EXECUTIVE SUMMARY

Lessons from COVID-19 Aid to State and Local Governments for the Design of Federal Automatic Stabilizers

by Jeffrey Clemens and Stan Veuger

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KEY TAKEAWAYS

As the COVID-19 pandemic unfolded, Congress allocated nearly $1 trillion in federal aid to state and local governments. This unprecedented level of aid was motivated in part by the need for increased spending to address the public health crisis, and in part in anticipation of diminished state and local tax revenues resulting from widespread economic shutdowns. In their chapter, "Lessons from COVID-19 Aid to State and Local Governments for the Design of Federal Automatic Stabilizers," authors Jeff Clemens and Stan Veuger describe how federal aid to state and local governments in response to the pandemic was far too generous, and consequently less cost-effective in achieving its economic aims than were comparable past programs.

The authors make three policy recommendations to better deliver aid in future times of crisis:

1. The federal government should develop transparent formulas to automatically deliver aid to states and localities in times of need. Rule-based approaches—as opposed to discretionary allocations—hold the promise of producing fiscal assistance packages that are more proportionate to the magnitude of state and local budget shortfalls.
2. Aid formulas should be based on indicators that are closely tied to revenue. Tax bases (and forecasts thereof) are superior to expected unemployment rates for estimating revenue shortfalls. Fiscal assistance based on a formulaic approach incorporating the most up-to-date information could deliver predictable, appropriately-sized aid for states and localities.
3. The goals of revenue stabilization and funding for crisis-specific spending needs can most effectively be achieved if they are decoupled from one another. Discretionary spending is more appropriate for targeted relief and specific spending priorities, and should be decoupled from revenue stabilization. Independent policy objectives should be met with independent policy instruments.

COVID-19 PANDEMIC AID PROJECTIONS AND IMPACTS

In the US system of fiscal federalism, balanced budget requirements adopted by state governments contribute to inflexible budgets with limited financing flexibility. As such, the federal government plays a major role in macroeconomic stabilization through a wide range of policies, including aid to state and local governments. Federal aid to subnational governments comes in two forms: through so-called automatic stabilizers—programs legislated in advance of potential downturns—and through discretionary spending, which are typically one-off, temporary programs legislated in response to specific downturns.

During the COVID-19 pandemic, federal fiscal assistance to state and local governments through ad hoc measures totaled nearly $1 trillion and included not only general funds, but also assistance earmarked for education, healthcare, transportation, and various other state

and local government functions. Yet, empirical analysis finds no impact of this federal aid on macroeconomic outcomes, suggesting that while state and local aid did help governments manage the public health emergency by improving the equitability and volume of vaccine and test administration, it did not stimulate the economy during the initial downturn. The authors estimate that the federal government allocated $855,000 for each state or local government job-year preserved, approximately eight times more than the cost per job-year of the American Recovery and Reinvestment Act in 2009.

Explanations for the different impacts of federal fiscal assistance during the COVID era as compared to the Great Recession include the volume of fiscal assistance provided, the ongoing measures taken by public and private actors alike to mitigate the spread of the novel coronavirus, and the pandemic's macroeconomic context, which features substantial inflationary pressures, whereas the Great Recession featured shortfalls in aggregate demand. Additionally, federal allocations were based on early, pessimistic forecasts; they did not incorporate new information as it became available. Had the forecasts of need been updated to reflect conditions on the ground, unemployment-based estimates would ultimately have called for around $400 billion in aid, rather than more than $950 billion.

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GUIDANCE FOR FORMULATING FEDERAL AID

Under the status quo, booms and busts carry state and local governments through alternating cycles of bloat and beseeching the federal government for aid. Clemens and Veuger argue that a formula-based revenue stabilization program would relieve these pressures. States and other subnational governments would see their spending restrained toward responsible levels during booms, while assistance would flow formulaically during busts. During downturns, this flow would enable subnational budgeting agencies and federal policymakers to focus their attention on the myriad other concerns facing their constituents.

The authors propose an approach aimed to achieve several goals, including long-run budget neutrality, timely injections of aid during recessions, an expectation of aid when forecasters anticipate revenue shortfalls, and ease of implementation. Clemens and Veuger propose the straightforward use of aggregate income as a proxy for the income tax base, and consumption expenditures on goods as a proxy for the sales tax base.

The authors suggest benchmarking aid allocations using a simple algorithm for assessing the performance of major tax bases relative to trend. The basic idea is to forecast the growth of each tax base based on its recent history, though policymakers would need to decide how many years' worth of recent historical data to include in the forecasting formulae.

GUIDANCE FOR DELIVERING FEDERAL AID

Clemens and Veuger propose three options for how fiscal assistance, calculated on the basis of shocks to tax bases and neutral over the business cycle, can be delivered.

1. **Grants-in-aid:** The federal government could continue its current practice of relying on grants-in-aid—federal money granted to fund projects or programs—and policymakers could adjust transfers downward in "normal times" to achieve revenue neutrality.
2. **Federal Lending Program:** The federal government would loan money to states. States would be encouraged to request only those funds that suit their needs, making federal efforts to measure the magnitude of shocks less necessary. Capping the loan size may still prove helpful.
3. **Revenue Insurance Scheme:** A federal government sponsored revenue insurance scheme would require state and local governments to pay in premiums and would enable them to collect payouts when negative shocks materialized. Policymakers could use formulas to determine the appropriate timing and size of payouts. Calculating premiums may pose political and conceptual challenges.

ABOUT THE AUTHORS

Jeffrey Clemens

Associate Professor, University of California-San Diego, School of Economics

Jeffrey Clemens is an Associate Professor of Economics at the University of California at San Diego (UCSD). Professor Clemens obtained both his BA and PhD in Economics at Harvard University. In addition to his current position at UCSD, Professor Clemens is a Research Associate at the National Bureau of Economic Research, a CESifo Network Fellow, and a Visiting Fellow at the Hoover Institution. Professor Clemens has a research portfolio spanning the economics of health insurance regulation, health care payment systems, minimum wages, and the finances of state and local governments. His ongoing projects focus primarily on the economic drivers of medical innovation, on the fiscal effects of the COVID-19 pandemic, and on understanding the broad set of margins through which firms have responded to minimum wage increases in recent years. Jeff's research has appeared in journals including the American Economic Review, the Journal of Political Economy, the Journal of Economic Perspectives, American Economic Journal: Economic Policy, American Economic Journal: Applied Economics, and a number of leading field journals. He currently serves as a Co-Editor at both the Journal of Public Economics and the Journal of Health Economics

Stan Veuger

Senior Fellow in Economic Policy Studies, American Enterprise Institute

Stan Veuger is a senior fellow in economic policy studies at the American Enterprise Institute (AEI). He is also the editor of AEI Economic Perspectives, and a fellow at the IE School of Global and Public Affairs and at Tilburg University. He was a visiting lecturer of economics at Harvard in the fall of2021 and a Campbell Visiting Fellow at the Hoover Institution in May 2022. Dr. Veuger's research has been published in leading academic and professional journals, including the Journal of Monetary Economics, The Quarterly Journal of Economics, and The Review of Economics and Statistics. He is the coeditor, with Michael Strain, of "Economic Freedom and Human Flourishing: Perspectives from Political Philosophy" (AEI Press, 2016). Dr. Veuger also comments frequently on economics, politics, and popular culture for general audiences. His writing has been featured in The Bulwark, Foreign Affairs, The New York Times, USA Today, and The Washington Post, among others. His broadcast appearances include CNN, Fox News, MSNBC, Telemundo, and Univision. He received a PhD and an AM in economics from Harvard. He also holds degrees from Erasmus University Rotterdam, Universitat Pompeu Fabra, University of London, and Utrecht University.

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