2005 Market Street, Suite 2800
Philadelphia, PA 19103-7077
P 215.575.9050
F 215.575.4939

901 E Street NW, 10th Floor
Washington, DC 20004
pewtrusts.org
P 202.552.2000
F 202.552.2299

To: Meredith Moon and Luke Teater, Governor's Office of State Planning and Budgeting
From: Josh Goodman, The Pew Charitable Trusts
Date: April 29, 2021
Subject: American Rescue Plan Act Funding

In response to your request, this memo discusses three questions states should consider when deciding how to allocate federal funding from the American Rescue Plan Act (ARPA) and points to Pew research that is relevant for answering these questions. These questions include:

- What should the balance be between one-time and ongoing spending?
- Are there opportunities for states to improve their long-term fiscal position?
- What strategies can ensure initiatives to revitalize the economy are effective and accountable?

This memo builds off Pew's research on subjects such as long-term budget forecasting, rainy day fund policy, and the design, targeting, and evaluation of economic development programs. We're happy to provide additional Colorado-specific analysis on these topics or others at your request.

What should the balance be between one-time and ongoing spending?

Key ideas:

- Conduct multi-year revenue and expenditure forecasts to determine how much ongoing spending is affordable.
- Define recurring and non-recurring revenue and spending.
- Devise policies for the use of non-recurring money to avoid creating structural budget deficits.

Over the long-term, states need recurring revenue to pay for recurring expenses. A general principle of state budgeting—and one supported by Pew's research—is that states shouldn't use one-time money to increase ongoing expenses to a level that is unsustainable over the long-term.

In this context, as states consider how to spend ARPA—a massive infusion of non-recurring money—they should conduct analysis of what revenues and expenditures will look like after the federal relief expires at the end of 2024. Of course, it's hard to predict how a state's budget and economy will change four years from now and beyond (though Colorado's Taxpayer Bill of Rights simplifies analysis of how much revenue will be available to spend compared to other states). With that in mind, states' forecasts should account for a range of scenarios and assess the probability of these scenarios.

For example, last November (prior to ARPA) California's Legislative Analyst's Office produced a five-year revenue projection that included a primary forecast and ranges above and below this main forecast showing how high or low revenue collections were likely to be. Then, the office compared the revenue numbers to a projection of state spending. This analysis showed that, despite a short-term surplus, ongoing revenue was unlikely to keep up with spending under current policy.

THE PEW CHARITABLE TRUSTS

2005 Market Street, Suite 2800
Philadelphia, PA 19103-7077
P 215.575.9050
F 215.575.4939

901 E Street NW, 10th Floor
Washington, DC 20004
P 202.552.2000
F 202.552.2299
pewtrusts.org

Analysis such as California's can inform decisions about how to use ARPA money. If ongoing spending is currently below what the state is likely to be able to sustain over the long-term, then using some of the federal dollars for ongoing expenses is a reasonable choice. Based on this principle, governments could restore cuts to their programs, services, and workforces made during the pandemic, unless they already faced structural deficits before the pandemic began. They could also boost funding for programs that are temporarily experiencing increased demand such as Medicaid—Medicaid enrollment has increased by at least 10% in many states since the pandemic began and even more in Colorado—so long as the demand is expected to abate as the economy improves. But they'd want to be cautious about using the money to create new ongoing programs.

With every state grappling with decisions about non-recurring funding as a result of ARPA, now is also an ideal time for states to create or reexamine definitions of recurring and non-recurring revenue and spending. How to categorize revenue and spending isn't always obvious. For example, building a new prison might be considered a one-time cost, but staffing and maintaining it requires ongoing funding. Personal income taxes provide ongoing revenue, but during an economic boom in which tax collections grow above the long-term trend, a portion of this revenue might rightly be considered one-time money. To follow the principle that non-recurring money shouldn't increase ongoing spending to an unsustainable level, states need a clear, well-considered definitions of these terms.

Some states have developed policies and analyses to help. For instance, Alabama statute defines "recurring revenue" and "nonrecurring revenue." Based on these definitions, legislative fiscal staff identify revenue sources that are generally nonrecurring and removes the one-time payments when calculating long-term revenue trends. In acknowledgement that ongoing revenue sources sometimes grow unsustainably, Tennessee law requires its Department of Revenue to separate revenue from its corporate franchise and excise taxes—highly volatile revenue sources—into recurring and nonrecurring portions.

Once states have clarified these definitions, they can devise policies to limit the use of non-recurring money for ongoing expenses. For example, the Louisiana Constitution requires lawmakers to direct one-time money to any of a specific set of non-recurring spending categories such as capital projects, rainy day fund deposits, or to pay off bonds early. These policies could help inform states' ARPA decisions and other budget decisions in the coming years, reducing the risk of structural budget deficits.

Are there opportunities for states to improve their long-term fiscal position?

Key ideas:

- Replenish rainy day funds
- Unwind temporary budget balancing maneuvers
- Pay off long-term liabilities such as deferred maintenance

THE PEW CHARITABLE TRUSTS

2005 Market Street, Suite 2800
Philadelphia, PA 19103-7077
P 215.575.9050
F 215.575.4939

901 E Street NW, 10th Floor
Washington, DC 20004
P 202.552.2000
F 202.552.2299
pewtrusts.org

After a painful year, states are rightly eager to use the ARPA money to combat the ongoing public health crisis, help get their residents back to work, and to fund ambitious initiatives to improve their economic competitiveness. As states act to achieve those goals, however, they should also be mindful that budget surpluses offer them a rare opportunity to position their budgets for the future. While ARPA funding is temporary, states may be able to use the money to make lasting improvements to their fiscal health. Specifically, some uses of the money can help states prepare for future downturns and pay off long-term liabilities.

With regard to future downturns, rainy day funds are states' best line of defense against the budget shortfalls that recessions tend to cause. As with previous downturns, many states tapped reserves to reduce the need for spending cuts, tax increases, and other budget maneuvers—15 states withdrew money from their rainy day funds in FY 2020, while 11 included withdrawals in their enacted FY 2021 budgets. Forthcoming guidance from the U.S. Department of the Treasury may clarify in what circumstances states can deposit ARPA money in their rainy day funds. At least preliminarily, some states such as Nevada are interpreting the law to allow them to replenish money from rainy day funds that they used to balance their budgets and maintain services during the pandemic. States that have continued to add to reserves since the pandemic began at a minimum have the option to hold some money back for now to hedge against a downturn or other unexpected needs prior to January 2025. Florida's budget plan keeps $3.6 billion in ARPA funds in reserve.

Even if states aren't directly depositing ARPA money into rainy day funds, the federal aid may indirectly offer them the chance to increase savings by creating temporary budget surpluses. And, an unusually strong economy—forecasters project U.S. GDP growth for 2021 could be the highest in decades—could boost these surpluses even higher. As a result, the next year or two might be the best chance states have to increase their savings prior to the next recession—whenever it might be. To ensure they take that opportunity, states can adopt policies that automatically deposit unsustainably high revenue collections in rainy day funds. For example, by law Massachusetts automatically deposits revenue from unusually high collections from taxes on capital gains into its rainy day fund.

In addition to their formal rainy day funds, states often rely on a range of informal reserves and temporary maneuvers to close budget shortfalls. They shift money from dedicated accounts to the general fund, delay spending, move up revenue collection, and engage in short-term borrowing. Budget surpluses offer states an opportunity to unwind these maneuvers. By doing so, states can make sure the same tools are available the next time they face shortfalls, increasing their fiscal flexibility and making it less likely they'll need to enact painful spending cuts and tax increases. For states that borrowed money from the federal government for unemployment insurance payments, using ARPA dollars to repay that borrowing may fit in this category—with the added benefit that it would prevent tax increases on businesses.

In addition to preparing for downturns, states may be able to use ARPA money to pay-off old liabilities and thereby reduce long-term fiscal pressure. Deferred infrastructure maintenance is a primary

THE PEW CHARITABLE TRUSTS

2005 Market Street, Suite 2800
Philadelphia, PA 19103-7077
P 215.575.9050
F 215.575.4939

901 E Street NW, 10th Floor
Washington, DC 20004
P 202.552.2000
F 202.552.2299
pewtrusts.org

example: One estimate puts states' deferred maintenance costs at $873 billion. ARPA specifically authorizes infrastructure investments in water, sewers, and broadband, and other types of infrastructure projects may be permissible as well to the extent they respond to the economic effects of Covid-19. Infrastructure maintenance is an ongoing cost that ideally is supported by ongoing revenue. But, using a portion of the ARPA funds to pay for overdue maintenance could help states get back to a point where the long-term challenge is less daunting. Then, policymakers can devise a plan to direct ongoing revenue to pay for ongoing expenses, to prevent deferred maintenance backlogs from growing again.

What strategies can ensure initiatives to revitalize the economy are effective and accountable?

Key ideas:

- Provide immediate financial help to businesses without long-term commitments
- Focus on providing valuable information and business services
- Rigorously evaluate results

Stimulating the economy was one of federal policymakers' central goals in approving ARPA. The act is designed to both offer immediate relief to businesses and workers affected by the downturn and to help pay for big investments for states to improve economic competitiveness. The money also could help states accomplish their specific economic development objectives, whether they hope to revitalize distressed areas, increase opportunities for disadvantaged racial and ethnic groups, diversify the economy, or something else. By heeding lessons from the economic development research literature, states will be more likely to achieve their goals and do so without creating long-term budget risk.

One key lesson from this literature is that if governments choose to offer financial incentives to businesses, they should do so on short timeframes. This approach improves cost-effectiveness. Research shows that businesses tend to heavily discount money they're promised far in the future, meaning economic deals that promise businesses money for 10, 15, or 20 years offer a weaker return than shorter ones. With this principle in mind, states could choose to use ARPA to make immediate cash payments to businesses affected by the pandemic. But they should be cautious about combining ARPA dollars with other economic development programs to promise long-term support to companies beyond ARPA's December 2024 deadline.

Limiting the duration of this support is especially important because many of the types of businesses hit hardest by the pandemic are in industries that aren't typically targeted by economic development programs. In normal times, supporting businesses that are limited by local demand such as restaurants won't grow the economy, which is why states usually focus economic development efforts on export industries. Helping restaurants, retailers, and service industry businesses may make sense right now, but maintaining government financial support for these companies over the long-term is harder to justify.

2005 Market Street, Suite 2800
Philadelphia, PA 19103-7077
P 215.575.9050
F 215.575.4939
901 E Street NW, 10th Floor
Washington, DC 20004
P 202.552.2000
F 202.552.2299
pewtrusts.org

States should plan to revisit any shift in economic development priorities in response to the pandemic as conditions change. For example, in 2020 Louisiana temporarily expanded eligibility for the state's Enterprise Zone program to include the retail, accommodation, and food service industries, but lawmakers included a sunset date on the expansion.

Even without large, long-term financial commitments, states can use ARPA as a starting point to make lasting economic improvements. One of the most cost-effective ways to do so is to provide businesses with information and services that they need. For example, research shows that manufacturing extension services, in which small manufacturers receive expert guidance on how to improve their enterprises, offer a stronger return than financial incentives. And, it's not just manufacturers that benefit from information and customized services. The pandemic has driven this point home. Businesses have needed more than just cash—they've often needed help qualifying for federal assistance programs, support to transition their enterprises to a remote environment, and knowledge of how to follow public health regulations.

With this concept in mind, states could use ARPA dollars to make big investments in services for businesses that offer a long-term payoff. Improving broadband infrastructure is one example. They could also hire staff and develop online tools to help companies navigate regulations and locate and expand more easily. For example, the Washington State Department of Commerce has developed a site feasibility worksheet to help manufacturing firms understand and consider all the regulatory repercussions of various site options. The tool can help calculate the number of parking spaces that would be required for a facility of a given size, for instance, and the cost if more spaces would need to be built. Especially valuable for small manufacturers, the tool helps them understand which city, county, state, and federal requirements will apply, how to navigate the various agencies, and what the estimated cost and time for fulfilling all regulatory requirements will be. The department has also developed similar tools to help restaurants locate.

Whatever strategies states pursue, they need to make sure they are implemented well and ultimately achieve their intended goals. Rigorous evaluations can help determine the effectiveness of economic development programs. As a first step, governments can ensure they're collecting the data needed to measure whether ARPA investments achieve their goals.

Colorado already is a leader in tax incentive evaluation, thanks to regular studies produced by the state auditor, and could use the evaluation process as a starting point for assessing ARPA economic development initiatives. Conclusions from the auditor's studies conducted to date could also inform ARPA decisions—the state could direct dollars to programs that are proven to work well.