Insight

The American Rescue Plan: Coronavirus State and Local Fiscal Recovery Funds

GORDON GRAY | APRIL 8, 2021

Executive Summary

- The American Rescue Plan (ARP) provides $362.05 billion in fiscal assistance for state, local, municipal, tribal, and territorial governments, even as subnational government finances appear to have stabilized and with several states now showing surpluses.
- The ARP pairs this aid with a number of vague restrictions, particularly with respect to offsetting revenue reductions.
- These restrictions may complicate the efficient and timely use of these funds and may expose states and localities to recoupment at a later date.

Introduction

State and local governments have been at the front lines in combating the COVID-19 pandemic and have been charged with administering a substantial share of the household relief provided by Congress. On a bipartisan basis, federal policymakers have recognized the vital role of these subnational governments in the public health and economic crisis and have provided them with hundreds of billions in supplemental funding. Since last year, however, both the health and economic conditions of the country have improved – although the virus itself remains a threat – and aggregate subnational government revenues are even up over last year.

Despite these improvements, the recently enacted American Rescue Plan (ARP) provides over $350 billion in new funding for state, local, tribal, and territorial governments. Paired with the funding are vague restrictions on the use of the relief funds that at once appear to grant wide latitude to spend the federal funds but also introduce complexity and uncertainty around those allowable uses. The ARP's restrictions on using the funds to offset revenue reductions is particularly problematic. While the restrictions may seem simple, the ARP does not provide adequate clarity on how these restrictions may interact with other policies – including those otherwise implemented in the ARP and by the administration.

State and Local Assistance Funding

In March, the president signed into law the ARP, a $1.9 trillion spending bill nominally related to the COVID-19 pandemic. Among the major provisions in the new law are substantial appropriations – $362.05 billion – for state, local, municipal, tribal, and territorial government fiscal assistance. The pandemic has had disparate impacts on communities throughout the United States, and given the scale of the COVID-19 challenge, federal support to subnational governments has been an important component of the federal response to the pandemic. In the preceding COVID-19 bills, Congress appropriated about $212 billion in aid to such governments. As these measures were being debated and considered, state governors were engaged in a vocal lobbying effort for $500 billion

in direct federal aid to make up for projected revenue shortfalls. That interested parties may lobby Congress for more than they may need is hardly new, and given the uncertainty surrounding the economic and public health outlook, the governors' concerns over potential budget shortfalls affecting public services were not wholly unreasonable.

The passage of time, trillions in federal expenditures, and the miracle of modern medical innovation has allayed the worst fears for states' and localities' bottom lines, however. A year after the pandemic began, the data show that in the aggregate, state and local tax revenue is up about 2 percent from last year. Some states are enjoying something of a revenue boom. To be sure, not every state is awash in new tax revenue – tourism-dependent Hawaii and oil-dependent Alaska and North Dakota have seen significant drops in revenue. But states that base their budgets on oil are necessarily exposed to price fluctuations and plan accordingly, or should reconsider their tax policies. The upshot is that while there have been some legitimate needs, the subnational funding in the ARP is excessive – as much as 116 times the needs by one measure. The $362 billion pot of funding is somewhat of a policy in search of problem.

Allowable Use of Funds

While the aid aims to strengthen the fiscal position of subnational governments, numerous restrictions both undermine this goal and venture more into states' authority to determine their own tax and spending priorities than is typical of the federal government. When Congress appropriates funds, it specifies how those funds may be used and for how long the funding is available. The ARP similarly provides for two tranches of funding for state and local governments in sections 602 and 603 of the legislation, respectively. Section 602 establishes the Coronavirus State Fiscal Recovery Fund (CSFRF) and provides $219.8 billion for states, territories, and tribal governments, plus $50 million for administrative expenses. The funding is available until the end of 2024. Similarly, section 603 establishes the Coronavirus Local Fiscal Recovery Fund (CLFRF) and provides $130.2 billion for cities, counties, and other local governments, which is also available through the end of 2024. The stated purpose of both funds is to "mitigate the fiscal effects stemming from the public health emergency with respect to the Coronavirus Disease (COVID-19)."

While simple enough in concept, the respective Relief Funds come with some additional restrictions and conditions that are somewhat complex and internally inconsistent. The funds provided under these sections may be used for four major categories of approved spending. The first allowable use is "to respond to the public health emergency with respect to the Coronavirus Disease 2019 (COVID–19) or its negative economic impacts, including assistance to households, small businesses, and nonprofits, or aid to impacted industries such as tourism, travel, and hospitality." The second allows for providing "premium pay to eligible workers." The third condition allows for the funds to be used for "the provision of government services to the extent of the reduction in revenue" experienced by the governmental entity. Finally, the funds provided under sections 602 and 603 may be used "to make necessary investments in water, sewer, or broadband infrastructure." Fundamentally, these conditions allow subnational governments to provide direct aid to households and businesses, provide funds for public and private essential workers, fund operating budgets, and make certain approved capital expenditures with the federal funds. The statute precludes making pension fund contributions.

The legislation empowers the Secretary of the Treasury to recoup funds that do not comport with the restrictions and adjust on a pro-rata basis the disbursements to subnational governments. As highlighted by the Senate Finance Committee, however, the allowable use of funds introduces a number of complications and requires substantial clarification from Treasury to identify just what states and localities can and can't do with these funds. The ARP requires states and localities to certify that they need the funds provided and for the allowable uses. Yet there remains considerable uncertainty over what the full scope of those allowable uses are, and what

criteria receiving governments may use to assess compliance with the funds' restrictions.

Revenue Restrictions

Where the ARP goes more afield than typical and introduces a degree of incoherence to the overall policy is in Sec. 602(c)(2)(A), which requires that the relevant funding cannot be used to:

… either directly or indirectly offset a reduction in the net tax revenue of such State or territory resulting from a change in law, regulation, or administrative interpretation during the covered period that reduces any tax (by providing for a reduction in a rate, a rebate, a deduction, a credit, or otherwise) or delays the imposition of any tax or tax increase.

It seems plain that the intent of the legislation is to prevent subnational governments from giving "tax cuts" to their citizens while receiving federal funds. On its face that seems a reasonable limitation if the goal of the policy is to stabilize subnational governments suffering profound revenue declines due to an international pandemic. But the policy is somewhat more ambitious and allows for the funds to be used to provide households, families, and institutions relief. The restriction on funds being used to "indirectly" offset a reduction in revenues through any number of legislative or administrative state actions is somewhat more puzzling and heavy-handed.

While one can understand not wanting to subsidize state-level tax reductions through federal funds, the restriction on "indirect" reductions and the mechanisms for those indirect reductions contemplated in the legislation (e.g. changes in law, regulations, or administrative interpretations) is at odds with other policies put in place by the administration and Congress. For example, in the ARP, Congress exempted up to $10,200 from federal taxation. If the national policy is to provide unemployment insurance benefits tax-free, what is the rationale for precluding states from adopting a similar policy, as 602(c)(2)(A) would appear to do? The Internal Revenue Service recently announced a delay in the tax filing deadline; would states lose funding under 602(c)(2)(A) for following suit? The Tax Foundation has explored additional scenarios that demonstrate the confounding nature of this policy.

In general, the excessive funding, paired with vague and complicated restrictions, lend a sense of incoherence to the policy. The legislation at once grants subnational governments the authority to make determinations as to how much revenue has been lost due to COVID-19 for the purposes of using the federal funds to finance government services, but as a policy matter precludes those governments from using the state tax code to deliver assistance to households and businesses. As Treasury Secretary Yellen observed in recent testimony before Congress, these restrictions raise "thorny questions" as to how these purportedly struggling states can use the federal funds. Legislation introduced by members of the Senate Finance Committee would obviate at least some of these thorns by eliminating the revenue-related restrictions.

Conclusion

After a year of vocal lobbying, state and localities secured $362 billion in additional funding, paired with a number of restrictions on how those funds can be used. The legislation allows for fairly varied uses of the funds for spending, and grants these governments apparent latitude in some areas while simultaneously highly restricting the disposition of funds in others. These restrictions may complicate the efficient and timely use of these funds and may expose states and localities to recoupment at a later date. The ARP further restricts the use of these funds to preclude the funds being used to offset any reduction in revenue. In practice, this policy introduces some needless confusion and complexity for states and stands at odds with other policies enacted in

the ARP and elsewhere.