What Surplus?

Assessing State-Local Government Aid after a Decade of Austerity

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INTRODUCTION

As early as spring 2021, states were reported to be "flush with cash" or have excessive amounts of revenue (O'Brien 2021). This has led conservative groups like the Committee for a Responsible Federal Budget (CRFB) to argue that the amount of federal funds transferred to state and local governments under the American Rescue Plan Act (ARPA) was unwarranted (CRFB 2021). In March 2022, Republican members of the United States Congress proposed rescinding some of the aid, and have raised the subject again more recently (Murakami 2022a; Murakami 2022b). At the subnational level, many state governments have begun—or are considering— using the funds to justify personal income tax cuts (Wilson 2021; Faler 2022).

In this brief, we argue that the federal aid distributed to state and local governments during the pandemic should be assessed as addressing a decade-long shortfall in state-local spending, and not only as a response to the pandemic. State and local governments should treat current budget surpluses not as unexpected windfalls, but as a means to fill spending gaps left by the Great Recession and the inadequate recovery that followed.

In this context, taking back the aid at the federal level or implementing state-level tax cuts doesn't make sense. We argue that the federal transfers from the CARES Act and ARPA should be allocated to historically underfunded public sectors, particularly infrastructure and employment. Not only would these investments be more equitable than regressive tax cuts but they would help support critical state and local government spending in areas that never recovered from the Great Recession—and were made even more fragile by the pandemic.

In this brief, we:

- Demonstrate the shortfall in state-local spending from 2009 to 2019;
- Identify areas where state-local spending declines were most significant and in some cases are still depressed; and

- Recommend that state and local governments allocate their remaining ARPA funds to build public infrastructure and directly support public employment, rather than enact further tax cuts.

What Do State and Local Governments Do?

Why should people care what state and local governments do with their budgets? First, state and local governments use their budgets to provide vital public goods and services. For example, throughout the COVID-19 pandemic, state governments supported displaced workers, public universities, hospitals, and small businesses, while local governments supported schools in their transition to remote learning. Second, when the 50 state and 90,000 local governments in the US are viewed as an aggregate, their sheer size makes them an important factor in the design and implementation of macroeconomic policy. In 2019, state and local expenditures made up about 11 percent of US GDP, and total employment for the sector was about 13 percent of total nonfarm employment.

How Much Federal Aid Did State and Local Governments Receive from the CARES Act and ARPA?

Table 1 shows the amount of funds allocated to state and local governments under the Coronavirus Aid, Relief, and Economic Security (CARES) Act and ARPA. The distribution guidelines under the CARES Act provide states with a minimum allocation of $1.25 billion, with additional payments based on population (US Department of the Treasury 2022a). This totaled $111.4 billion for state governments. Local governments (i.e., cities or counties) were eligible for direct payments if their population exceeded 500,000. The total amount allocated to cities was $7.6 billion, and the total for counties was $20 billion. Territories were allocated $3 billion and tribal governments were allocated $8 billion (US Department of the Treasury 2022c).

Under ARPA, state, city, county, territorial, and tribal governments were allocated a combined $350 billion in federal aid (US Department of the Treasury 2022b). States received $195.3 billion, of which $25.5 billion was equally distributed to the 50 states and DC while the remaining $169 billion was distributed in relation to the number of unemployed people in the state (US Department of the Treasury 2021d). Cities were allocated $45.57 billion on the basis of a formula which takes into account poverty, population, housing overcrowding, and age of housing (US Department of the Treasury 2021b). County governments received $65.1 billion, which was allocated based on the county's population share (US Department of the Treasury 2021a). Territorial governments received $4.5 billion, half of which was distributed equally and the remaining balance distributed based on population share (US Department of the Treasury 2021e). Non-entitlement units (NEUs) are local governments with populations under 50,000. These governments received $19.53 billion (US Department of the Treasury 2021c), and tribal governments were allocated $20 billion (US Department of the Treasury 2021f). Local governments received their federal allocations in two waves (50 percent in May 2021 and 50 percent in May 2022). States with slower labor market recoveries received their funds in one payment while states with stronger labor market recoveries received two installments. Territories received a single payment while tribal governments received two installments: one in May 2021 and the other (based on employment data) in June 2021 (US Department of the Treasury 2022b).

Table 1. Federal Funds Allocated to State and Local Governments under CARES Act and ARPA

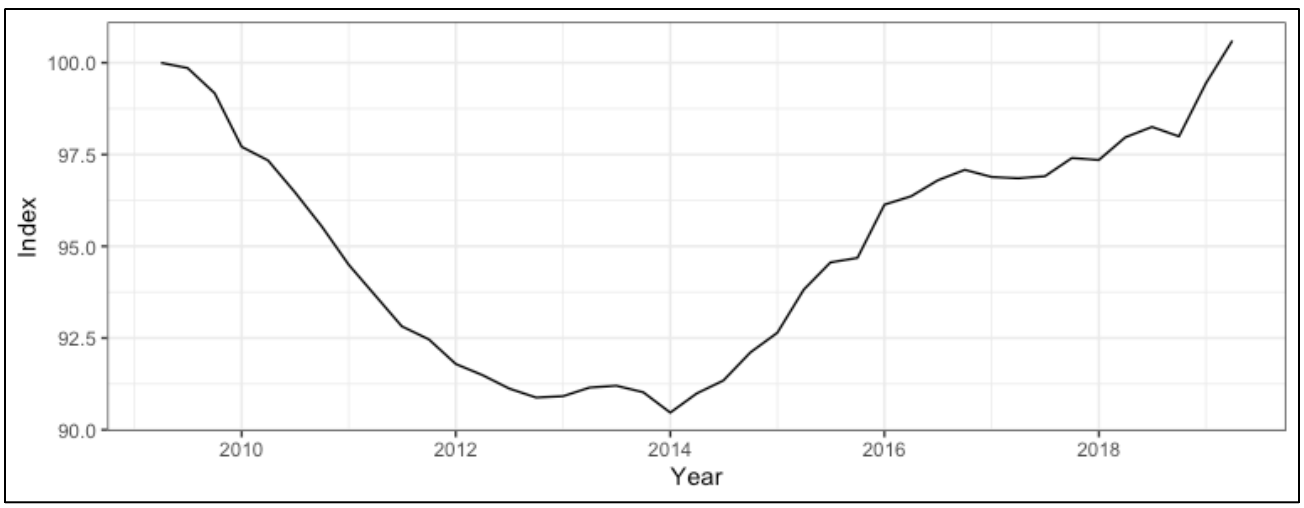
	Federal Allocation from CARES Act (in billions of dollars)	**Federal Allocation from ARPA** (in billions of dollars)
States	$111	$195
Cities	$8	$45
Counties	$20	$65
Territories	$3	$5
NEUs	n/a	$20
Tribal	$8	$20
Total	***$150***	***$350***

Source: US Department of the Treasury 2022.

A DECADE OF AUSTERITY

Because of current budget surpluses, some believe the funds allocated to state and local governments under the CARES Act and ARPA were unwarranted, prompting proposals to withdraw remaining aid and implement state-level income tax cuts. But these proposals are misguided. Current assessments of the CARES and ARPA federal transfers to state and local governments should consider the long-term shortfall in spending these governments have experienced over the last 10 years. In this context, COVID-19 federal assistance can be seen as filling a spending gap left by a decade of austerity, and not just as short-term financial support for state and local governments through the pandemic. In this section, we demonstrate that at the onset of the COVID-19 pandemic, state and local government spending had just barely recovered from the Great Recession. Furthermore, when we break down overall spending into various types, it becomes clear that spending in some areas never reached 2009 levels.

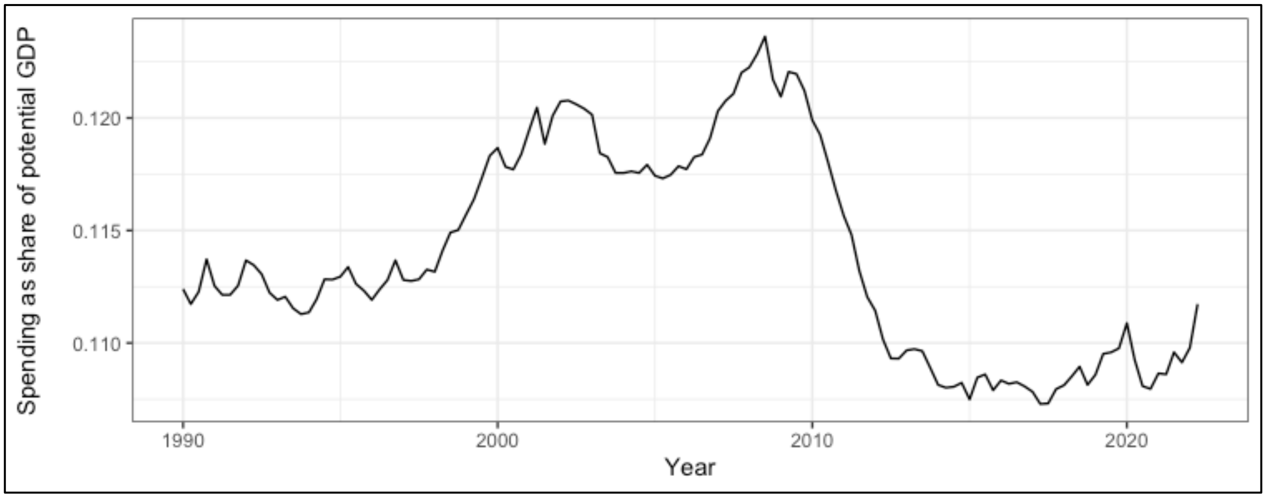
Figure 1. Real State-Local Government Spending During the 2009 Recovery



Note: The black line shows what happened to real state-local government spending after the Great Recession. The index equals 100 at the end of the Great Recession, so any subsequent index value below 100 means that the level of spending was lower than it was during the second quarter of 2009. Source: BEA via FRED.

Figure 1 shows that on an inflation-adjusted basis, it took an entire decade for state and local government spending to return to its 2009 level. At the end of the Great Recession, real state and local spending was about $2 trillion. From the second quarter of 2009 to the first quarter of 2014, state-local spending decreased, reaching a low of about $1.8 trillion. This may not seem like a large decline, but historically, state and local governments have acted as a helping force in recoveries. Their spending usually *increases* after the end of a recession. However, for five years after the Great Recession, state and local government spending contracted, slowing the overall economic recovery instead of assisting it. After 2014, state and local spending grew but did not surpass 2009 levels until the first quarter of 2020. This means that state and local government spending had only recently fully recovered from the Great Recession when the COVID-19 pandemic hit.

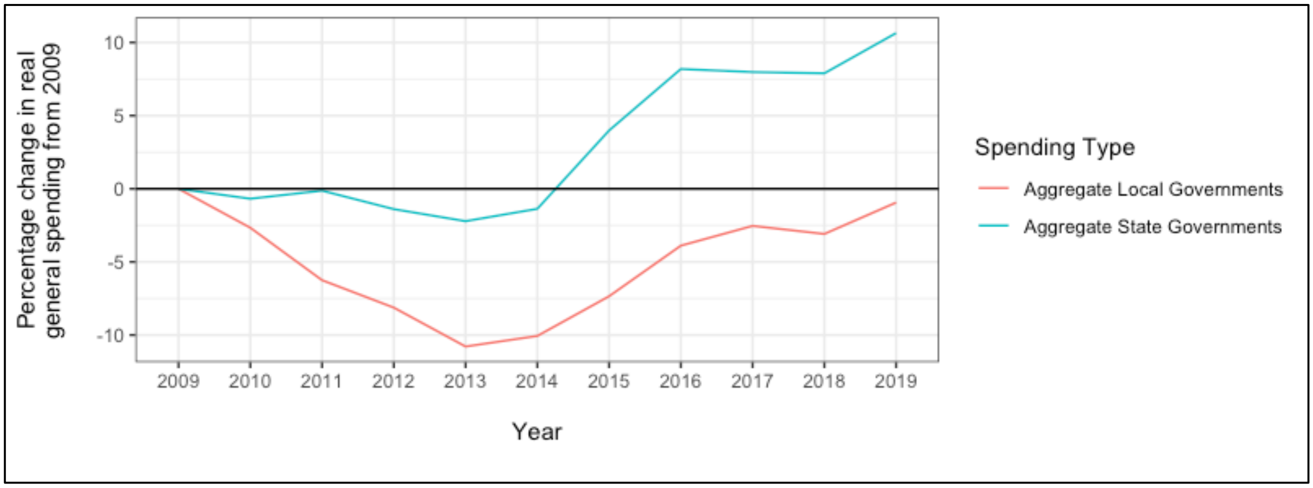
Figure 2. State-Local Government Spending as a Share of Potential GDP



Source: BEA via FRED.

Figure 2 shows that as a share of potential GDP, state and local government spending has decreased by about 1 percentage point from quarter two in 2009 to the same quarter in 2022. State and local government spending was about 12.2 percent of potential GDP in the second quarter of 2009 and about 11.2 percent of potential GDP in the second quarter of 2022. There was a sharp drop in state-local spending from the second quarter of 2009 to the third quarter of 2012, and a slow but persistent decline in spending from 2012 to 2018. Unlike the level of real state-local spending, spending by this measure has never recovered from the Great Recession. In this context, it does not make sense to use current budget surpluses for tax cuts. It is much smarter to use the funds to support spending that has been depressed since 2009. The following figures help us begin to examine where federal assistance funds should be channeled.

Figure 3. State Government vs. Local Government Spending Growth since 2009

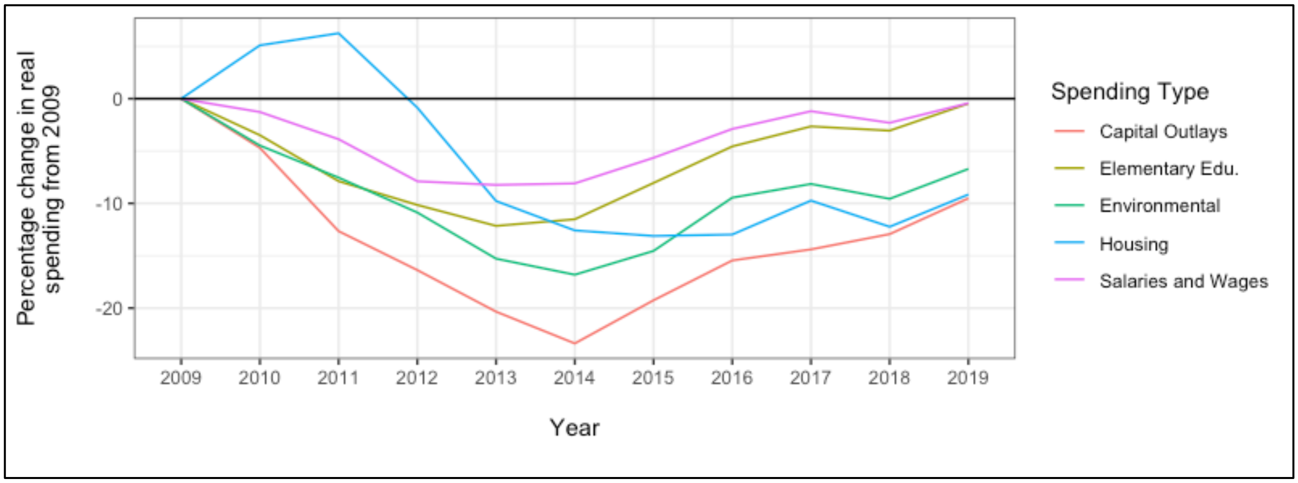


Note: Nominal dollars were deflated with state and local government implicit price deflator with a base year of 2012. Source: Annual Survey of State and Local Governments via Urban Institute and BEA via FRED.

Figure 3 shows that local government spending cuts were deeper and more persistent than state government spending cuts. In 2013, aggregate state government spending bottomed out at 2.2 percent of its 2009 spending level. However, in the following years it increased steadily. Overall, it took state government spending about five years to completely recover to 2009 levels. In contrast, local government spending was still 1 percent below its 2009 level by 2019, a full 10 years after the end of the Great Recession. The fall in aggregate local government spending was also much sharper. In 2013 and 2014, local government spending in aggregate was about 10 percent below its level in 2009. Since local government spending was depressed during the recovery from the Great Recession, it makes sense to use remaining funds from the CARES Act and ARPA to fill this shortfall rather than engage in state-level tax cuts.

Depressed local government spending has real, material impacts for communities that rely on public services. For example, New York City recently cut hundreds of millions of dollars from the city's education budget, leading to layoffs and reduced programming. This means fewer teachers and social workers, fewer arts and after-school programs, and larger class sizes (Moynihan and Fadulu 2022; Gould 2022).

Figure 4. Aggregate State-Local Government Spending Growth by Type since 2009



Note: Nominal dollars were deflated with state and local government implicit price deflator with a base year of 2012. Source: Annual Survey of State and Local Governments via Urban Institute and BEA via FRED.

Figure 4 shows that several types of state-local government spending were still below their 2009 levels as of 2019. Capital spending suffered the worst declines, dropping 23 percent below its 2009 baseline in 2014. It remained about 10 percent below the baseline in 2019. State-local government spending on housing initially increased at the onset of the recovery, but fell in 2012 and averaged 11 percent below the 2009 baseline from 2013 to 2019. Environmental spending—which includes spending on natural resources, parks and recreation, sewerage, and solid waste management—was about 7 percent of its 2009 baseline in 2019. By 2019, spending on state and local government employee salaries and elementary education was almost back to 2009 levels.

These results are consistent with the hypothesis that local governments experienced more severe cuts because most of these types of spending are conducted at the local—rather than state—level. For example, in 2019, local government spending accounted for 63 percent of capital outlays, 84 percent of housing spending, 80 percent of environmental spending, 70 percent of salary spending, and 99 percent of elementary school spending. The results here imply that the specific sectors that may benefit from remaining federal transfers are concentrated in infrastructure (capital outlays, housing, and environmental) and, to a lesser extent, overall employment and elementary education.

We have outlined the general shortfall in state-local spending from 2009 to 2019 and identified some key areas of spending that never fully recovered. With this longer-term historical context in mind, it becomes clear that the remaining federal assistance should be used to support those areas that experienced depressed spending over the last decade, and not to justify further tax cuts.

INVEST IN INFRASTRUCTURE AND EMPLOYMENT, NOT TAX CUTS

Given that the state and local government sector experienced a shortfall in spending over the last 10 years, it doesn't make sense to use budget surpluses for tax cuts. Instead, these resources should be invested back into the areas where spending was—and in some cases still is—depressed. In this section, we review how state and local governments have begun to allocate their ARPA aid. Ultimately, we make the case for more infrastructure spending, particularly in green infrastructure, and more employment support, particularly in education.

How Have State and Local Governments Spent Federal Transfers from ARPA Thus Far?

The US Department of Treasury has not yet released comprehensive data on how state and local governments have used their CARES Act and ARPA allocations. However, they have released a fact sheet that highlights a few project examples from each state (US Department of the Treasury n.d.). Although official documentation is lacking, a handful of organizations have attempted to track this spending. The National Conference of State Legislatures (NCLS) has two separate databases that track CARES allocations (NCSL 2021) and ARPA allocations (NCSL 2022) by state and by category of spending. The Council of State Governments (CSG) also has an ARPA utilization tracker categorized by state and type of spending (CSG n.d.). The CSG also has collected reports from each state that describe how they plan to use their recovery funds (CSG 2021). Brookings, in partnership with the National Association of Counties and the National League of Cities, has released a local government ARPA investment tracker

(Aguilar et al. 2022). The Center on Budget and Policy Priorities (CBPP) has collected (and made publicly available) data on state-level allocations and usage (Lazere and Hinh 2022).

The CBPP estimates suggest that as of September 2022, all state governments, plus Puerto Rico and DC, have appropriated about $157 billion out of the $198 billion in federal transfers, or around 79 percent. The final deadline to appropriate the remaining ARPA transfers is December 31st 2024 and the final deadline to spend the funds is December 31st 2026. Thirty-two state governments, Puerto Rico, and DC have allocated 80 to 100 percent of their ARPA aid. Only one state government (Oklahoma) has allocated under 20 percent of its ARPA transfers. Brookings estimates that large counties and cities have budgeted about 41 percent of their overall ARPA aid, but have budgeted about 82 percent of the aid they received in 2021. Cities budgeted about 55 percent of their total allocation while counties only budgeted about 30 percent of their allocation (Berube et al. 2022).

As Tables 2 and 3 show, one of the most frequently cited uses of the ARPA aid is revenue replacement at the state level and general government operation spending at the local level. This implies that the federal aid was necessary to help support state and local government budgets during the COVID-19 downturn. Another major reported use of the ARPA aid at the state and local level is capital construction, 21 percent and 10.1 percent respectively, with the bulk falling in the subcategories of broadband and water/sewer. At the state level, about 11 percent of ARPA aid has gone to unemployment insurance (UI) funds, with almost no funding toward improving UI systems. This is somewhat surprising given the widespread stories across states of UI websites crashing due to the massive increase in volume of initial unemployment claims. Human services is another popular area of state ARPA allocation, at 14 percent, with the bulk of the funds going toward housing (9 percent). At the local level, housing was allocated a similar share—9.3 percent. However, food assistance for both state and local governments thus far has been relatively low, at 0 percent and 1.5 percent, respectively. Funds allocated to education at the state level thus far have hovered around 7 percent. Local governments have allocated about 14 percent to government employee wages or hiring, while little has been allocated for return-to-work bonuses at the state level (0 percent).

Table 2. State Government Allocations of ARPA Aid, by Category of Spending

Category of Spending	Percentage of Total Appropriations
Revenue Replacement	15%
Capital Construction	21%
Unemployment Insurance	11%
Health	10%
Human Services	14%
Economic Development	11%
Education	7%
Public Safety	3%
Other	7%

Note: The category of revenue replacement here are funds that will be used as general revenue, meaning funds that have not yet been allocated to any of the specific types of spending listed above. Source: Lazere and Hinh 2022.

Table 3: Local Government Allocations of ARPA Aid, by Category of Spending

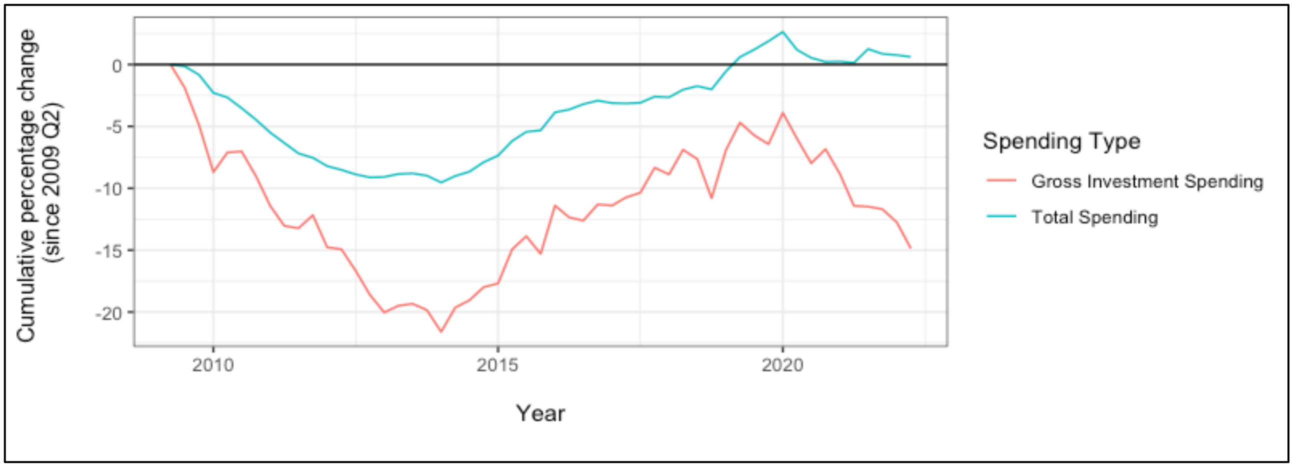
Type of Spending	Percentage of Total ARPA Funds
Government Operations	43.5%
Housing	9.3%
Community Aid	8.4%
Public Health	11.7%
Infrastructure	10.1%
Economic Workforce Development	9.1%
Public Safety	7.5%

Source: Aguilar et al. 2022.

Why Do We Need More Capital Spending?

If state and local governments have already used 21 percent and 10.1 percent of ARPA aid, respectively, on capital construction, why is there a need to do more? First, the data shows that state-local government capital spending is still depressed. Figure 5 shows that state-local government investment spending has not only not returned to its 2009 level but as of the second quarter of 2022 it is almost 15 percent below the 2009 baseline. The figure demonstrates how capital spending growth has lagged far behind overall spending growth during this period and how the gap has widened substantially in the past year.

Figure 5. State-Local Government Total Spending vs. Investment Spending from 2009 Q2 to 2022 Q2



Note: Nominal dollars were deflated with state and local government implicit price deflator with a base year of 2012. Source: BEA via FRED.

Second, we should engage in more capital spending because there is much work to be done. The American Society of Civil Engineers (ASCE) graded US infrastructure in 2021 as a C-, a slight improvement from 2017's D+. The report notes that there is a "water main break about every two minutes" and that "about 43 percent of public roadways are in poor or mediocre condition" (ASCE 2022). State and large local governments usually develop capital budget plans that can span up to five or ten years into the future. These plans document the current and prospective needs to maintain existing infrastructure and build out new infrastructure to accommodate population growth. These plans include lists of projects that are sorely needed, as identified by the officials who live and work in these states and cities. One obvious area to focus on is housing. As Figure 4 showed, state-local government housing spending was on average 11 percent below the 2009 baseline between 2013 and 2019.

Third, state and local government infrastructure spending can help achieve other socially desirable goals, such as reducing inflationary pressure and reaching climate change targets. Our country's crumbling infrastructure does not only inconvenience the residents who use it day-to-day, but also contributes to increased pressure on prices. For example, an ocean port that's experienced underinvestment may not be large enough or have the technology to handle even a small increase in the volume of ships (Alloway and Weisenthal 2021). These bottlenecks can put upward pressure on transportation costs, which may ultimately be passed on to the consumer. Producers of goods and services that rely heavily on oil and gas might increase prices to offset fluctuations of increased input costs. Making investments in clean, renewable energy can help reduce exposure to volatile oil and gas prices, decreasing inflationary pressures from these sources in the future. We saw in Figure 4 that environmental spending was cut sharply during the recovery from the Great Recession and remained 7 percent below its 2009 baseline as of 2019. The environmental category includes spending on natural resource conservation, promotion, and development as well as storm sewer maintenance—all areas that are important to the development of climate resilient, green energy infrastructure. Remaining federal aid should be channeled to help fill the environmental spending shortfall. To date, only 0.3 percent of local government ARPA aid has been allocated to green infrastructure projects.

Furthermore, policymakers who are concerned with current rates of inflation but do not wish to engage in fiscal austerity should support infrastructure spending. New infrastructure projects, such as libraries or bridges, can add up to substantial amounts of spending; however, the timeframe during which this spending takes place is stretched over several years. For example, before construction can begin on a new project, land may have to be acquired, environmental assessments may have to be conducted, the design must be drawn up, and the work must be contracted out.[1] Thus, capital spending can help fill longer-term shortfalls, relieve inflationary pressure in the long run, and avoid contributing to inflation in the short run.

[1] See Page-Hoongrajok (2021) for more details on lags in the capital spending process.

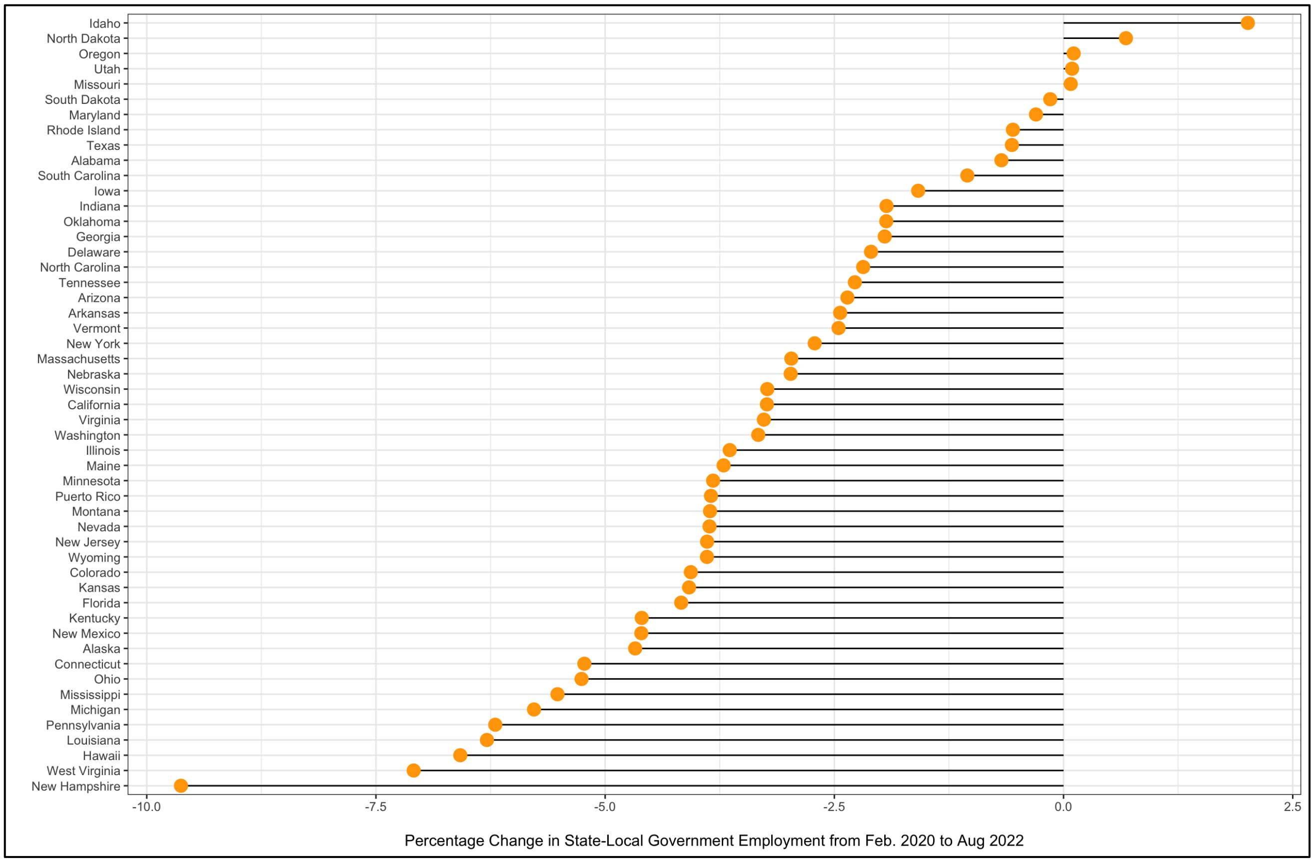
Why Should State and Local Governments Use the Aid to Support Public Employment?

The remaining federal aid should be used to replenish state-local government employment for two major reasons. First, public workers were laid off in the wake of the Great Recession and again during the pandemic. Second, the evidence shows that across states, state-local government employment has not recovered to where it was before the onset of the pandemic. In fact, the ARPA guidance contains explicit permission to use the federal aid for employment purposes.

As Figure 4 (above) shows, payroll spending had just barely recovered to its 2009 level before the onset of the COVID-19 pandemic. This shortfall in spending was immediately followed by another decline. Public employment at the state and local government level dropped sharply, like many other sectors. However, unlike other sectors, public employment at the state and local government level has remained depressed.

Figure 6 shows the percentage change in state-local government employment from the start of the pandemic (February 2020) to the present (August 2022) across all 50 states and Puerto Rico. Only two states, Idaho and North Dakota, have posted positive employment growth over this period. Every other state has lower public employment than it did at the onset of the pandemic. New Hampshire, West Virginia, and Hawaii had the worst government employment cuts at 9.6, 7.1, and 6.6 percent reductions, respectively. The average employment cut was about 3.1 percent, meaning state-local government employment is currently about 3.1 percent lower than it was at the start of the pandemic. The remaining aid could be used to shore up this employment gap rather than enact more tax cuts at the state level.

Figure 6. Percentage Change in State-Local Government Employment from Feb. 2020 to Aug. 2022, Across States



Note: This data is seasonally adjusted. Source: Bureau of Labor Statistics (BLS).

A major stated goal of the ARPA aid was to support public sector employment. The US Treasury Department outlines three ways the aid could be used toward this goal: restoring pre-pandemic employment, supporting and retaining public workers, and covering administrative costs to hire, support, and retain workers. In fact, the Final Rule on the ARPA aid, which dictates appropriate uses of the funds, states:

> SLFRF funding may be used to support a broader set of uses to restore and support public sector employment. Eligible uses include hiring up to a pre-pandemic baseline that is adjusted for historic underinvestment in the public sector, providing additional funds for employees who experienced pay cuts or were furloughed, avoiding layoffs, providing worker retention incentives, and paying for ancillary administrative costs related to hiring, support, and retention. (US Treasury Department 2022d)

However, to date, local governments have only allocated about 14 percent to government employee wages or hiring.

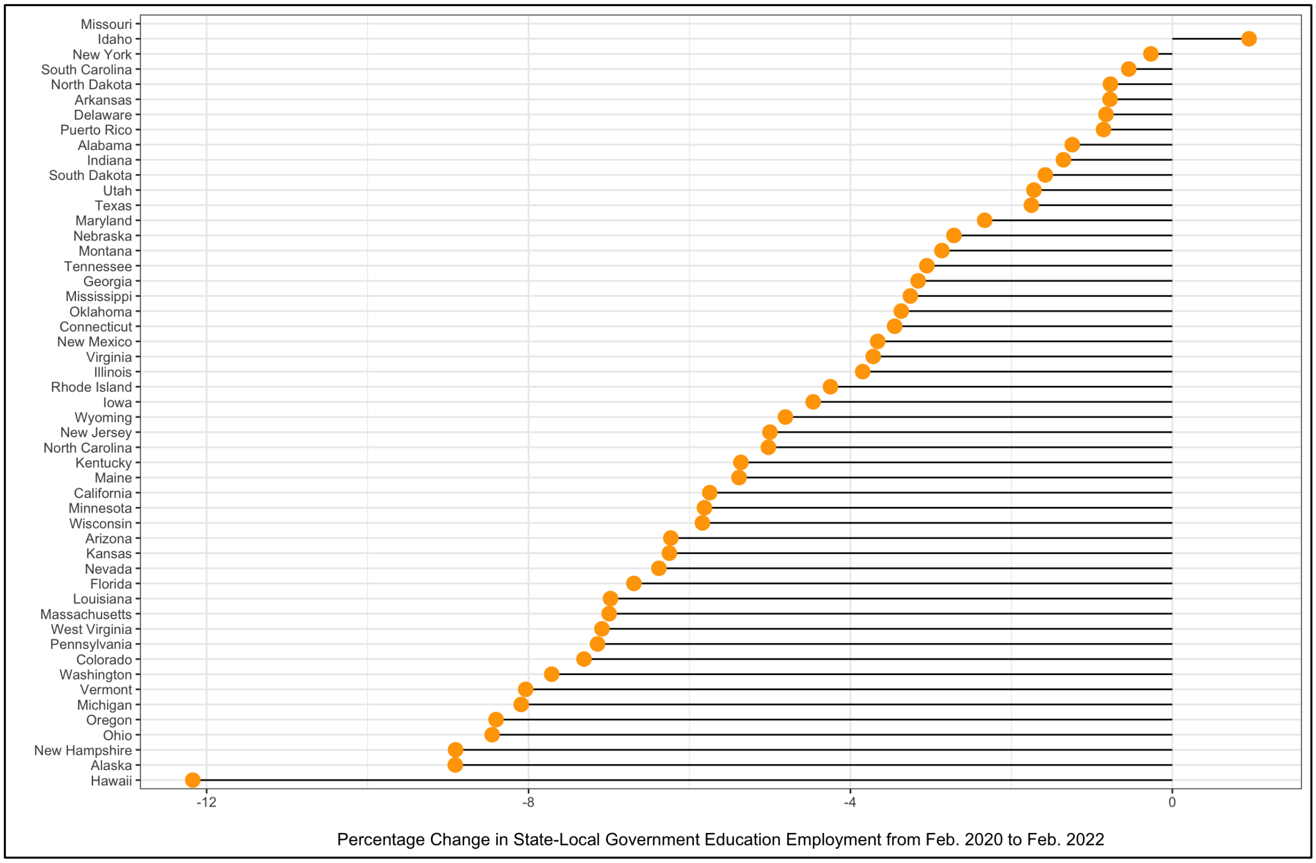
Why Should State and Local Governments Use the Aid to Support Public Education Employment in Particular?

Like payroll spending, elementary and secondary education spending had only recently returned to its 2009 level before COVID-19 hit. Figure 7 shows the percentage change in non-seasonally adjusted state-local government education employment from the start of the pandemic, in February 2020, to February 2022.[2] Only one state (Idaho) has experienced positive growth in state-local government education employment. Twenty-four states have state-local government education employment levels that are 5 or more percent lower than their February 2020 level and seven states have levels that are 8 or more percent lower than the 2020 baseline. On average across states, the level of education employment is 4.6 percent lower than the level in February 2020.

One of the stated purposes of the ARPA aid was to support essential workers who "have and will bear the greatest health risks because of their service in critical sectors" (US Department of the Treasury 2022a). It seems that public education workers may fit this criterion as schools transition back to in-person learning. However, to date, state ARPA funds (specifically the State and Local Fiscal Recovery Funds [SLFRF]) allocated to K-12 and higher education are around 2 percent each. Thus, remaining federal transfers should be used to rehire educational professionals who were laid off or to reopen positions that were eliminated during the past two downturns.

Figure 7. Percentage Change in State-Local Government Education Employment from Feb. 2020 to Feb. 2022, Across States

[2] The Bureau of Labor Statistics (BLS) does not have state and local government education employment data for each individual state on a seasonally adjusted basis. Therefore, we chose an endpoint of February 2022 to make sure any decline in education employment is not due to the fact that the endpoint was during the summer months.



Note: Data is not seasonally adjusted; therefore, February 2022 was selected as the endpoint rather than using the most recent data (August 2022). Hawaii and Puerto Rico include state government only, since no local government numbers were reported. Missouri reported no educational employment data at the state or local government level. Source: BLS.

CONCLUSION

This brief has argued that state and local governments experienced a long-term spending shortfall over the last decade and that we should view the federal aid distributed during the pandemic as not merely a response to the COVID-19 downturn but as support for a sector barely back on its feet after the last recession. In this context, we argue that any surplus funds should be put toward historically underfunded public services, rather than tax cuts. First, state-local government infrastructure and natural resource spending never recovered to its 2009 levels, and infrastructure spending remains depressed today. Although state governments have allocated a promising 21 percent of ARPA funds to capital construction thus far, local governments (which do the bulk of the nation's capital spending) have allocated only 10.1 percent to infrastructure and only 0.3 percent to specifically green projects.

Second, state-local government payroll and elementary education spending had just barely recovered at the onset of COVID-19. These two areas have also been hard hit by the pandemic. Across almost all states, state-local government public employment is at a lower level than at the start of COVID-19, and education employment has grown more slowly than overall public employment.

There are two broad lessons here for structuring future state and local government aid packages. First, federal government support in expansions can help decrease the amount and scale of stimulus needed in the future. At the onset of COVID-19, the private sector reduced inventories sharply in anticipation of a weak governmental response and a drawn-out recession. If state and local governments had the support they needed during the recovery from the Great Recession, perhaps such a robust stimulus package would not have made as much sense. Second, more research needs to be done on the interconnections between state and local government budgets and macroeconomic policy. For example, understanding why state and local government revenue grew so slowly after the Great Recession might have helped us better anticipate the robust recovery in state-local tax revenues in the most recent recovery.

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