A COVID-19 Federal Fiscal Recovery Plan for US States and Localities

OCTOBER 2020

Lourdes Germán, J.D.
Asst. Prof. of Practice & Co-Director
Boston College Carroll School of Management
germanl@bc.edu

Aaron Seybert
Managing Director, Social Investment Practice
The Kresge Foundation
atseybert@kresge.org

THE KRESGE FOUNDATION

SIP1035-1020

Introduction

The United States is facing an unprecedented fiscal crisis due to the global COVID-19 pandemic. It has led to the U.S.'s gravest recession since World War II and has resulted in the largest declines in per capita output in economies worldwide since 1870.[1] The fiscal health of state and local governments, which are primarily dependent on stable revenues and a healthy economy, face severe dislocations and rising resident demands. Concurrently, the pandemic has laid bare widespread systemic inequality and revealed how communities of color are disproportionately affected by COVID-19. To that end, the goal of this paper is to introduce policy recommendations and solutions that can stabilize and grow the fiscal base of U.S. cities during and after the COVID-19 crisis.

We will begin by summarizing the most notable fiscal trends impacting local governments in COVID-19's wake. These trends will inform short-term and long-term priority action areas. Next, we will outline new policies and programs to consider at the Federal level to enable municipalities to stabilize, strengthen, and grow fiscally via strategies that address fiscal health and equity. Historically, cities emerging from a recession with successful fiscal growth and investment strategies do not often ensure that emergent economic opportunities are equally accessible to underserved geographic areas and populations, thus exacerbating underlying economic and racial inequality. Therefore, it is essential that fiscal recovery strategies include meaningful measures to address the needs of underrepresented groups, to rebuild an economy that encourages inclusive growth and leaves no one behind.

The State of Local Government Public Finance in a COVID-19 World

COVID-19 has spawned extreme reductions in fiscal capacity, at levels that far exceed the last Great Recession. All primary local tax revenue sources in U.S. cities slowed in 2020, and most cities have reported average expectations of 13% declines in the coming fiscal year's revenues.[2] As of late August 2020, local governments reported a $360 billion revenue shortfall due to these factors arising from the pandemic.[3] These declines are occurring at a time of dramatic growth in expenditure needs that, in the opinion of nearly 90% of finance officers, is challenging their ability to meet the fiscal needs of communities in the coming fiscal year, according to a recent National League of Cities study.[4]

As of late August 2020, local governments reported a $360 billion revenue shortfall due to these factors arising from the pandemic.

Yet despite the widespread hardship, the COVID-19 fiscal crisis is not affecting all localities equally.[5] Cities in regions with a high or disproportionate economic dependency on particular sectors—such as mining, oil, gas, transportation, employment services, travel, leisure, and hospitality—have been especially vulnerable to the recessionary effects of the pandemic.[6] Also, the economic and health impacts of COVID-19 have also varied widely by race and ethnicity, with Hispanic and African-American communities hardest hit.[7] Municipalities more reliant on income taxes, sales tax, hospitality taxes, casino revenues, and the like will be further at risk for the foreseeable future. A recent study by the Brookings Institute noted that Midwestern industrial cities are most at risk from COVID-19's economic fallout, given the elasticity of their revenues to human interaction.[8] The Brookings Institute study also underscored how majority-minority cities with property values that are relatively low compared to peer cities are also at risk, as they rely more on elastic forms of income.[9]

The fiscal condition of state governments can also exacerbate a city's budgetary problems during an economic downturn and, as a result, should be considered and addressed when devising solutions to the COVID-19 fiscal crisis. Many American cities receive approximately 30% to 40% of revenues from intergovernmental transfers from state governments. Where an extensive revenue reliance on budgetary transfers from states exists, localities often face elevated fiscal risks if state budgets become so constrained that there is less revenue to distribute to localities in the form of grants, tax-sharing arrangements, or other mechanisms. While states are traditionally poised to withstand periodic deficits without endangering their long-term fiscal health, the pandemic has unexpectedly intensified the challenges states were already facing, leaving many with abruptly diminished resources. The federal government's decentralized response to the COVID-19 crisis has effectively created an unfunded mandate. States and local governments must pick up the tab for a national health crisis without the necessary resources to do so. For instance, costs for Medicaid, a health care program representing the second-largest budget expense for most states, have increased significantly during COVID-19.[10] As a result, revenue and expenditure imbalances exist in several states, jeopardizing their respective long-term fiscal stability.[11] The circumstances surrounding these states indicate potential broader trends of unstable fiscal dynamics, wherein American cities nationwide may not be able to depend upon states as a reliable and consistent source of intergovernmental aid.

At present, 70% of CARES Act funds for state and local governments have already been allocated. Still, only 36 of the 19,000 cities, towns, and villages in the United States have received direct assistance under the CRF.

Targeted federal aid also plays a crucial role in a crisis, but the two primary national COVID-19 programs intended to support cities have lacked consistency and widespread adoption. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted in March 2020, created the Coronavirus Relief Fund (CRF) to provide direct aid to states, cities, and other localities. At present, 70% of CARES Act funds for state and local governments have already been allocated. Still, only 36 of the 19,000 cities, towns, and villages in the United States have received direct assistance under the CRF.[12]

The Federal Reserve also established the Municipal Liquidity Facility (MLF) to support the immediate flow of credit and liquidity to state and local governments borrowing money during the pandemic, under Section 13(3) of the Federal Reserve Act.[13] The heart of the program established a Special Purpose Vehicle (SPV), which is empowered to purchase $500 billion of short-term notes directly from states, counties with a population of at least 500,000 residents, and cities with a population of at least 250,000 residents.[14] Currently, the MLF program has not been used to its full capacity to support transactions by many municipalities due to many practical difficulties associated with the program and other factors. It will sunset in December

2020, absent further federal action to extend the program.[15]

In response to these events and trends, many cities have begun imposing service cuts, layoffs, furloughs, and delays in spending to ease budgetary pressures.[16] Where cities cannot raise new revenues from intergovernmental channels or their own sources, many may resort to borrowing via municipal capital markets as a mechanism to raise money for infrastructure, to refinance past debt liabilities to generate savings, and to borrow money to account for short-term revenue gaps. However, many of the cities affected most by COVID-19 are limited in borrowing ability, given high existing debt obligations, reduced revenues available for debt service, and declining credit quality, affecting bond ratings and raising capital costs. Any federal intervention must be designed to address the fiscal limitations of each jurisdiction and provide resources equitably.

Priority Areas for Action, Strategies & Policy Recommendations

To help local governments emerge from the COVID-19 fiscal crisis, a series of short- and long-term interventions and policy responses are necessary. Those avenues should be attentive to cities' unique needs, guided by values of equity, and reflective of important inter-governmental dynamics.

Direct Municipal Support

First, localities need additional federal direct aid. This aid would afford cities access to additional funding and greater flexibility to use such funds to cover a broader range of costs associated with COVID-19. When establishing the list of reimbursable expenses for a new federal aid program, it is essential to ensure that all emergency, personnel, and equipment costs incurred by states and localities related to COVID-19 are eligible expenditures. A new direct federal aid program's expiration date should not be arbitrary and should wind-down in a phased approach that acknowledges the different regional experiences and economic needs tied to the pandemic.[17] The financial toll of COVID-19 is heavily dependent on implementing a successful public health campaign to control a pandemic where several variables remain unknown. In regions and cities where containment remains unpredictable, the future might include prolonged shutdowns of various economic sectors and industries, resulting in reduced consumption and investment patterns, increased unemployment, heightened volatility of municipal and state revenues, and an expanded need for federal aid.

Reforming and Expanding the Municipal Liquidity Facility (MLF) of the Federal Reserve

The Federal Reserve has expanded its lending programs to states and cities, enlarging the boundaries for what a central bank can do given the unprecedented nature of the crisis and fulfilling its mission to promote the health of the U.S. economy and the stability of its financial system. However, cities have had limited use of key programs. Therefore, the Federal Reserve should reform the MLF program to realize the program's full potential as an avenue that offers expanded credit market liquidity to cities.

At present, rather than turning to the MLF, cities continue borrowing in significant numbers, using the capital markets as a consistent source of liquidity.[18] The list of eligible instruments for purchase by the SPV should be expanded to reflect better actual borrowing patterns exhibited by cities accessing the capital markets during the COVID-19 crisis. In addition, the Federal Reserve should examine the efficacy of the fee structure associated with participation in the MLF program. This fee restructuring could expand the degree to which municipal governments use the program and provide issuers with significant savings. The expansion could also include extending the SPV's purchasing authority to include borrowing vehicles critical to helping cities manage the top budgetary stressors arising under COVID-19, such as refunding bonds, where an issuer refinances outstanding bonds by issuing new bonds to reduce their interest costs and generate savings.

If the Federal Reserve expanded the MLF program to include the refinancing and refunding of existing municipal bonds under certain conditions, it could design the program in targeted ways. For example, the Federal Reserve could limit such a program to municipal governments considered to be hardest hit by COVID-19, using the refunding vehicle to generate present and future debt service savings. The Tax Cuts and Jobs Act made previously tax-exempt interest on advance refunding bonds taxable, eliminating or reducing many of the savings generated via advance refunding bonds issued after December 31, 2017.[19] If the Federal Reserve can support issuers by providing a lower transaction cost when they engage in refunding transactions, it can be particularly meaningful in an environment where every single dollar of savings is significant.

For a municipality, this could generate millions of dollars in savings that otherwise would have been allocated to debt service available in their general fund to use for other purposes. A municipality's general fund typically consists of assets and liabilities used to finance most municipal governments' daily and long-term operations. The noted expansion of the MLF could expand a municipal government's available resources to invest in health care, small businesses, housing, and other necessary investments required to stabilize their local economies and prevent further life loss.

The Federal Reserve should also consider re-examining the maximum maturity period for securities issued under the MLF program.[20] Currently, the maximum term is 36 months (an increase from 24 months) when the program was first created in April. An expansion of the maximum term could better support issuers and expand the SPV's use by aligning the SPV's purchasing powers to actual capital market needs and borrowing patterns manifesting during the crisis.

Create a new U.S. Treasury Credit Enhancement Program for Hardest Hit Cities

The COVID-19 crisis has reached every corner of the country, but the severity of impact has been uneven. Majority-minority cities and communities of color have felt the impact more acutely on economic and human fronts. Cities with large communities of people of color earning low wages tend to be cities of "front line" or "essential" workers. Many of these communities have experienced disproportionate infection rates, mortality rates, unemployment levels, and wage loss, all of which combine with historical barriers in health care access and employment. The Treasury Department has a long history of establishing temporary guarantee programs to address temporary dislocations in credit markets. It should use its broad authority to guarantee the municipal securities obligations of hardest-hit municipalities to lower their overall borrowing costs, particularly where the cities have weaker credit profiles.

In designing the guarantee program, the Treasury should make necessary assets available to support the guarantee and structure the program to ensure participation won't jeopardize the tax-exempt treatment of interest of tax-exempt municipal securities covered by the guarantee. The guarantee program should be designed carefully given potential constitutional and legislative limitations to encourage cities to adopt more sound fiscal management practices and discourage cities from pursuing revenue-raising efforts more likely to exacerbate the crisis's impact on individuals with low incomes.

Expand Federal Tax Credit Programs

The Treasury could also use its expansive powers to create new tax credit programs to support cities facing significant operating and capital expenditure needs in key sectors where the challenge is greatest and integral to funding a healthy functioning community. In the past, tax credit programs have allowed municipal governments to raise money from institutional investors at a zero percent rate in discrete and time-limited programs. For example, Qualified Zone Academy Bonds (QZABs), authorized under Section 54A of the Internal Revenue Code, enabled municipalities to borrow money at zero percent to fund select program and infrastructure expenditures for educational facilities located in economically distressed communities. This includes schools where at least 35% of students came from families whose income was below 130% of the Federal poverty level and other criteria.[21] Investors were compensated with a tax credit from the Treasury rather than interest payments from the municipality.[22] The program included states as meaningful partners, with a structure that provided allocations to states that placed controls on issuance volume by their localities via a volume cap mechanism.[23]

Similar programs were enabled for renewable energy, energy conservation, and school construction projects. They represented some of the lowest-cost public financing avenues available for municipal governments funding projects in the noted sectors.[24] If tax credit bond programs are expanded to fund new sectors where cities (particularly those hardest hit) are facing rising investment needs, this can present a crucial source of low-cost capital to further inclusive growth. Expanding zero-percent borrowing avenues via tax credit bond mechanisms will also forestall immediate erosions in solvency and prevent interruption of essential investment. This will enable cities managing extreme deficits, which have declining credit qualities, access to critically important capital in ways they otherwise may not get in traditional capital markets without risking solvency.

Although such actions stand to increase the role of the Treasury in the economy, these policies and programs can be adopted with a measured approach that places proper limitations on the program, including sunset provisions tied to economic indicators of fiscal progress and recovery within cities that could be monitored and administered in partnership with states.

Create a Program to Enhance A Long-Term Plan for Municipal Fiscal Stability

Recognizing that it is not enough to address acute insolvency risks with short-term relief mechanisms, it is vital to consider the Treasury's role in advancing long-term fiscal strategies. The Treasury should adopt the first comprehensive Urban/Rural Economic & Equity Investment Program for municipal governments. The program would enable hybrid investment in local governments' operations and capital needs guided by two values—advancing fiscal sustainability and furthering a moral and economic imperative to help communities collectively embrace the promise of inclusive growth.

The program would be the first of its kind. It would elevate the need to approach investment opportunities with a regional lens and to develop essential community facilities and programs in urban and rural areas in ways that leverage multiple potential sources of funding at different stages of projects and initiatives. In this way, funding should be available in several complementary forms:

- Low-interest direct loans, offered on a tax-exempt or taxable basis depending on the nature of the financing and scope of what is to be funded, structured in a revolving loan fund;
- Zero percent loans, where investors are compensated with U.S. Treasury tax credits, where essential tax-exempt purposes are financed;
- A loan guarantee program for municipalities seeking credit enhancement as part of the financing arrangement;
- Grants to support feasibility, planning, and funding for other necessary operations that are essential to the sustainability of the project or initiative being financed; and
- A program that expands land-based financing and value capture mechanisms at scale that enables localities to leverage potentially underutilized funding sources fully.

A priority point system based on population, median household income, racial disparities, and fiscal distress could be implemented to limit funding awards and participation to regional projects or initiatives demonstrating the most significant need for those underserved by traditional market sources of capital and equity metrics (i.e., communities with distinct population size, cities having a median household income below a percentage of the state nonmetropolitan median household income, among others). The priority point system can also be attentive to municipalities that demonstrate challenging revenue practices, such as excessive reliance on revenue from forfeitures, fines, seizures, or highly regressive revenues. It could support them in reducing such practices by broadening their approach to resource mobilization. An over-reliance on the noted revenue sources often disproportionately impacts individuals with low incomes and runs counter to healthy equity outcomes.

Using a revolving fund mechanism coupled with tax credit and direct lending options could allow the program to be self-sustaining. This usage would offer various debt-structuring tools that would encourage participation by small- and mid-sized cities that have mostly been unable to utilize existing federal support to address COVID-19. Revolving fund mechanisms and tax credit programs have been used successfully in federal programs that enable financing of essential purposes such as water, sewers, and schools. They have also been used for decades for economic development purposes, establishing many proven models well suited for this context that could be explored and adapted by the Treasury into one new comprehensive program.[25]

The program would be innovative and singular in its approach to economic development with specific attention to regional outcomes and by recognizing that cities are economic growth engines that do not operate in a vacuum separate from community investment and other government actors.

Conclusion

Researchers and economists agree that COVID-19 has created fiscal challenges of an unprecedented nature. New solutions are needed to ensure that cities can preserve financial solvency and sustainability while being guided by fairness and equity values for all residents, particularly the most underserved. To date, traditional public finance approaches that encourage local economic development in the United States have been sporadic and lack intentional integration with development, urban planning, equity, and community investment decisions that impact regional outcomes.

The programs and policy recommendations presented here would set the foundation for changing that. They would encourage a first step toward exploring expanded inter-governmental collaboration to ensure that a post-COVID-19 economy can operate at its full potential by introducing new economic inclusion models in which state and local governments can partner to produce strong social outcomes on a regional scale. This paper serves as a point of departure for future research aligned with these recommendations. Research would assess these practices' feasibility, the legislative changes needed, and significant constitutional and legal limitations that must be evaluated to enable these policies and programs at a federal level and support American cities in using them to tocreate and implement successful and sustainable economic futures.

Notes & References

1 World Bank. Global Economic Prospects, June 2020. Ed. M. Ayhan Kose and Franziska Ohnsorge (Washington, DC: World Bank, 2020), doi: 10.1596/978-1-4648-1553-9.

2 Christiana K. McFarland and Michael A. Pagano, City Fiscal Conditions 2020. (Washington, DC: National League of Cities, 2020), https://www.nlc.org/resource/city-fiscal-conditions-2020.

3 McFarland and Pagano, City Fiscal Conditions 2020.

4 Ibid.

5 Mark Muro, Robert Maxim, and Jacob Whiton, "The Places a COVID-19 Recession Will Likely Hit Hardest," The Brookings Institute, The Avenue (blog), March 17, 2020, https://www.brookings.edu/blog/the-avenue/2020/03/17/the-places-a-covid-19-recession-will-likely-hit-hardest/.

6 Muro, Maxim, and Whiton, "The Places a COVID-19 Recession Will Likely Hit Hardest".

7 Mark Hugo Lopez, Lee Rainie, and Abby Budiman, "Financial and health impacts of COVID-19 vary widely by race and ethnicity," Pew Research Center, Fact Tank (blog), May 5, 2020, https://pewrsr.ch/2L15rwr; Patricia Buckley and Akrur Barua, "COVID-19's impact on U.S. income inequality: It's going to get worse before it gets better," Deloitte. Insights (blog), July 23, 2020, https://www2.deloitte.com/us/en/insights/economy/issues-by-the-numbers/covid-19-impact-on-income-inequality.html.

8 Alan J. Auerbach, William G. Gale, Byron Lutz, and Louise Sheiner, "Fiscal Effects of COVID-19," Brookings Papers on Economic Activity, BPEA Conference Drafts, September 24, 2020, https://www.brookings.edu/bpea-articles/fiscal-effects-of-covid-19/.

9 Auerbach, Gale, Lutz, and Sheiner, "Fiscal Effects of COVID-19".

10 Barb Rosewicz, Justin Theal, and Alexandre Fall, "Fiscal 50: State Trends and Analysis. COVID-19 Abruptly Ends Decade of State Tax Revenue Growth," Pew Charitable Trusts, September 6, 2020, https://www.pewtrusts.org/en/research-and-analysis/articles/2020/09/04/covid-19-abruptly-ends-decade-of-state-tax-revenue-growth.

11 Rosewicz, Theal, and Fall, "Fiscal 50".

12 David Park, Yucel Ors, and Michael Wallace, "Local Governments Report Progress on Coronavirus Relief Funds, But Few Unobligated Dollars Remain for Cities and Towns Waiting for Aid," National League of Cities, Cities Speak (blog), August 3, 2020, https://citiesspeak.org/2020/08/03/cares-act-coronavirus-relief-fund-not-enough-to-support-local-government-reopening-and-recovery/.

13 Federal Reserve Bank of New York. "FAQs: Municipal Liquidity Facility," last modified September 8, 2020, https://www.newyorkfed.org/markets/municipal-liquidity-facility/municipal-liquidity-facility-faq.

14 Federal Reserve Bank of New York, “FAQs”.

15 Ibid.

16 Mark Muro, “As COVID-19 Resurges, So Does the Threat to Local Budgets,” The Brookings Institute, The Avenue (blog), June 30, 2020, https://www.brookings.edu/blog/the-avenue/2020/06/30/as-covid-19-resurges-so-does-the-threat-to-local-budgets/.

17 International Monetary Fund, “Policy Tracker By Country: Policy Responses to COVID-19,” last modified September 25, 2020, https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19.

18 Andrew Coen, “Northeast Volume Rises Amidst Coronavirus Curveball,” The Bond Buyer, August 21, 2020, https://www.bondbuyer.com/news/northeast-first-half-volume-rises-amid-coronavirus-curveball.

19 Municipal Securities Rulemaking Board, “Municipal Securities Provisions of H.R. 1, The ‘Tax Cuts and Jobs Act,’” Market Topics (blog), January 2018, http://www.msrb.org/Market-Topics/~/media/20AB21E90C3E4103885B4E8670B1F1E8.ashx.

20 Karen Pierog, “U.S. States, Cities May Snub Fed Lending Program Over High Rates,” Reuters Business News, May 28, 2020, https://www.reuters.com/article/us-health-coronavirus-fed-states/u-s-states-cities-may-snub-fed-lending-program-over-high-rates-idUSKBN2341J3.

21 Internal Revenue Service, “Qualified and Specified Tax Credit Bonds - General FAQs,” last modified April 27, 2020, https://www.irs.gov/tax-exempt-bonds/qualified-and-specified-tax-credit-bonds-general-faqs.

22 IRS, “Qualified and Specified Tax Credit Bonds - General FAQs”.

23 Ibid.

24 Ibid.

25 United States Environmental Protection Agency, “How the Drinking Water State Revolving Fund Works,” https://www.epa.gov/dwsrf/how-drinking-water-state-revolving-fund-works.