GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-11-401, a report to congressional committees

March 2011

STATE AND LOCAL GOVERNMENTS

Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance

Why GAO Did This Study

The most recent recession, which started in December 2007, is generally believed to be the worst economic downturn the country has experienced since the Great Depression. In response to this recession, Congress passed the American Recovery and Reinvestment Act of 2009 (Recovery Act), which provided state and local governments with about $282 billion in fiscal assistance. The Recovery Act requires GAO to evaluate how national economic downturns have affected states since 1974. In this report, GAO (1) analyzes how state and local government budgets are affected during national recessions and (2) identifies strategies to provide fiscal assistance to state and local governments and indicators policymakers could use to time and target such assistance. This report is being released in conjunction with a companion report on Medicaid and economic downturns to respond to a related statutory requirement in the Recovery Act. GAO analyzed economic data and states' general fund budget data; reviewed past federal fiscal assistance and related evaluations; and interviewed analysts at key associations and think tanks. GAO shared relevant findings with policy research organizations and associations representing state and local officials, who generally agreed with our conclusions. We incorporated technical comments from the Bureau of Labor Statistics.

GAO identifies strategies for Congress to consider but does not make recommendations in this report.

View GAO-11-401 or key components. For more information, contact Stanley J. Czerwinski at (202) 512-6806 or czerwinskis@gao.gov, or Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov.

What GAO Found

Understanding state and local government revenue and expenditure patterns can help policymakers determine whether, when, where, and how they provide federal fiscal assistance to state and local governments in response to future national recessions. In general, state and local governments' revenues increase during economic expansions and decline during national recessions (relative to long-run trends). State and local revenue declines have varied during each recession, and the declines have been more severe during recent recessions. Additionally, revenue fluctuations vary substantially across states, due in part to states' differing tax structures, economic conditions, and industrial bases. State and local government spending also tends to increase during economic expansions, but spending on safety net programs, such as health and hospitals and public welfare, appears to decrease during economic expansions and increase during national recessions, relative to long-run trends. These trends can exacerbate the fiscal conditions of state and local governments given that demand for health and other safety net programs increases during recessions, and these programs now consume larger shares of state budgets relative to prior decades. This implies that, during recessions, state and local governments may have difficulties providing services. To mitigate the effect on services from declining revenues, state and local governments take actions including raising taxes and fees, tapping reserves, and using other budget measures to maintain balanced budgets.

Although every recession reflects varied economic circumstances at the national level and among the states, knowledge of prior federal responses to national recessions provides guideposts for policymakers to consider as they design strategies to respond to future recessions. Considerations include

- **Timing** assistance so that the aid begins to flow as the economy is contracting, although assistance that continues for some period beyond the recession's end may help these governments avoid actions that slow economic recovery;
- **Targeting** assistance based on the magnitude of the recession's effects on individual states' economic distress; and
- **Temporarily** increasing federal funding (by specifying the conditions for ending or halting the state and local assistance when states' economic conditions sufficiently improve).

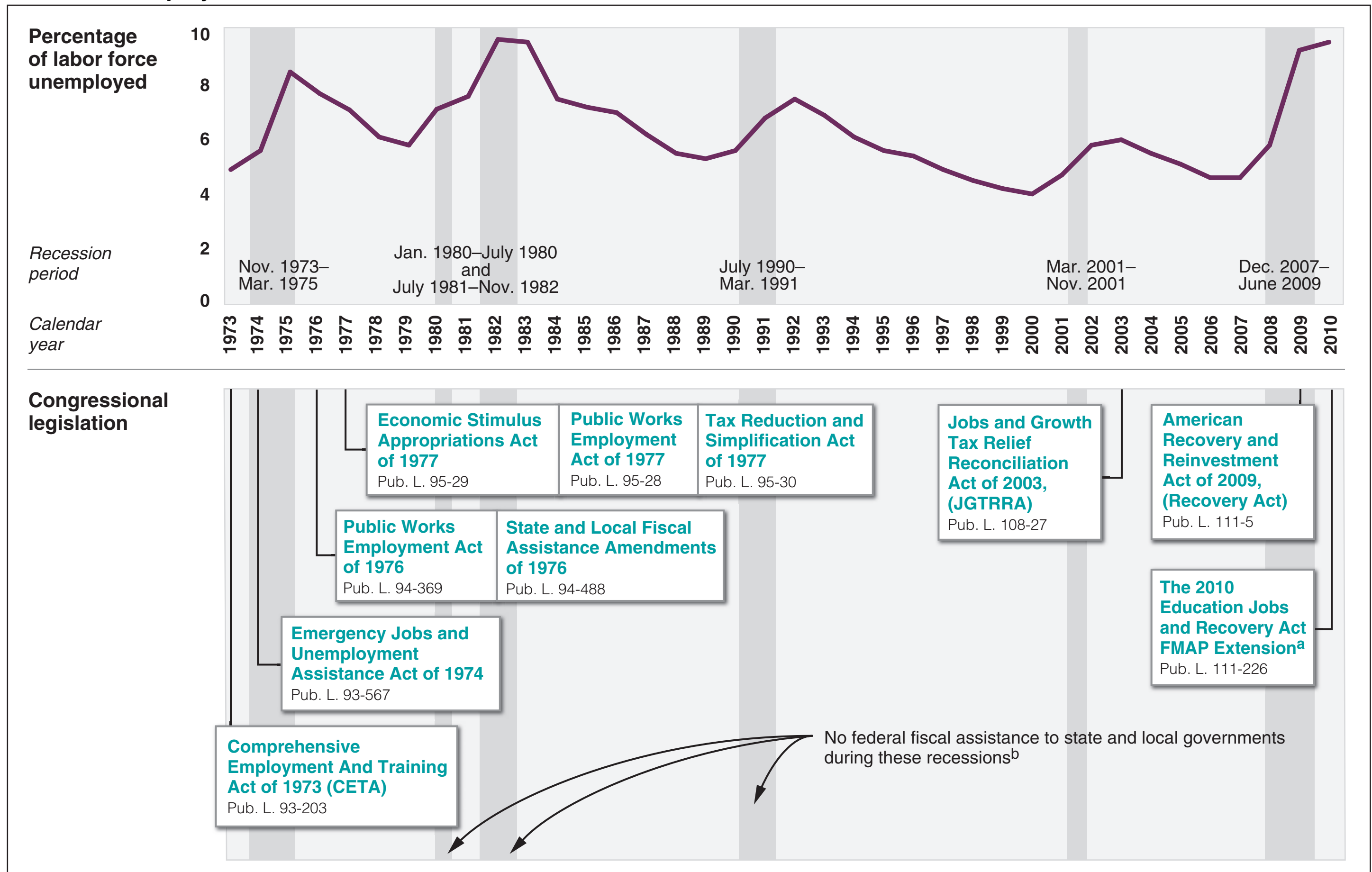
Policymakers also balance their decision to provide state and local assistance with other federal policy considerations such as competing demands for federal resources.

Policymakers can select indicators to identify when the federal government should start and stop providing aid, as well as how much aid should be allocated. Timely indicators are capable of distinguishing states' economic downturns from economic expansions. Indicators selected for targeting assistance are capable of identifying states' individual circumstances in a recession. In general, timely indicators capable of targeting assistance to

states can be found primarily in labor market data. Indicators such as employment, unemployment, hourly earnings, and wages and salaries also offer the advantage of providing information on economic conditions rather than reflecting states' policy choices (a limitation of data on state revenue trends). In some cases, it may be appropriate for policymakers to select multiple indicators or select indicators to reflect their policy goals specific to a particular recession.

States have been affected differently during each of these recessions. For example, unemployment rates, entry into, and exit out of economic downturns have varied across states during past recessions. Federal responses to prior recessions have included various forms of federal fiscal assistance to these governments as well as decisions not to provide direct fiscal assistance to these governments. In three of the six most recent national recessions, the federal government did not provide fiscal assistance directly to state and local governments. However, during these recessions, the federal response included increased spending for other programs such as unemployment insurance as well as increases in existing grants not administered by state and local governments. When the federal government has provided fiscal assistance directly to state and local governments in response to national recessions, such assistance has included unrestricted fiscal assistance, increased funding for existing programs, and new grant or loan programs. Federal assistance in response to the recessions beginning in 1973 and 2001 represented a relatively small share of total federal grant funding to the sector. In contrast, the 2009 Recovery Act provided a significant increase in grant funding to the sector and helped offset the sector's tax receipt declines. The figure below summarizes the national unemployment rate, recession dates, and federal fiscal assistance to state and local governments since 1973.

National Unemployment Rate and Federal Fiscal Assistance to State and Local Governments, 1973 to 2010



Sources: GAO analysis of BLS and NBER data, federal fiscal assistance public laws, and pertinent legislative history.

[a]Pub. L. No. 111-226 has no official title, so we refer to this act as The 2010 Education Jobs and Recovery Act FMAP Extension.

[b]Other forms of federal assistance were provided, but these approaches did not focus on fiscal assistance to state and local governments.