local economies annually through intergovernmental grants. To be sure, every dollar of federal government spending occurs somewhere, and not every expenditure is a place-based investment. Nevertheless, it may be possible to leverage existing federal grant programs to help revitalize distressed areas and expand economic opportunity for residents.¹

This chapter explores what it would take for the U.S. federal grant system to respond better to long-term regional economic decline and short-term economic shocks including recessions. After a review of intergovernmental grants, including why they exist, how they work, and how they have evolved over time, it discusses critiques of the existing system and proposals to modify it. It concludes with an evaluation of potential obstacles to these proposals and how such obstacles might be overcome.

FIGURE 1.
Federal Grants to State and Local Governments by Category, 1980–2017



Source: Office of Management and Budget (OMB) 2018b.

Note: Each category represents the share of total federal funds allocated to that sector.

Background

The federal government spends roughly \$700 billion a year on state and local government grants, equivalent to about \$1 of every \$5 in federal outlays (Office of Management and Budget [OMB] 2018a). Nearly two-thirds of these expenditures are for health-related programs, including Medicaid (figure 1). However, the federal government also operates major state and local grant programs in transportation, education, housing, and social services (table 1).

TYPES OF FEDERAL GRANTS

Federal grants can take one of three basic forms.² First, categorical grants restrict funding to specific programs or activities, and the federal government awards them by formula or through a competitive application process. For example, the Better Utilizing Investments to Leverage Development (BUILD) program will award \$1.5 billion in fiscal year 2018

for road, bridge, transit, port, and intermodal transportation projects to improve economic competitiveness among other selection criteria.³

The second form is the block grant. Similar to many categorical grants, block grants are allocated on a formula basis. However, while they restrict funding to a broad set of goals, block grants allow states and localities broad discretion in how they will meet those goals. For example, in 1996 the Personal Responsibility and Work Opportunity Reconciliation Act replaced Aid to Families with Dependent Children (AFDC) and other programs geared to low-income families with children with the block grant Temporary Assistance for Needy Families (TANF).⁴

TABLE 1.

Federal Outlays on the Largest State and Local Grant Programs

	2017 actual	2018 estimate (millions of dollars)	2019 estimate
Medicaid & Children's Health Insurance Program	390,906	417,508	423,457
Federal-aid highways	42,498	42,592	43,782
Child nutrition programs	22,445	24,019	23,486
Tenant-based rental assistance	20,584	20,748	19,902
Education for the disadvantaged	16,186	16,276	16,011
Temporary Assistance to Needy Families	15,972	16,328	15,353
Special education	12,479	12,845	12,759
Children and families services programs	10,232	11,673	10,587
Transit formula grants	9,460	9,786	9,985
Foster care and adoption assistance	7,712	8,267	8,615

Source: OMB 2018c.

Note: This table omits disaster relief funds (an estimated \$20 billion in fiscal year 2018 outlays) because outlays vary depending on extreme weather events and other natural disasters. It combines Medicaid and the Children's Health Insurance Program (CHIP) into one entry because states may administer their programs as an expansion of Medicaid, as a program entirely separate from Medicaid, or as a combination of both approaches. Data are for fiscal years.

The third major type of federal grant, unrestricted revenue sharing, has only a short history in the United States in contrast to other federalist countries such as Australia, Canada, and Switzerland. The closest U.S. approximation to these types of grants, General Revenue Sharing, lasted from 1972 to 1981 for states and 1972 to 1986 for localities (Maguire 2003).⁵ The official justification for the end of general revenue sharing was that the federal government had “no revenue to share” (Sawicky 2001, 3). However, the program had long generated controversy among Democrats who viewed it as a smoke screen for diverting federal funds away from cities, and Republicans who viewed it as big government (Dilger 2018).

Beyond direct grants, the federal government subsidizes states and localities through the tax code, allowing federal individual income taxpayers to deduct state and local property taxes plus income or sales taxes and to exclude municipal bond interest payments from their taxable income. These subsidies had an estimated value of \$137 billion in foregone federal revenue in fiscal year 2017. The 2017 Tax Cuts and Jobs Act (TCJA) capped the state and local tax deduction, substantially limiting its value to high-income taxpayers (Sammartino, Stallworth, and Weiner 2018).

Other federal dollars flow into local areas through low-interest loans and contracts for services provided. For example, the Environmental Protection Agency provides grants to states for water and sewerage improvements. States use these grants to establish revolving loan funds that localities access at

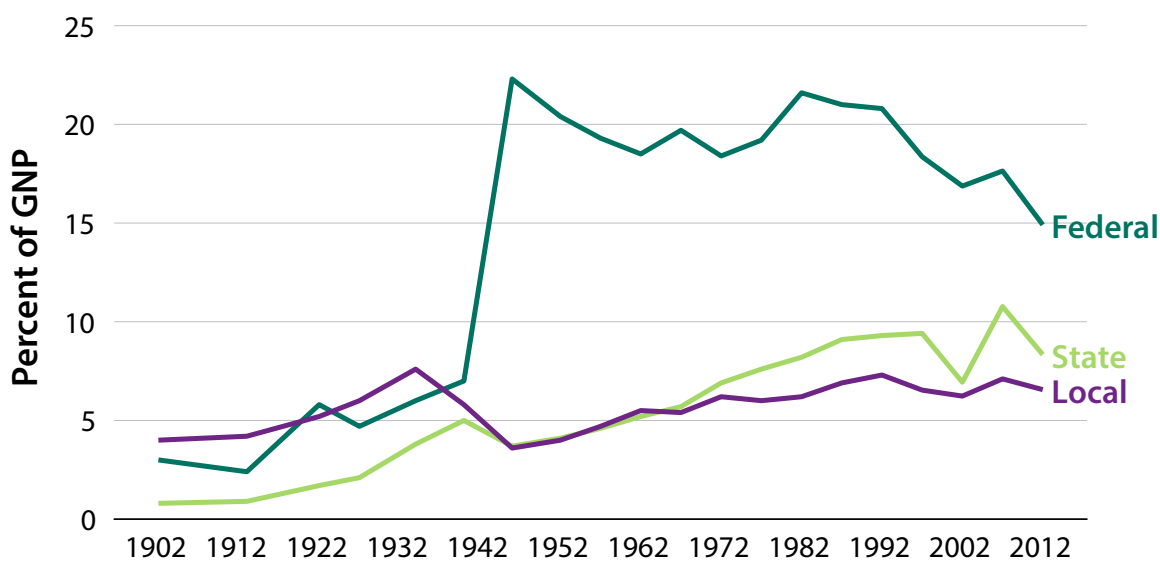
subsidized interest rates for local infrastructure improvements. The presence of a military base or other large federal employer can also produce community economic benefits.

HOW THE USE OF FEDERAL GRANTS HAS CHANGED OVER TIME

Before the early 20th century, with the exception of land grants, the federal government distributed few resources to state and local governments, reflecting its limited role. For most of American history, states and localities were the de facto public sector, collecting twice as much revenue as the federal government and bearing primary responsibility for all functions except national defense, foreign relations, courts, and the postal service (figure 2).

That relationship shifted during the Great Depression and World War II. The federal government introduced new spending programs like Social Security and grew its military using revenue from new sources such as income taxes enabled by the 16th Amendment to the U.S. Constitution, ratified in 1913. Even as it expanded, however, the federal government relied on states and localities to administer many public programs, especially in infrastructure and public welfare. From 1933 to 1940 federal grants to state and local governments grew from a negligible share of the federal budget to 9 percent of total outlays (Wallis 2000).⁶

FIGURE 1.
Federal, State, and Local Government Revenues, 1902–2012



Source: For years before 1977, data are from Wallis 2000, table 1. For 1977 onward, data are from U.S. Bureau of Economic Analysis (BEA) 2018a; Urban-Brookings Tax Policy Center 1977–2014.

Note: State and local revenues are locally generated or “own-source” revenues, excluding federal funds.

Many grants from this period, such as the Federal Emergency Relief Act of 1933, were intended to provide relief from the Great Depression to state and local governments and to individuals. Although they ended in the 1940s, these programs established precedents for federal involvement with state and local governments in areas of national concern and for the use of mathematical formulas including economic and fiscal variables in distributing federal assistance (Advisory Commission on Intergovernmental Relations [ACIR] 1978a; Dilger 2018; Wallis 2010).

After World War II the federal government turned its grant-making attention to economic development, with programs in airport construction (1946), urban renewal (1949), and urban planning (1954). The largest and most enduring legacy of this era were the grants to build the interstate highway system after passage of the Federal-Aid Highway Act of 1956. Overall, this period, when intergovernmental tensions were low and state and local governments had significant latitude on how to spend funds, is generally known as one of cooperative federalism.

The next major phase of federal–state–local relations, sparked by President Johnson’s War on Poverty, ran from 1960 to 1968. In 1965 two new major grant programs, Medicaid and Title I of the Elementary and Secondary Education Act, were both established as matching grants wherein the federal government reimbursed states for their own expenditures based on a formula reflecting measures of need. However, most programs established during this period had minimal matching requirements to encourage maximum participation in programs reflecting national goals (Dilger 2018).

Most grants created during this period were also categorical, or restricted to narrowly defined purposes (such as combating illiteracy, controlling crime, or fixing substandard housing) with strings attached. By one estimate, 204 categorical programs were created during the Great Society, including 109 in 1965 alone (ACIR 1978a). Hence, this phase is known as one of creative or coercive federalism.

The pendulum swung in the other direction after President Richard Nixon’s election in 1968. The Nixon administration sought to combine 129 federal grants across six functional categories into six “special revenue sharing programs” or block grants (Dilger 2018). Ultimately only two block grants—the Comprehensive Employment and Training Assistance Block Grant and the Community Development Block Grant (CDBG)—as well as the General Revenue Sharing program became law, however.

In the 1980s President Reagan and Congress continued the consolidation trend through the Omnibus Budget and Reconciliation Act of 1981, and federal grants-in-aid declined in real per capita terms. However, subsequent block grants,

and a so-called swap and turnback proposal to give states full responsibility for AFDC in exchange for the federal government’s assuming all of Medicaid, never gained traction. By the end of the 1980s the number of federal grants escalated again (Dilger 2018).

The 1990s brought major changes to the structure of intergovernmental transfers, including the block granting of the country’s main cash welfare program, AFDC, as noted earlier. In the 2000s the federal government flexed its muscles again, instituting new accountability requirements in education—such as the No Child Left Behind Act—as well as the REAL ID Act. In addition to significantly expanding Medicaid, the Patient Protection and Affordable Care Act (ACA) authorized or amended 71 federal categorical grants to state and local governments (Dilger 2018).

The Trump administration has charted a different vision of federalism, calling for the elimination of CDBG, the Low Income Home Energy Assistance Program (LIHEAP), the Community Services Block Grant, certain secondary and postsecondary education grants, and the TIGER grant program. However, the most recent two-year federal discretionary spending bill actually increases funding for these programs. Looking across administrations, members of both political parties have found it difficult to eliminate grant programs due to opposition from governors and other constituencies as well as their own ambivalence about losing federal control when moving from categorical to block grants.

REASONS FOR FEDERAL GRANTS

The promise of federal grants is that they allow for the best of centralized and decentralized government. Scholars have long noted that the U.S. faces a “vertical fiscal imbalance” (Bird 2005). The federal government has an easier time raising revenue because it is more difficult than at the state or local level for individuals and businesses to evade taxes through migration. However, states and localities often have an advantage in spending because they can use local information about preferences and costs to tailor policies to their own circumstances.

The problem is that when making spending decisions states and localities do not consider spillovers, or benefits and costs to neighboring areas and the rest of the country (Oates 1972). Commonly associated with capital investments in roads, bridges, and other infrastructure, spillovers may also exist for state and local government human capital investments, for example in K–12 education, especially if these investments affect national economic growth and mobility (Chetty et al. 2014).

The main vehicle for addressing spillovers is the matching grant, whereby the federal government makes it cheaper for

states and localities to spend on a given function by matching each dollar in proportion to benefits flowing to nonresidents (Gramlich 1993). In theory, these grants should be open-ended rather than capped if the spillovers themselves are not limited (Break 1980).

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, more geographically dispersed, or otherwise more expensive to serve at a given level of quality. These places may provide an unacceptably low level of so-called merit goods, or goods that society deems important for a healthy and productive life (Musgrave 1959). In theory, an unrestricted transfer is the preferred tool to address equity considerations, and conditional block grants can encourage spending on specific government functions.

In practice, however, grant design often does not correspond to the principles just described. Grants are typically capped rather than open ended, programs addressing the same spillover may have different matching rates, and matching rates are often too high, converting what should be a subsidy

for spending with positive spillovers into an income support grant (Gramlich 1993).

Many of these design flaws stem from politics, including the difficulty of targeting federal dollars or limiting them to where they will be most effective. For example, the 1960s' Model Cities Program started by identifying roughly a half dozen cities for intensive federal investment. However, within a few years the final number grew to 150 cities and the program also had a mixed track record (Haar 1975).⁷

Other problems in grant design reflect a continual tug-of-war between the federal government and states and localities about the purposes for which money will be spent. Federal policymakers who have done the difficult work of raising revenue are often loath to give states and localities control over how to spend it. One solution is requiring recipients to continue their own previous spending levels (so-called maintenance-of-effort, or MOE, rules). However, despite these and other rules, states and localities often exercise considerable discretion, including substituting federal dollars for their own spending.⁸

The Challenge

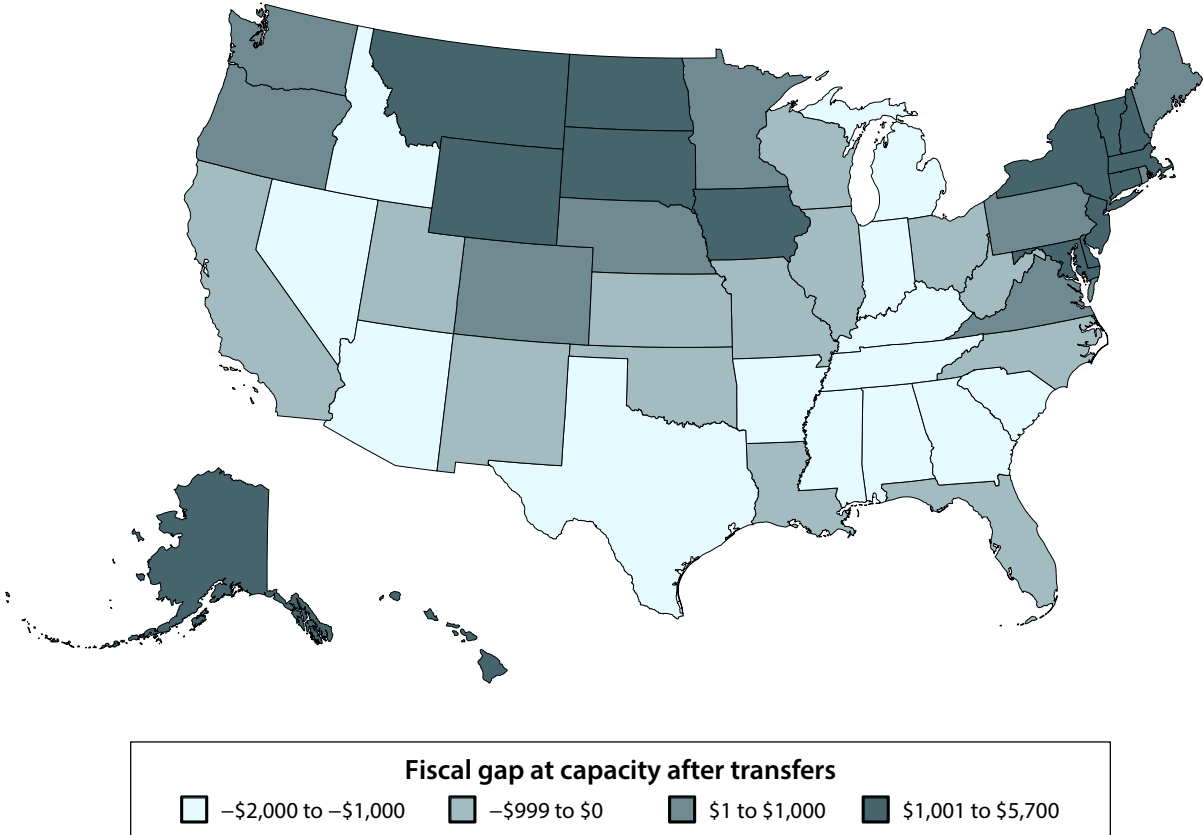
In broad terms, the U.S. intergovernmental grant system reflects an appropriate division of labor among different levels of government. Looking a bit deeper, however, the existing intergovernmental grant system falls short in both static and dynamic terms. In the static sense, federal grants do a poor job responding to divergent regional economic and fiscal fortunes. In a dynamic sense, federal grants are not as responsive as they could be to regional effects of economic shocks or recessions.

Starting with the static issue of state differences, in addition to history, climate, geography, and political representation,

states differ in their ability to raise revenue and to spend on services, including public goods that affect national economic growth and opportunity for residents. One method for measuring these state differences, the Representative Revenue/Expenditure System (RRS/RES), was developed by the Advisory Commission on Intergovernmental Relations (ACIR) in an attempt to better direct federal aid.⁹

Importantly, fiscal capacity as measured by the RRS/RES ignores actual policy choices made by state and local elected officials. It reflects only the background conditions that constrain policy and are out of the hands of political decision

FIGURE 3.
State Fiscal Gaps at Capacity after Federal Transfers



Source: Gordon, Auxier, and Iselin 2016.

Note: Gap at capacity after transfers equals a state's revenue capacity plus federal transfers minus expenditure need. A negative number indicates that expenditure need exceeds revenue capacity plus transfers, whereas a positive number suggests the opposite.

makers. For example, fiscal capacity does not consider whether a state has chosen to enact sales tax but only the level of personal consumption in a state.¹⁰ Similarly, it does not depend on whether a state has chosen to construct a particularly generous or limited social safety net.

Fiscal capacity is defined as the difference between what a state and its local governments could raise in revenue if they taxed at nationally representative rates and what they would spend if they reached national average spending levels adjusted for their own labor costs and program workloads (e.g., the number of school-aged children or low-income and elderly residents).¹¹

Gordon, Auxier, and Iselin (2016) assessed state fiscal capacity in fiscal year 2012. They found that nearly all states faced gaps between revenue capacity and expenditure need. More than half of all states continued to have gaps even after taking account of federal grants (see figure 3).¹²

The reason for this disconnect is that most federal grant programs (with the important exceptions of Title I education

grants and Medicaid) are not explicitly linked to measures of state income or need. For example, many grant programs rely on population as a basis for distributing aid. Together with hold harmless provisions (which prevent reductions in allocations to a jurisdiction), caps, small-state minimums, and other floors and ceilings, this can limit responsiveness to local economic conditions (U.S. Government Accountability Office [GAO] 2009a).

In addition, matching rates and MOE requirements ensure that states receiving federal funds demonstrate at least a minimal level of revenue effort (or actual tax and fee collections) regardless of their underlying capacity. As discussed below, these requirements exist for a reason but they limit or reverse federal grants' equalizing role.

In a dynamic sense, federal grants respond to recessions as more people become eligible for public programs when they lose employment and income. However, grants do not automatically respond to pressures on state and local

TABLE 2.

Federal Outlays for Recovery Act Provisions Affecting State and Local Governments, 2009–19

	2009	2010	2011	2012	2013	2014	2015-2019	Total
	(billions of dollars)							
<i>Flexible fiscal relief</i>								
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 (SFSF)	6.5	28.4	16.1	2.4	0.3	0.0	0.0	53.6
<i>Other non-infrastructure purposes</i>								
Education (beyond SFSF)	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
<i>Infrastructure</i>								
Highway construction and other transportation	5.0	9.4	8.8	7.0	6.1	5.4	6.4	48.1
Clean water and 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 (CBO) 2009b.

Note: "Education (beyond SFSF)" includes funds for facilities modernization, renovation, repair, other education, and other, as classified by the CBO. Data are for fiscal years. FMAP refers to the federal Medicaid assistance percentage.



government budgets, which arise because of balanced budget requirements and other limits on borrowing.¹³ Moreover, states and localities bear primary responsibility for many services, such as public assistance and job training, for which demands rise when state revenues decline (Heller and Pechman 1967).

State tax hikes and spending cuts can be harmful in a recession because they risk derailing a recovery. Economists have long noted the potential for such “fiscal perversity,” blaming it for prolonging the Great Depression and Japan’s Lost Decade of the 1990s, among other episodes (Brown 1956; Hansen and Perloff 1944; Kuttner and Posen 2001). A related concern is state and local fiscal austerity in regional downturns, such as the oil price shocks of the late 1970s. These regional downturns

might not be highly or even positively correlated with each other or national economic conditions (Gramlich 1987).

Recognizing these concerns, 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 (LPW) and continuing through to extensions to the Comprehensive Employment and Training Act of 1973 (CETA) and the Antirecession Fiscal Assistance program (ARFA).¹⁴ However, aid was often poorly targeted, slow to arrive, and not spent quickly (ACIR 1978b).

Countercyclical fiscal assistance then fell out of favor until the early 2000s, when the Jobs and Growth Tax

BOX 1.

Effects of the Recovery Act’s State and Local Fiscal Assistance

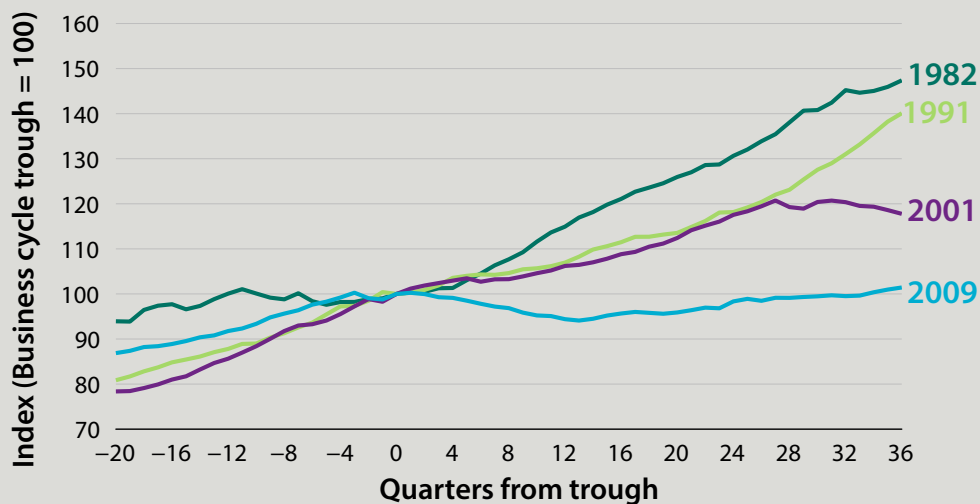
Early assessments of the Recovery Act’s state and local fiscal relief found no net stimulus, whether examining government spending that counted toward GDP (consumption and gross investment) or total spending (including transfer payments, interest payments, subsidies, and other expenses) (Aizenman and Pasricha 2010, 2011; Cogan and Taylor 2012).

However, these assessments were based on time-series data. During the Great Recession states experienced their worst revenue declines on record. State and local government purchases have still not recovered (see box figure 1). Under these circumstances, it is difficult to develop an appropriate baseline from historical trends, particularly starting in the mid-1990s, when the economy and state revenues were booming.

Later studies that exploited cross-sectional variation in the timing of fiscal relief payments found significant job and output gains. For example, Wilson (2012) detected positive employment effects at a cost of \$125,000 per job. He also found that overall employment gains leveled off after March 2010. Chodorow-Reich et al. (2012) found that \$100,000 of formula-based Medicaid grants led to 3.8 job-years. Carlino and Inman (2016) found positive effects from “welfare aid” including enhanced Medicaid transfers.

BOX FIGURE 1.

Real State and Local Government Purchases for Selected Business Cycles



Source: BEA 1977–2014, BEA 2018b, Federal Reserve Bank of St. Louis 1977–2014.
 Note: Dollar values are deflated using the CPI-U deflator.

Relief Reconciliation Act of 2003 (JGTRRA) appropriated \$10 billion in one-time, population-based grants to states as well as \$10 billion in additional 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 (GAO 2004).

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) was the next major experiment, directing nearly

\$280 billion to the nation's state and local governments. In all, nearly half of every Recovery Act dollar spent would flow through state capitols, city halls, county seats, school districts, and other local entities.¹⁵ The Recovery Act also made substantial resources available to states and localities as general fiscal relief, or with few federal strings attached (see table 2). Most independent evaluations have found that the Recovery Act's state and local aid helped stimulate job creation and economic growth although estimate magnitudes vary (see box 1).

The Proposal

This chapter documents the need for a system of federal grants that is better targeted to economic need and more responsive to national and regional economic downturns.¹⁶ In this section, I explore opportunities for reconfiguring policy to better address these problems, proposing concrete steps that would help lagging areas and their workers.

To be clear, addressing cyclical and structural (i.e., long-run) declines are distinct policy goals. Indeed, the GAO has emphasized that a prototype formula it developed to boost grants in a recession should not be thought of as a response to structural decline (GAO 2011c). In practice, however, it can be difficult to avoid conflating the two purposes. For example, a critique of 1970s anti-recessionary fiscal assistance was that funds went to places already experiencing low growth prior to the start of the recession (GAO 1977).

Another tension is between economic and fiscal stabilization. Economic theory and evidence suggest that if the goal is jumpstarting the economy, stimulus should go to people and businesses most affected by the downturn. If the goal is helping states and localities smooth out budget cycles, funds should be allocated more flexibly so that states are able to allocate their own resources as needed.¹⁷ Fiscal and economic stabilization also follow different time profiles because of lags in state budget processes (GAO 2011a).¹⁸

However, it is worth noting that fiscal stabilization can support economic stabilization. Even the expectation of budget support can help states and localities avoid disrupting services to businesses and residents as well as avoiding layoffs, tax hikes, and other potentially harmful economic actions. Many states reported these uses of flexible Recovery Act funds (GAO 2009b).

Regardless of the goal, any proposal for enhanced federal assistance to states and localities must address several basic design questions. These include:

- whether to use a new or existing program,
- whether the program should be mandatory or discretionary for federal budget purposes,

- whether to commit additional resources or reallocate existing funds (perhaps through better targeting), and
- whether aid should be automatic (based on a pre-determined formula) or discretionary (requiring congressional action).

Given the difficulty of designing and implementing a new program, federal policymakers should restrict attention to adjusting existing grants. The federal government currently operates roughly 1,300 state and local grant programs (Dilger 2018). Many are small and narrowly focused, making them unsuitable candidates for adjustment.

However, several large grant programs rely on formulas that leave considerable room for improvement, whether the goal is addressing cyclical or structural distress.

The choice of mandatory or discretionary programs affects whether funding is capped or open-ended. If total funds are capped, responding to places in need will require diverting resources from other grantees unless a contingency fund has already been established as with TANF and LIHEAP. Of course, an open-ended program would use federal resources in ways that may be difficult to project.

Federal budget commitments are ultimately political questions. However, if the goal of policy is to respond to economic shocks in a timely manner, programs should be automatic (i.e., mandatory) and not discretionary. Ample evidence confirms the importance of automatic stabilizers generally (Council of Economic Advisers [CEA] 2014; Follette and Lutz 2010; McKay and Reis 2016). Had a larger fraction of federal assistance to states come in the form of automatic stabilizers during the Great Recession, the country could have avoided some of the fiscal drag that states and localities exerted on economic growth through 2012 (Gordon 2012).

Beyond these basic design questions, policymakers will want to consider more-specific issues including:

- **Timing**, or when aid is triggered on and off
 - Should thresholds be set at the national, regional, or state level?

- Should thresholds be defined in absolute or relative terms?
- If relative, should thresholds be based on a previous level, average, or potential value?
- Should a jurisdiction's economic activity be measured at a single point in time or over a sustained period?
- **Targeting**, or who gets what
 - Should aid be directed to places hardest hit or most likely to recover?
 - Should it go to states, localities, or both?
 - Once triggered, should aid remain constant or be proportional to local circumstances such as the speed and severity of decline?
 - Should aid be capped or open ended?
- How to ensure **federal objectives** are met
 - When federal dollars are directed to a particular state activity, should the federal government try to limit state substitution of federal dollars for its own spending on that activity? If so, how?
 - Should the federal government encourage spending on specific populations and sectors of the economy? If grants go to states, should the federal government encourage spending in specific localities?
 - How can the federal government limit gaming (i.e., state and local governments taking on more economic

or fiscal risk because they know that federal dollars will be available in the event of a setback)?

Bearing these questions in mind, policymakers should do the following:

ADJUST MAJOR GRANT PROGRAM FORMULAS TO MAKE THEM MORE RESPONSIVE TO LOCAL ECONOMIC CONDITIONS

Medicaid is the single largest grant program to states and therefore a strong candidate for adjustment to help places and people that are struggling. Numerous evaluations have found fault with the formula used to calculate the federal government's funding share, or federal medical assistance percentage (FMAP).¹⁹ Notably, the FMAP overlooks important differences in state need, fiscal capacity, and costs of providing medical care (GAO 1983, 2003, 2013).

To better reflect state differences in the need for program services, the federal government should incorporate state poverty rates into its matching formula. It could also use poverty rates weighted to reflect the proportion of low-income state residents who are elderly and therefore are more-intensive users of the health-care system and more expensive for Medicaid to cover (GAO 2003, 2013).²⁰

To capture the costs of providing medical care, the federal government should also include an index for labor and other input costs in the FMAP.²¹ For example, GAO (2003) notes that the District of Columbia and Connecticut had similar per capita incomes in that year, but the District had twice as many residents living in poverty. In addition, health-care costs were 10 percent higher in the District than in Connecticut.²²

BOX 2.

Measuring State Fiscal Capacity

More straightforward and potentially less controversial measures of fiscal capacity include gross state product (GSP) and personal income. Whereas state personal income captures all income received by state residents (e.g., wages, salaries, interest payments), GSP refers to all income produced in a state (e.g., corporate income produced in-state but received by residents of other states). In a closed economy, the two measures would be equivalent. However, states are far from closed economies. Indeed, a state's ability to export or shift tax burdens to nonresidents is part of its revenue capacity.

Total taxable resources (TTR) is an amalgam of state personal income and GSP that aims to capture all income flows that could in principle be taxed by a state. TTR is currently used to allocate block grants administered by the Substance Abuse and Mental Health Services Administration (SAMHSA). TTR sums all income flows produced in a state, adding income from out of state such as dividends or federal transfer payments, and subtracting certain indirect federal taxes and contributions to social insurance programs that are not considered to be taxable by states (Compson and Navratil 1997; Sawicky 1986).

Currently, TTR is only available with a considerable lag; calculations for 2016 will not be available until the fall of 2018 (U.S. Department of the Treasury [Treasury] 2017). It may be possible to speed up production of the series given that it relies heavily on GSP, which is measured with less of a lag. However, because states' ranking in terms of TTR is substantially different from that for GSP or for personal income, it would be controversial to change this measure (appendix table 1).

Beyond need and cost, Medicaid should reflect state differences in fiscal capacity. The RRS/RES method described above is one way to capture these differences. However, it is computationally intensive and requires analyst judgment, for example to determine the relationship between demographics and program costs. States may object to those evaluations as well as using national average effective tax rates and per capita spending as benchmarks, given that states may have very different fiscal preferences. It might therefore be preferable to take a simpler approach, as described in box 2.

Beyond Medicaid, federal policymakers should revisit other funding formulas as well. Federal highway grants, for example, have frequently drawn criticism for awarding funds based on highway lane miles, vehicle miles traveled, population, and tax payments to the federal Highway Trust rather than measures of need and performance (CBO 2016; Cooper and Griffith 2012; Puentes 2008). Title I education, SAMHSA, and CDBG formulas have also been targeted for improvement in ways that could help states and localities facing structural economic decline (GAO 2005; Jabine, Louis, and Schirm 2001).

MAKE MEDICAID'S ANTI-RECESSIONARY ROLE PERMANENT

Federal policymakers have relied on Medicaid to distribute enhanced state and local aid after the past two recessions and in natural disasters such as Hurricane Katrina (Mitchell 2018).

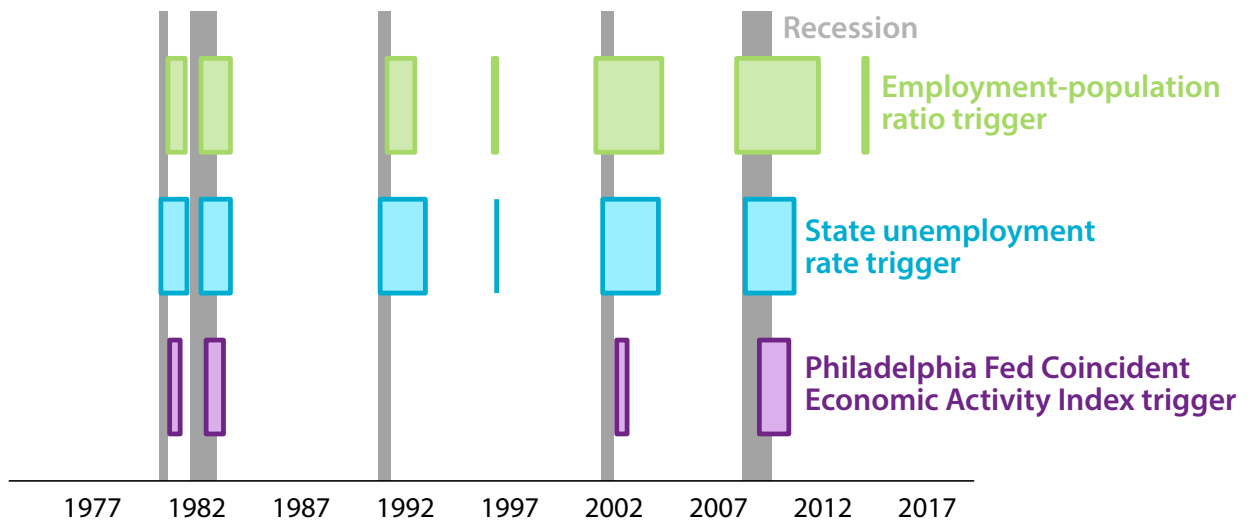
The Recovery Act made three temporary changes to Medicaid: it instituted an across-the-board 6.2 percent increase in the matching rate for federal Medicaid funds (the FMAP); it held states harmless from planned FMAP reductions due to previous personal income growth; and it provided states an additional increment in funds linked to local unemployment rates.

After the 2001 recession, the Jobs and Growth Tax Relief Reconciliation Act of 2003 authorized \$10 billion in spending for a temporary increase in the FMAP and included a hold harmless prohibition against normal decreases in matching rates based on improvements in state personal income per capita. In addition, JGTRRA appropriated \$10 billion in one-time, population-based grants to states.

The Recovery Act worked faster than JGTRRA. Aid started to flow in the first quarter of 2009, retroactive to six months earlier (GAO 2011b). With JGTRRA, the aid did not start until after the recession was already over (GAO 2004, 2006), in part because of delays in enacting the legislation, but also because the 2001 recession was relatively brief. The Recovery Act was also better targeted to places in need, although unemployment was a better indicator of Medicaid enrollment pressures than the across-the-board FMAP increase or hold harmless provision (GAO 2011b).

Given the importance of timeliness and the delays in JGTRRA compared to the Recovery Act, federal policymakers should

FIGURE 4.
Length of Federal Assistance Triggers by Business Cycle, 1977–2017



Source: BLS 1976–2017, 1976–2018; Federal Reserve Bank of Philadelphia 1979–2017; Federal Reserve Bank of St. Louis 1979–2017.

make Medicaid’s anti-recessionary role permanent. Triggers could be based on any number of timely state-level economic indicators (table 3). Figure 4 shows how three triggers—adapted from GAO (2006, 2011b, 2011c); Bernstein and Spielberg (2016); and Mattoon, Haleco-Meyer, and Foster (2010)—would have operated during past business cycles.

The first trigger is based on sustained decreases in the employment-to-population ratio (EPOP).²³ It would trigger on for the entire country (although benefits to states would vary based on local conditions) after at least 26 states experienced four months of declines in the EPOP (based on a moving average calculated over three months and compared to the same period one year earlier). It would trigger off for the entire country when the number of states experiencing sustained employment decreases fell below 26.

The second trigger follows the same rule but uses increases in the unemployment rate instead of declines in the EPOP.

A third trigger suggested by Mattoon, Haleco-Meyer, and Foster (2010)—the Federal Reserve Bank of Philadelphia State Coincident Indicators—turns off more quickly once recessions end and failed to turn on in the early 1990s.

There are clear tradeoffs in the design of triggers: for example, starting aid too quickly when economic conditions do not warrant it, versus failing to start aid or ending it too quickly when states are still feeling the effects of a downturn. To balance these tradeoffs as well as budgetary considerations, policymakers could adjust the number of states in the threshold to start assistance or the number of months with a sustained decrease in economic conditions.

Policymakers may also want to consider allowing aid to start flowing to individual states based on local economic conditions. Despite some trade-offs in terms of data quality, state-level triggers might be preferable to national ones for cushioning state- or region-specific shocks.²⁴

Once triggered, aid could be targeted based on the severity of the recession, using an across-the-board metric, or based on population. GAO (2011c) developed a prototype formula that would direct aid to states based on their change in unemployment and reductions in wages and salaries. GAO finds that its prototype would have been more timely than the Recovery Act, providing assistance from January 2008 (just after the Great Recession began) to September 2011, compared

TABLE 3.
Selected Indicators for Timing or Targeting Federal Assistance to States

Indicator	Source	Frequency
Coincident index	Federal Reserve Bank of Philadelphia	Monthly
Employment	Bureau of Labor Statistics (BLS) State and Metro Area Employment, Hours, and Earnings (SAE)	Monthly
	BLS Local Area Unemployment Statistics (LAUS)	Monthly
	BLS Quarterly Census of Employment and Wages (QCEW)	Monthly
Hourly earnings	BLS SAE	Monthly
Housing units authorized by building permits	U.S. Census Bureau	Monthly
Personal income	U.S. Bureau of Economic Analysis (BEA)	Quarterly
Unemployment	BLS LAUS	Monthly
Unemployment rate	BLS LAUS	Monthly
	BEA	Quarterly
	BLS QCEW	Quarterly
Weekly hours	BLS SAE	Monthly

Source: GAO (2011a), table 3.



to the Recovery Act's October 2008 (retroactive) to June 2011. The prototype also would have removed support for states more gradually compared to the Recovery Act's or JGTRRA's fiscal cliffs.²⁵

Depending on the timeframe, federal highway grants may be another good candidate for restructuring to address regional economic decline. As CBO (2009a) and others have noted, inherent lags in project development typically make infrastructure less than ideal stimulus.²⁶ However, if a downturn is long enough, infrastructure becomes more attractive as a stimulus in addition to providing long-term benefits to residents and economic activity (Austin, Glaeser, and Summers, forthcoming; Busso, Gregory, and Kline 2013).

As with the Recovery Act, the federal government could attach conditions for states to spend infrastructure funds quickly and emphasize "state of good repair" improvements over system expansion (Lew and Pocari 2018).²⁷ Before the next downturn, the federal government could provide additional funds for states to maintain five-year capital improvement plans and a list of projects that, if not shovel ready, at least would have passed minimal cost-benefit criteria (CBO 2016).²⁸

CONSIDER LOANS, GRANT ADVANCES, OR A NATIONAL RAINY-DAY FUND

Several authors, including Galle and Stark (2012), GAO (2006), and Mattoon (2004) have proposed creating an ongoing countercyclical assistance fund modeled after the unemployment insurance (UI) program.²⁹ The fund could

take the form of a new federal rainy-day account (RDA), federal subsidies to state RDAs, or loans and grant advances.

Under the Mattoon (2004) proposal, after an initial state and/or federal capitalization, states would pay into a national RDA in good years and draw down their reserves in bad years. Their repayments would be experience-rated (as with employer contributions to the UI system) in the sense that states' contributions would be larger if a more-volatile tax system made subsequent withdrawals more likely.

As with state RDAs, withdrawals would be limited to specific circumstances such as negative revenue growth, negative personal income growth, or unemployment increases of more than 1 percentage point.³⁰

A national RDA with standard contribution and withdrawal rules may also help overcome incentive problems with existing state RDAs. Namely, states tend not to accumulate large enough RDAs.³¹ They may also set up too many procedural hurdles to access saved funds, such as obtaining supermajority legislative approval and finding a way to repay funds quickly, even within the same fiscal year (Mattoon 2004). As a result of these obstacles and uncertainty about the pace of economic recovery, some states such as South Dakota and Vermont never drew down their reserves during the downturn (McNichol 2013). Furthermore, many states turned to refilling their rainy-day funds while unemployment rates were still high, perhaps because of overly stringent rules governing these accounts, rather than waiting for stronger economic circumstances.

Questions and Concerns

1. Will your proposal weaken state and local budget discipline?

With any proposal to increase federal aid in recession or recovery, an overarching concern is the set of incentives this produces for state and local policymakers. In the past, concerns about incentives have been so strong that they have led to further pathologies in the federal grants system. For example, MOE requirements—intended to ensure that federal funds are spent on desired objectives—are one reason for the low correlation between grants and state fiscal capacity. Furthermore, with the notable exception of Medicaid, most matching grants are capped rather than open-ended, but capped grants can limit the extent to which state and local positive spillovers are taken into account by policymakers, even as they limit federal budget exposure.³²

The General Revenue Sharing program further illustrates tensions in grant design. It relied on a complicated two-tiered aid formula that directed aid to both states and localities, attempting to equalize differences in fiscal capacity, or per capita income, while also rewarding their revenue effort or dollars collected. It is not difficult to see how these goals could work at cross purposes. As economist George Break would later write, “The implied diversity of purpose became an inherent problem for the new program since it could hardly be expected to satisfy all expectations at once” (Break 1980, 145). The General Revenue Sharing program also illustrates the difficulty of targeting local areas within states (Maguire 2003).

Consequently, this proposal argues for targeting aid based on measures such as unemployment that are easily observed and difficult to manipulate (i.e., tagging, as in Akerlof 1978),

thereby mitigating these problems of state moral hazard. It also focuses on measures of fiscal capacity, like Total Taxable Resources, that are not manipulable by states. These and other aspects of the proposal’s design help to minimize any unintended negative effects on state and local budget discipline. The key is to choose a measure that is not easily politically manipulated or that creates incentives for poor policy choices, including decisions to rely on overly volatile revenue sources. Otherwise, governors could alter their tax systems to attract more federal aid.

2. How can federal aid be effectively targeted to places with high levels of need?

In addition to the targeting considerations outlined in the proposal, a complementary approach is to require extensive reporting to discourage jurisdictions that are not truly needy from applying. Although intended to ensure program transparency, the Recovery Act may unintentionally have mimicked these so-called ordeal mechanisms (Nichols and Zeckhauser 1982) by requiring all recipients to file quarterly reports on their use of funds and jobs created. It further mandated that a Recovery Accountability Transparency Board review all agency reports, conduct audits and reviews, and release the underlying data through a website (which became Recovery.gov).³³

Relatedly, relying on existing formulas has the advantage of expediency but also reinforces traditional donor versus recipient state roles (Boyd and Dadayan 2017). An alternative for political expediency, although worse from a targeting perspective, is simple per capita grants as under JGTRRA.

Conclusion

This chapter has argued that the federal grant apparatus is often overlooked when considering ways to help places in crisis due to long-term structural decline or short-term cyclical swings in the economy. To address growing regional disparities in economic growth and the impact of recessions, existing programs could be reconfigured to better support places that are struggling. In particular, federal policymakers might want to consider changing the formula for Medicaid or other programs to make the grants better targeted to lagging states, making countercyclical

enhancements to the Medicaid program permanent, and creating a new countercyclical fund that states could draw on during downturns. In all cases, funds should be targeted based on characteristics not subject to political manipulation or gaming. These targets would be based on unemployment and/or other labor market conditions—as well as measures of fiscal capacity—thereby helping to equalize the resources available for communities to invest in local public goods and provide economic opportunity for their residents.

Appendix

APPENDIX TABLE 1.

Gross Domestic Product, Personal Income, and Total Taxable Resources Per Capita, by State

State	GDP	Rank	Personal income	Rank	TTR	Rank
District of Columbia	180,900	1	73,800	1	106,100	1
North Dakota	74,500	2	55,600	9	79,300	6
Delaware	74,000	3	47,100	23	81,700	4
New York	73,600	4	58,300	5	82,200	3
Massachusetts	72,200	5	62,800	3	81,000	5
Alaska	71,100	6	56,500	6	74,200	9
Connecticut	70,500	7	68,200	2	87,600	2
Wyoming	67,400	8	56,300	7	77,700	7
California	64,300	9	54,700	10	69,800	12
Washington	63,400	10	53,100	12	70,100	11
New Jersey	62,900	11	60,100	4	76,800	8
Nebraska	61,300	12	49,600	19	65,600	16
Maryland	60,900	13	56,200	8	72,700	10
Illinois	60,500	14	50,700	16	67,100	14
Minnesota	59,500	15	51,100	15	65,200	17
Texas	58,700	16	46,800	25	63,000	19
Colorado	58,000	17	52,000	14	63,600	18
Iowa	57,900	18	45,800	27	62,000	22
Hawaii	57,400	19	48,800	21	59,700	25
Virginia	57,300	20	52,200	13	66,000	15
New Hampshire	56,500	21	54,500	11	68,600	13
Pennsylvania	55,500	22	49,800	17	62,600	20
South Dakota	55,300	23	47,900	22	62,300	21
Oregon	53,800	24	44,400	29	59,000	26
Rhode Island	53,200	25	49,700	18	62,000	23
Wisconsin	52,700	26	46,000	26	58,400	27
Ohio	52,700	27	43,800	31	56,800	28
Kansas	52,200	28	47,000	24	60,300	24
Louisiana	51,800	29	42,800	35	54,100	33
Indiana	50,400	30	41,900	39	55,800	31
Utah	50,100	31	39,800	42	53,400	36
North Carolina	50,000	32	41,400	40	53,600	35
Georgia	49,600	33	41,000	41	53,100	38

APPENDIX TABLE 1. (CONTINUED)

Gross Domestic Product, Personal Income, and Total Taxable Resources Per Capita, by State

State	GDP	Rank	Personal income	Rank	TTR	Rank
Nevada	49,300	34	43,100	32	56,000	30
Oklahoma	48,600	35	44,000	30	53,200	37
Vermont	48,500	36	49,000	20	56,300	29
Tennessee	48,100	37	42,200	38	51,700	40
Missouri	48,000	38	42,400	37	54,200	32
Michigan	47,400	39	43,100	33	52,700	39
Montana	44,900	40	42,600	36	50,500	41
New Mexico	44,700	41	37,900	49	48,200	43
Florida	44,000	42	45,400	28	54,000	34
Kentucky	43,200	43	38,500	47	47,900	44
Arizona	43,100	44	39,700	43	47,400	45
Maine	43,100	45	42,900	34	48,600	42
South Carolina	41,500	46	38,800	46	46,400	46
Alabama	41,200	47	38,200	48	45,700	50
Arkansas	40,000	48	39,100	44	46,100	47
Idaho	39,800	49	38,900	45	45,800	48
West Virginia	39,500	50	36,600	50	45,800	49
Mississippi	35,600	51	34,800	51	40,100	51
United States	56,100		48,900		62,300	

Source: BEA 2016a, 2016b; U.S. Census Bureau 2015; Treasury 2017.

Note: Data are for 2015. States are in descending order of GDP per capita.

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Endnotes

1. For example, the Promise Zone program, launched in 2013, awards preferences for certain competitive federal grants to places experiencing high poverty, among other requirements. Designated zones also receive technical assistance and help navigating federal programs. Tax incentives proposed by the Obama administration were never approved by Congress. See OMB (2016).
2. For more information, see CBO (2013) and GAO (2012).
3. BUILD replaced the Transportation Investment Generating Economic Recovery (TIGER) program created by the American Recovery and Reinvestment Act of 2009 (the Recovery Act). Since 2009 the TIGER grant program has provided a combined \$5.1 billion to 421 projects in all 50 states, the District of Columbia, Puerto Rico, Guam, the Virgin Islands, and tribal communities. See U.S. Department of Transportation (2018).
4. Under the 1996 welfare reform law, states have broad discretion on how to spend federal TANF funds as long as they are meeting one of four program goals: (1) providing assistance to needy families so that children may be cared for in their own homes or in the homes of relatives; (2) promoting job preparation, work, and marriage among needy parents; (3) preventing and reducing the incidence of out-of-wedlock pregnancies; and (4) encouraging the formation and maintenance of two-parent families. Nationally, the preponderance of TANF is spent on noncash assistance, which is less targeted to the lowest-income recipients and less responsive to economic downturns. See Bitler and Hoynes (2016).
5. The federal government also experimented with revenue sharing in 1803 and 1837 (Break 1980).
6. See also Wallis and Oates (1998) for a discussion of how federalism evolved during the New Deal.
7. It remains to be seen how the newest economic development program created through the TCJA, Opportunity Zones, will fare on this criterion (e.g., Looney 2018; Theodos 2018).
8. See, for example, Gramlich and Galper (1973), who found that \$1.00 of unrestricted federal aid stimulated \$0.36 in state and local spending, \$0.28 in lower state and local taxes, and \$0.36 in higher fund balances or saving. However, other research has found evidence that federal dollars stimulate more than the expected state and local spending response. Some early flypaper effect research might have mistook matching as lump sum grants or overlooked MOE requirements. Other explanations include tacit understandings between federal appropriators and grant recipients about how recipients will respond to federal money (Chernick 1979; Knight 2002).
9. Established by the 86th U.S. Congress, the ACIR was a “permanent, bipartisan body of 26 members, to give continuing study to the relationship among local, state, and national levels of government.” Among its statutory responsibilities were to “provide a forum for discussing the administration and coordination of Federal grant and other programs requiring intergovernmental cooperation” (Advisory Commission on Intergovernmental Relations Act of 1959). For more information on this method, see ACIR (1962, 1971, 1982), Tannenwald (1999), Tannenwald and Turner (2006), Yilmaz and Zahradnik (2008), Yilmaz et al. (2007).
10. To take one example, Washington State derived about a quarter of its total state and local revenue from sales taxes in 2012 (and a similar portion today), while its neighbor Oregon (along with Alaska, Delaware, Montana, and New Hampshire) collected no general sales taxes. The RRS/RES also cannot capture differences in tax administration capabilities, efficiency of public service provision, or the ability to export tax burdens to nonresidents.
11. Labor costs are typically measured using a regression framework or wage index assessing what all employers—public and private—in a state must pay to attract workers of a given education and experience level. This approach separates background conditions such as regional costs of living from policy choices about what to pay public sector workers. See Gordon, Auxier, and Iselin (2016, appendix C).
12. This calculation does not include the taxes paid to the federal government by state residents. Thus, even though a state like New York received transfers that more than offset its fiscal gap in 2012, this does not mean it was a net recipient of federal money overall, because the taxes paid by New York residents more than offset the federal transfers. See Boyd and Dadayan (2017) for discussion of net contributions and draws on the federal budget. High-income states also benefit the most from federal tax deductions and exemptions (such as those for home mortgage interest, charitable contributions and the previously uncapped SALT deduction) accruing to high-income tax payers (Sammartino 2017). However, these benefits may help offset another problem in the federal tax code, the penalty workers living in high-productivity areas pay because taxes are not indexed for regional costs of living (Albouy 2009).
13. Although details of these rules vary considerably and affect their stringency, most states are constitutionally or statutorily bound to balance their budgets each year (Rueben and Randall 2017).
14. In all, Congress appropriated \$14.5 billion for countercyclical fiscal assistance from November 1975 to March 1978 (ACIR 1978b). See also ACIR (1978b), GAO (1977; 2011a, 34–37, appendix III).
15. The Recovery Act created individual earnings Promise Zone 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 \$700 billion; this figure excludes the alternative minimum tax (AMT) patch best thought of as continuation of long-standing policy. See CBO (2009a).
16. This chapter does not consider technical assistance and other temporary measures to help a specific community after a natural disaster or financial crisis as in Detroit or Puerto Rico most recently.
17. This was the intent of the Recovery Act’s state and local fiscal relief (Grunwald 2013).
18. Most states start their fiscal year on July 1st, so in mid-2009, for example, spending levels would have been set in the summer of the previous year although many states were forced to reopen their budgets mid-year to close gaps due to revenue shortfalls (e.g., McNichol 2012).
19. The FMAP is a declining function of state per capita personal income:
$$FMAP = 1.00 - 0.45 \times \left(\frac{StatePCI}{U.S.PCI} \right)^2$$
The FMAP formula’s 0.45 term ensures that the average state receives a federal match of 55 percent. Squaring the personal income term amplifies the effect of falling above or below national average income (so that lower-income states receive even higher matches and higher-income states even lower ones, subject to the statutory limits above).
20. A simulation by Miller and Schneider (2004) suggests that shifting to this kind of measure would increase FMAPs in some relatively wealthy states with high poverty populations while reducing matching rates in states with smaller populations living in poverty. It would also increase federal budgetary commitments, although this could be paid for by reducing statutory minimums on FMAP rates.
21. See Gordon, Auxier, and Iselin (2016, appendix C) for one approach.
22. The District of Columbia also receives special federal matching rates set in

- statute that gives it higher matching rates than they would have otherwise received based on per capita income (PCI).
23. Unlike the unemployment rates, the EPOP reflects both unemployed and discouraged workers (i.e., those who have stopped searching for work) because the denominator is total population rather than the labor force.
 24. Mattoon, Haleco-Meyer, and Foster (2010) experimented with three national triggers:
 - Excess unemployment (a 1 percentage point–increase from most recent trough turns on aid; aid turns off when the national rate falls by more than 1 percentage point).
 - Sales tax revenues (when a four quarter moving–average falls by more than 5 percent, aid turns on; when the average returns to previous levels aid turns off).
 - Philadelphia Reserve Bank State Coincident Indicators (a 0.1 percentage point–drop in month over month log of index turns aid on; when the log of national index is back to 0 aid turns off).
 25. GAO’s consideration of these issues preceded the ACA and consequently does not account for states’ more recent Medicaid expansions.
 26. This criticism was less apt in the Great Recession given its protracted nature, however this may not have been apparent at the outset. For example, in January 2008 the CBO noted an output gap was emerging but suggested that it would close by 2011 after reaching a maximum of 2 percent of GDP in 2008. By January 2009 the CBO estimated that the output gap would hit 7 percent of GDP and not close until 2014 (CBO 2008, 2009a).
 27. As noted in McGuire et al. (2014, 43), most Recovery Act transportation funds were distributed according to procedures of established federal highway, transit, and airport grant programs. This meant that highway grants were based on highway lane miles, vehicle miles, population, and that tax payments to the federal Highway Trust Fund are attributable to highway users in the state. Transit grants considered population; population density; and transit vehicle miles, passenger miles, and route miles. However, 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.
 28. Many, but not all, states maintain five-year capital improvement plans (National Association of State Budget Officers 2014).
 29. UI is a joint federal–state program. The federal government funds state UI program administrative costs and part of the costs of the federal–state extended benefits program by levying a 6 percent payroll tax, known as the Federal Unemployment Tax Act (FUTA) tax, on the first \$7,000 of covered workers’ earnings. Employers can claim credits against 5.4 percentage points of FUTA taxes if they operate in states where unemployment programs meet federal standards, reducing the effective FUTA tax rate to 0.6 percent, or a maximum of \$42 per worker. Federal standards for state UI programs are broad. States must levy their own payroll taxes on a base of at least \$7,000 per worker and use experience rating to impose higher tax rates on firms that lay off more workers. Also, states must impose maximum payroll tax rates of at least 5.4 percent and must deposit tax proceeds into a reserve account or trust fund held for that state by the Treasury and used solely to pay UI benefits (Vroman and Woodbury 2014).
 30. See, e.g., Rueben and Randall (2017).
 31. A generally accepted, although rarely substantiated, rule of thumb for state and local governments is that budget reserves and rainy-day funds should constitute roughly 5 percent of prior year spending. More savings may be desirable from an insurance point of view, but accumulating large surpluses also poses political challenges, as evidenced by California’s voters demand for property tax reduction in the early 1970s, an effort that culminated in Proposition 13.
 32. An important exception to Medicaid’s open-ended structure is in U.S. territories such as Puerto Rico where federal funds are typically capped although the cap was temporarily waived by the Recovery Act and ensuring federal action (Medicaid and CHIP Payment and Access Commission [MACPAC] 2018).
 33. Agency inspectors general were further instructed to review “any concerns raised by the public about specific investments using funds made available” and relay findings to agency heads (Title XV, Sections 1514 and 1515). In addition, the Comptroller General (head of the GAO) was to conduct bimonthly reviews on the use of funds by selected states and localities (Title IX, Sections 901 and 902), and the CBO and GAO had to comment on the recipient reports (Title XV, Section 1512 (c)) (Title XV, Sections 1521–1528).

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Highlights

The \$700 billion U.S. intergovernmental grant system is often poorly targeted to areas that are struggling. Tracy Gordon proposes reforms to Medicaid and other programs that would make federal aid to states more targeted toward struggling areas and more responsive to economic shocks.

The Proposals

Adjust major grant program formulas to make them more responsive to local economic conditions. Since Medicaid is the single largest grant program to states, it is especially important to make the federal medical assistance percentage (FMAP) more reflective of states' economic by incorporating state-level information about poverty rates, elderly and low-income populations, and fiscal capacity. Beyond Medicaid, funding formulas for other programs related to federal highway grants, Title I education, and the Community Development Block Grant should be revisited as well.

Make Medicaid's anti-recessionary role permanent. In previous recessions, the federal government has implemented temporary changes to Medicaid in order to distribute enhanced state and local aid. Policymakers should make this anti-recessionary role for Medicaid permanent. One way to do so would be to design the FMAP as an automatic stabilizer that varies depending on selected economic factors. Gordon offers three potential triggers that are all based on timely state-level economic indicators (the unemployment rate, employment-population ratio, or the State Coincident Economic Activity Index). These triggers could either be activated when a certain number of states reaches the threshold for the given indicator, or the mechanism could operate on an individual state-by-state basis.

Consider loans, grant advances, or a national rainy day fund. Lastly, Gordon proposes creating an ongoing countercyclical assistance fund modeled after the unemployment insurance (UI) program. The fund could take the form of a new federal rainy-day account (RDA), federal subsidies to state RDAs, or loans and grant advances. States would pay into a national RDA in good years and draw down their reserves in bad years.

Benefits

Gordon's proposal will help states and their residents in economically struggling regions, both during times of growth and times of recession. By fixing federal funding formulas so that they accurately reflect economic needs of states, this proposal will also provide assistance to states and their residents who are being underfunded by the current system.



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