Testimony of:

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Hearing on:

Tax Tools to Help Local Governments

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Chairman Thompson, Ranking Member Smith, and Members of the Subcommittee, thank you for inviting me to participate in today's hearing. My name is Michael Hendrix, and I serve as the director of state and local policy at the Manhattan Institute. Along with my colleagues, we seek to advance freedom and opportunity across America's communities.

My key message today is this: **Congress should focus on targeted support to fight the pandemic of Covid-19 and its direct impact on budgets, while helping state and local governments to rebuild and get their economies back on track**. Rather than papering over long-running budget problems or underinvesting in public health, we should prioritize what our infrastructure and communities actually need—and do so transparently and wisely. In so doing, state and local governments can help end this pandemic and safely reopen our economy.

THE FISCAL PICTURE

Covid-19 has devasted the lives and livelihoods of many Americans. Their communities have also felt the fiscal pain. States and localities at first faced large budgetary shortfalls as their economies locked down and public health costs soared. Indeed, many places would still be facing this fiscal plight were it not for the federal government's already unprecedented levels of aid, resilient consumer spending, and strong high-end employment.[1] In fact, some states are in finer fiscal health than even before the pandemic. What this suggests is a need for targeted fiscal relief.

While America's real GDP fell in 2020, states and local tax receipts actually increased—once you add in federal aid, revenues actually grew by nearly 10 percent.[2] As their costs from fighting the pandemic grew and layoffs loomed, Congress rightly stepped up to help. There's been $360 billion in direct relief for Covid-19 and hundreds of billions more in indirect aid—all told, Washington sent more than $1 trillion to states and localities last year.[3]

Yet even without federal help, some 21 states saw their tax receipts grow over the past year.[4] Take California, for instance. In early January, Gov. Gavin Newsom announced a $15 billion surplus in

[1] https://www.wsj.com/articles/covid-19s-hit-to-state-and-local-revenues-is-smaller-than-many-feared-11612706030 and https://www.bloomberg.com/news/articles/2021-03-03/biden-s-state-rescue-dwarfs-tax-hit-turning-it-into-stimulus?sref=ZCmh4lE6

[2] https://markets.jpmorgan.com/research/email/9oirrqoa/jA-9jthJ33avL4Z96Lz3vA/GPS-3630418-0

[3] https://www.crfb.org/blogs/state-and-local-governments-do-not-need-half-trillion-covid-relief

[4] https://markets.jpmorgan.com/research/email/9oirrqoa/jA-9jthJ33avL4Z96Lz3vA/GPS-3630418-0

the Golden State thanks largely to capital-gains taxes in a soaring stock market.[5] The Associated Press declared that "California is again swimming in money."[6] Gov. Newsom is even printing his own stimulus checks.[7]

Or consider Arizona, which is anticipating a $352 million surplus rather than the $1.1 billion deficit projected last April.[8] Minnesota turned a $2.4 billion shortfall into a $641 million budget surplus.[9] Arkansas, Idaho, and Illinois collected more tax revenues in the first three quarters of 2020 than in the same period in 2019.[10]

Of course, not every state has avoided seeing red. With travel limits in place, tourism dollars have fled states like Hawaii, which is now staring down a $1.8 billion budget hole.[11] States dependent on taxing energy and mining are digging out too. And places with volatile sales tax dollars, like New York, have been in worse shape from lockdowns than a property tax dependent state like Vermont. In total, 26 states saw their tax revenues decline in the first 10 months of 2020.[12]

Our cities and counties also present a mixed picture. Property tax receipts remain strong.[13] But a city like New York with highly progressive personal and corporate taxes stands to lose enormous sums from even a small amount of migration of well-off individuals or firms to lower tax places like Miami—and move they have this year.[14] While in some cases, local governments are in worse shape financially than their states, state capitals are likely better placed than Washington to know how to help (and a key reason for why they have rainy day funds).[15]

One thing we know is true: federal aid to states and localities rose an astonishing 42 percent over the past year.[16] State and local governments collected more revenue in 2020 than at any time in American history—some $3 trillion.[17] Federal aid supported businesses and households, which led to economic activity and hiring that boosted state and local tax revenues, while also hiking taxable unemployment benefits. The Federal Reserve also helped prop up—and even pump up—the stock and housing markets. This federal support was aid without judgment, and no bailout either—just funding to crush the virus, help Americans in need, and get the economy back on track. We should continue this focus.

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[5] https://www.gov.ca.gov/2021/01/08/governor-newsom-proposes-2021-22-state-budget/
[6] https://www.timesheraldonline.com/2021/01/08/california-governors-budget-booms-despite-pandemic-problems/
[7] https://www.mercurynews.com/2021/01/06/newsom-proposes-new-600-state-stimulus-checks/
[8] https://news.bloombergtax.com/daily-tax-report/unexpected-state-tax-hauls-prompt-tax-relief-across-the-country
[9] Ibid.
[10] https://news.bloombergtax.com/daily-tax-report/unexpected-state-tax-hauls-prompt-tax-relief-across-the-country
[11] https://www.hawaiitribune-herald.com/2021/01/26/hawaii-news/ige-introduces-digital-economy-initiative-during-state-of-the-state-address/
[12] https://markets.jpmorgan.com/research/email/9oirrqoa/jA-9jthJ33avL4Z96Lz3vA/GPS-3630418-0
[13] https://www.nytimes.com/2021/03/01/business/covid-state-tax-revenue.html
[14] https://www.manhattan-institute.org/modeling-tax-revenue-erosion-american-cities and https://www.city-journal.org/remote-workers-fleeing-high-cost-cities
[15] https://www.washingtonpost.com/business/2021/02/15/biden-stimulus-state-local-aid/?arc404=true
[16] https://www.city-journal.org/state-and-local-revenue-has-rebounded-to-pre-pandemic-levels
[17] https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=3&isuri=1&nipa_table_list=88&categories=survey and http://www.crfb.org/blogs/state-and-local-governments-do-not-need-half-trillion-covid-relief

FEDERAL AID

Now, President Joe Biden's $1.9 trillion coronavirus relief bill arrives with nearly $350 billion in flexible aid for states, localities, territories, and tribal governments.[18] The states' $195 billion share of that sum alone would leave them with a combined budget surplus. And since the federal aid formula would in part be tied to unemployment, a state like Florida with more residents hard at work would receive some $1.9 billion less than it otherwise should on population alone, while New York wins nearly $2.5 billion more.[19] Ultimately, fiscally profligate states like New York will be rewarded more than states where unemployment is lower and budgets stronger.

There's also the Biden plan's $130 billion for reopening K-12 schools with no requirement they actually open. Then there's the $20 billion for public transit agencies and $25 billion for public housing agencies, all while rural areas struggle, and an array of other enormous sums for everything from home energy to cash assistance and pensions. Combined with the additional aid the administration hopes to give households and employers, America's states and cities are looking at a potential federal windfall of well north of a half a trillion dollars. As it stands, nearly a third of Coronavirus Relief Funds remain unspent—dollars which were meant to help states and localities pay for unexpected costs during the pandemic.[20]

In fact, only five percent of this latest spending package goes toward public health needs stemming from the pandemic, and just one percent toward vaccinations. In other words, the vast majority is being spent on symptoms rather than the cure, and at least $300 billion goes toward "long-standing policy priorities that are not directly related to the current crisis."[21]

It is true that it is harder to reopen and grow local economies while public workforces are declining during the pandemic, particularly in education. That is why opening schools will give reason to rehire these teachers and other classroom workers, while also benefiting children directly. Some $113 billion was already allocated to schools in 2021 to help them deal with the pandemic and safely reopen.[22] Yet many school-age children nationwide are still learning entirely remotely.[23] The reality is that school reopenings are driven more by politics than by science: the likelihood of in-person teaching falls dramatically in counties that voted for Hillary Clinton in 2016 or have strong teachers' unions.[24] What the science does tell us is that closing school buildings has substantially harmed academic performance among children.[25] We cannot truly restore our economy without safely reopening our schools starting now.

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[18] https://oversight.house.gov/sites/democrats.oversight.house.gov/files/COVID COR Provisions-One Pager updated.pdf

[19] https://timmerkane.medium.com/the-gigantic-flaws-in-the-1-9-trillion-covid-relief-bill-1b48d5dc92db

[20] While these funds may be allocated for future spending, Congress has yet to establish so before allocated more dollars.

[21] http://www.crfb.org/press-releases/covid-relief-bill-losing-focus

[22] https://www.ncsl.org/ncsl-in-dc/standing-committees/education/federal-stimulus-funds-for-education.aspx

[23] https://scatter.wordpress.com/2021/02/09/whos-in-person-and-who-can-be-families-access-to-and-decisions-about-in-person-instruction-in-the-wake-of-covid-19/

[24] https://www.bc.edu/content/bc-web/bcnews/nation-world-society/law-and-politics/politics-and-school-reopenings.html

[25] https://www.bloomberg.com/opinion/articles/2021-01-28/covid-is-making-the-case-for-more-school-choice

Once federal relief goes beyond fighting COVID, even exceeding actual budgetary shortfalls as the Biden plan does, it begins to look more like a blue state bailout wrapped in a poorly targeted spending spree. Across the entire economy, this nearly $2 trillion in spending will overshoot the nation's output gap—the difference between where our economy is and where it should be—by upwards of 300 percent.[26] America will have spent $5.4 trillion in 12 months.[27] Federal debt was already on track to be larger than the size of the entire economy even before the Biden stimulus package—why go for broke?[28]

Federal relief to states and localities should preserve basic services and fight the pandemic, not cover up the effect of decades of fiscal mismanagement. Any bill containing unrestricted aid in excess of direct budget needs or allocates less than one percent of its dollars to vaccination is not truly about Covid relief or fiscal responsibility. The reality is that most states can manage their budgets just fine in the wake of the pandemic as long as they keep an eye on spending.

Where many places need help the most is in investing in their own future—in the infrastructure and growth of communities across America.

TARGETED SUPPORT

Federal grants to state and local governments have already increased by more than 160 percent since 2000, reaching some $750 billion in 2019.[29] Much of this spending growth has been due to Medicaid, along with a variety of other benefits targeted at individuals, such as social services and food assistance. In short, the federal government is already doing more for states and localities than ever before.

Meanwhile, as the Congressional Research Service noted, since at least the 1980s federal grants to states and localities have de-emphasized dollars that "build public highways, support public education, criminal justice systems, economic development endeavors, and government administration."[30] For instance, while health outlays to states and localities grew by 264 percent since 2000, transportation funding expanded by 109 percent. That is to say, while federal grants to *places* have not increased as much as it has for *people*, both categories of Washington support have enjoyed sizable increases. Nevertheless, there is a gap for infrastructure and community-based investment that states and localities can help fill, and where the federal government can help them do so.

How can the federal government help states and localities gain the resources and revenue they need to invest? There are three opportunities: **first**, in rebuilding America's infrastructure; **second** in restoring this country's distressed communities; and **third**, in encouraging better transparency and accountability. Lawmakers should avoid seemingly quick fixes, like raising the State and Local Tax (SALT) cap, which would merely serve to boost the incomes of those in the top tax brackets.[31]

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[26] https://www.crfb.org/blogs/how-much-would-american-rescue-plan-overshoot-output-gap
[27] https://www.thedailybeast.com/dollar19-trillion-is-too-much-and-biden-and-the-democrats-know-it?ref=author
[28] https://www.washingtonpost.com/us-policy/2021/02/11/cbo-deficit-debt-stimulus/
[29] https://fas.org/sgp/crs/misc/R40638.pdf
[30] https://fas.org/sgp/crs/misc/R40638.pdf
[31] https://www.manhattan-institute.org/redistribution-policies-benefit-wealthy

Moreover, as a general principle, while allowing innovative approaches to state and local financing as well as lowering tax bills are good and right steps to take, federal lawmakers should ensure these do not result in waste, complication, or micromanagement.

Take municipal bond issuance for states and localities. Here, the federal government has already done much of what it needed to do to support these critical financing tools. In March 2020, the Federal Reserve stepped in to backstop the $3.8 trillion municipal bond market, a critical source of financing for states, counties, and municipalities.[32] The aim was to keep credit flowing to states and localities as they reeled in the wake of the global coronavirus pandemic. This attempt succeeded—the market for "munis" largely returned to its pre-pandemic normal.[33] And the 2017 Tax Cuts and Jobs Act (TCJA) ensured these bonds will continue to receive favorable tax treatment, particularly so that they can support essential infrastructure. Moreover, the Fed's Municipal Lending Facility is authorized to lend up to $500 billion now to states and local jurisdictions but has so far found only two borrowers: the State of Illinois and New York's Metropolitan Transit Authority.[34] With interest rates at historic lows, the private market has been eager to back state and local bond issuances on favorable terms, all without the need for overly generous federal subsidies. For most states and localities, if they need to invest in infrastructure, the bond market is generally ready to help finance it.

The most important role for the federal government should be in cutting red tape around infrastructure so that we can fix what's broken and fix it fast, while avoiding throwing good money after bad transportation projects. For instance, a new highway project in America takes an average of seven years to go through environmental reviews alone.[35] Instead, we should streamline projects and avoid costly overruns; emphasize maintenance over new projects; and prioritize the infrastructure itself over ancillary job creation or economic development goals, which rarely pencil out for taxpayers. The private funding and wherewithal are there to achieve many of these aims; it should be Washington's job to get out of the way.

It's not just infrastructure where the government can help, but in restoring America's communities. Opportunity Zones represent vital support for helping grow distressed places nationwide by providing favorable tax treatment for long-term investments there. More than 31 million Americans call these Zones home, and where the average poverty rate is 26.4 percent—much higher than the national average.[36] The federal government can support the growth of these areas by developing impact and reporting measures and designating the Treasury Department to oversee transparency on how and where dollars get invested.[37] This kind of information will not

[32] https://economics21.org/fed-enters-municipal-bond-market
[33] https://www.stlouisfed.org/publications/regional-economist/fourth-quarter-2020/how-covid-affected-municipal-bond-market
[34] https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2020/10/the-municipal-liquidity-facility-how-it-works
[35] https://www.npr.org/2020/01/09/794857523/trump-administration-proposes-major-changes-to-bedrock-environmental-law
[36] https://eig.org/opportunityzones/facts-and-figures
[37] https://eig.org/news/eig-applauds-bipartisan-bill-on-opportunity-zones-reporting-requirements

only help investors best target their long-term commitment to Opportunity Zones, but help align and coordinate state and local economic development programs in these areas with what works.

States and localities should also be required to be more transparent when issuing municipal bonds. At present, jurisdictions do not have to disclose information to investors like private bond sellers.[38] While the Securities and Exchange Commission regulates underwriters, the agency is currently prevented from ensuring disclosures by states and localities, mostly due to a belief that such jurisdictions are unlikely to default. As Yale Law's David Schleicher observes, "In a world where states and cities have to borrow from the Federal Reserve to stay afloat, and where Congress is offering huge amounts of aid, this makes less sense."[39] Transparency around municipal bond issuances allow investors and the public to better hold government to account, and for the public sector to have greater encouragement for fiscal responsibility. Requiring similar transparency around the condition of infrastructure and unfunded repair liabilities would also incentivize a rightful focus on maintenance.[40] At the end of the day, these measures should increase the trust and faith in financing our state and local governments.

These are just a few of the examples of how lawmakers can provide sensible, targeted support to America's states and localities.

CONCLUSION

As Americans, we should care greatly about the health of our state and local budgets, especially now during the pandemic of Covid-19. That is why we must remain focused on curbing this virus and safely reopening our economy. Those places that have needed emergency aid during this crisis have largely gotten it. Doing more than is necessary may not, in fact, be necessary.

Many governors and mayors have governed well throughout this crisis, showed they can curb the virus, managed their budgets capably, grown their economies, and gotten jabs into arms to end this pandemic. That's who we should really be applauding—and helping—with targeted support and greater transparency.

[38] https://www.niskanencenter.org/reasonable-conditions-for-state-and-local-aid/
[39] Ibid.
[40] https://www.congress.gov/116/meeting/house/110410/witnesses/HHRG-116-WM00-Wstate-GribbinD-20200129.pdf