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United States General Accounting Office
Washington, DC 20548

May 7, 2004

The Honorable Don Nickles
Chairman
Committee on the Budget
United States Senate

Subject: *Federal Assistance: Temporary State Fiscal Relief*

Dear Mr. Chairman:

As part of the Jobs and Growth Tax Relief Reconciliation Act of 2003,[1] the federal government provided $10 billion in temporary fiscal relief payments to states, the District of Columbia, and the U.S. commonwealths and territories (herein referred to as states). Generally, use of these funds is unrestricted in nature; the act authorizes funds to be used to "provide essential government services" and to "cover the costs … of complying with any federal intergovernmental mandate." These funds were intended to provide antirecession fiscal stimulus to the national economy and to help close state budget shortfalls due to the recession that began in March 2001.[2] According to the National Conference of State Legislatures (NCSL), in February 36 states reported facing budget shortfalls with a cumulative budget gap of about $25.7 billion.[3]

This report responds to your February 13, 2004, request and subsequent agreement with your office to provide information to help Congress assess the use of the temporary state fiscal relief payments. Specifically, we are reporting (1) what is known about the potential impacts of unrestricted fiscal relief on the fiscal behavior of states, (2) how the temporary fiscal relief payments were distributed among the states relative to their fiscal circumstances, and (3) how state budget officials report these funds were used. The temporary fiscal relief payments reviewed in this report were designed to provide assistance to help state and local governments address cyclical deficits prompted by the recent economic downturn. These payments were

[1] Pub. L. No. 108-27, Title VI, May 28, 2003.

[2] A recession begins just after the U.S. economy reaches a peak of activity and ends as the economy reaches its trough. The National Bureau of Economic Research identified the period of the recession from the peak to the trough month (March 2001–November 2001).

[3] National Conference of State Legislatures, *State Budget Update: February 2003*.

not intended to address longer term structural fiscal challenges facing state governments, and accordingly our report does not address these issues.[4]

To respond to this request, we used findings from our and other reports on unrestricted federal aid to describe the known potential impacts of such funds on the fiscal behavior of states. We obtained data on the distribution of fiscal relief funds from the Department of the Treasury and compared this information with indicators of state fiscal circumstances we selected from our and other reports on grant design. We also discussed the use of fiscal relief funds with senior budget officials from 12 states with varying fiscal circumstances. We conducted our review from February to April 2004 in accordance with generally accepted government auditing standards. For a more complete discussion of our approach, see the scope and methodology section.

Results in Brief

Temporary state fiscal relief funds share common characteristics with similar programs enacted in the 1970s that provided unrestricted funds to state and local governments. Past analyses of these programs can provide insights into the potential impacts unrestricted funds can have on the fiscal behavior of state governments. For example, previous studies have noted that the effectiveness of unrestricted aid on stabilizing state finances during economic downturns can be limited if this aid is delayed beyond the trough of the downturn, or if the aid is not targeted to entities most affected by the recession and with the fewest available resources. Past studies have also shown that unrestricted federal funds are fungible and can be substituted for state funds, and the uses of such funds are difficult or impossible to track. One study suggested that states could come to rely on federal aid in order to close budget gaps during economic downturns instead of taking actions, such as setting aside budgetary reserves, to stabilize their own finances.

We examined the distribution of fiscal relief funds under the Jobs and Growth Tax Relief Reconciliation Act of 2003 in terms of its timing relative to national economic trends and its targeting relative to each states' fiscal circumstances. From the perspective of the national economy, the first distribution of fiscal relief funds occurred about 19 months after the end of the recession. However, employment levels continued to decline and this was reflected in continuing fiscal stress facing many states during this period. The funds were not targeted to take into account significant differences among states in the impact of the recession, fiscal capacity, and cost of expenditure responsibilities. Rather, the funds were allocated to the states on a per capita basis, adjusted to provide for minimum payment amounts to smaller states.

[4] A fiscal system is said to have a structural imbalance if it is unable to finance an average (or representative) level of services by taxing its funding capacity at average (or representative) rates. U.S. General Accounting Office, *District of Columbia: Structural Imbalance and Management Issues*, GAO-03-666 (Washington, D.C.: May 22, 2003).

According to NCSL, in April 2004 states reported facing a cumulative budget gap of $720 million, down from $21.5 billion at the same time the previous year.[5] In all of the states we contacted with the exception of New Mexico, budget officials indicated that they had used their own reserve funds, to varying degrees, to address budget shortfalls. States reported deploying fiscal relief funds in state fiscal year 2003, 2004, or planned to in future years. Many of the 12 states we contacted reported using the funds as general revenue available to support broad state purposes. The one-time federal fiscal relief funds were available to help close budget gaps and reduce the pressure for tax increases or spending cuts.

Past Experiences with Fiscal Relief Programs Provide Key Insights

Federal funding provided under the General Revenue Sharing (GRS) and Antirecession Fiscal Assistance (ARFA) programs enacted in the 1970s share common characteristics with the temporary fiscal relief funds provided under the Jobs and Growth Tax Relief Reconciliation Act of 2003.[6] Primarily, the temporary fiscal relief funds and the funds provided under GRS and ARFA were unrestricted. State or local recipient governments could choose to use the funds entirely at their own discretion. GRS funds were provided as general financial assistance to state and local governments. ARFA program funds, just as the temporary fiscal relief funds, were in part intended to stabilize the finances of state governments that had recently experienced budgetary stress due to an economic downturn.

Analyses of these programs can provide insights into the potential impacts unrestricted funds can have on state fiscal behavior. Previous studies have noted that the effectiveness of unrestricted aid on stabilizing state finances during economic downturns can be limited if this aid is delayed beyond the trough of the recession, or if the aid is not targeted to entities most affected by the recession and with the less available resources.

A Treasury study found that the timing of the ARFA funding disbursements was a key element toward the goal of stabilizing state finances during a recession.[7] The purpose of this program was to stabilize state budgets and discourage state governments from enacting tax increases or spending cuts because such budgetary actions would exacerbate the recession.[8] The Treasury study showed that the ARFA funds were poorly timed. They came late, after the trough of the recession, and did little to

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[5] National Conference of State Legislatures, *State Budget Update: April 2004*.

[6] Title I of the State and Local Fiscal Assistance Act of 1972 (Pub. L. No. 92-512) authorized general revenue sharing. Title II of the Public Works Employment Act of 1976 (Pub. L. No. 94-369) authorized antirecession payments to states and local governments.

[7] U.S. Department of the Treasury, *Federal-State-Local Fiscal Relations: Report to the President and the Congress* (Washington, D.C: September 1985).

[8] The general argument is that increasing state taxes or reducing state spending can work to offset the economic effects of federal countercyclical stimulus, such as the "automatic stabilizers" built into the federal budget that automatically reduce revenue and increase spending during economic downturns.

forestall state decisions regarding tax increases or spending cuts that could have contributed to the recession. Further, because the economy had already entered a period of strong recovery, the ARFA funds may have contributed to inflationary pressure.

Our and CBO studies noted that targeting unrestricted funds is also a key consideration in achieving effective fiscal stabilization.[9] Because recessions affect states unevenly, targeting unrestricted funds to states most affected and with less available resources could yield better results. Changes in employment rates can serve as an indicator for the magnitude of fiscal impact of the recession in that sales and income tax receipts are closely tied to employment levels. A recent Economic Policy Institute (EPI) paper noted that indicators of a state's fiscal capacity (a state government's ability to raise revenue through its taxable resource base), such as Gross State Product (GSP) or Total Taxable Resources (TTR), can also be considered.[10] Some states, relative to others, have more available resources to draw upon. States differ in their need for assistance due to variations in job losses, tax bases, and expenditure responsibilities.

We have previously reported that unrestricted funds, such as those provided under the GRS program are fungible, and easily substituted for state funds.[11] Within the context of stabilizing state budgets during recessions, the EPI paper noted that fewer restrictions governing the use of federal funds is appropriate because such funds do little to interfere with state spending priorities and can be mobilized more quickly. However, the ease with which unrestricted funds can be substituted for state funds suggests that timing and targeting issues take on a greater importance. If unrestricted federal funds are granted to a state with little need, the funds could be substituted for own source revenues and allow the state to lower taxes, increase spending, or place the funds in state reserves. Under these circumstances, the funds would do little to stabilize state budgets.

We have also previously reported that it is difficult or impossible to identify the states' uses of unrestricted federal funds.[12] Budget decisions are typically based upon total resources available to a state government. A state government can identify the amount of available unrestricted federal funds, as well as the amounts and sources of all other revenues. Once funds from different sources are commingled for budgeting purposes, it is difficult or impossible to identify the source of the dollars that fund

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[9] U.S. General Accounting Office, *Antirecession Assistance-An Evaluation*, PAD-78-20 (Washington, D.C: Nov. 29, 1977) and Congressional Budget Office, *Countercyclical Uses of Federal Grant Programs* (Washington, D.C.: Nov. 1978).

[10] Economic Policy Institute, *An Idea Whose Time Has Returned: Anti-recession Fiscal Assistance for State and Local Governments* (Washington, D.C.: October 2001).

[11] U.S. General Accounting Office, *Revenue Sharing: An Opportunity For Improved Public Awareness of State And Local Government Operations*, GGD-76-2 (Washington, D.C.: Sept. 9, 1975).

[12]GGD-76-2.

specific expenditures. Reporting on or tracking the use of funds can be somewhat meaningless where revenue sources can be used interchangeably for the same expenditures.

The potential availability of countercyclical federal funds could discourage state actions to prepare for the fiscal pressures associated with a recession. States can prepare their finances for fiscal stress and budget uncertainty, primarily through establishing budgetary reserves. Budgetary reserves (sometimes referred to as budget stabilization funds or "rainy day" funds) are available revenues set aside to provide a cushion that could be used in times of fiscal stress. According to a Center on Budget and Policy Priorities report, at the end of state fiscal year 2001 many states had accumulated substantial reserves, others modest reserves, and others none at all.[13] A Treasury study noted concerns that the availability of federal aid could discourage states from setting aside budgetary reserves to prepare for budgetary uncertainty. Unintended consequences such as this (sometimes referred to as a "moral hazard") are not new to federal-state relations when budgeting for uncertain events. For example, state budgeting for natural disasters provides an illustration of these unintended consequences. In 1999, we reported that while natural disasters and similar emergencies had an impact on state finances, states were less concerned about these situations because they relied on the federal government to provide most of the funding for recovery efforts.[14] For example, at the time, although California had experienced many catastrophic natural disasters over the prior 10 years, California did not provide any advance reserve funding for disaster costs. Instead, the state included in its budget only the estimated state share of funds needed for prior years' disasters.

The Timing and Targeting of Fiscal Relief Funds

The distribution of fiscal relief funds under the Jobs and Growth Tax Relief Reconciliation Act of 2003 occurred after the economy began to recover from the recession, but while the states were still struggling with revenue shortfalls. From the perspective of the national economy, the first distribution of fiscal relief funds occurred about 19 months after the end of the recession. In looking at three indicators of states' fiscal circumstances, we found large differences in indicators of the impact of the recession, fiscal capacity, and cost of expenditure responsibilities. The funds were not allocated according to these differences; rather, they were allocated on a per capita basis, adjusted to provide for minimum payment amounts to smaller population states. Consequently, the allocation of fiscal relief funds was not related to the state's relative need for antirecession aid.

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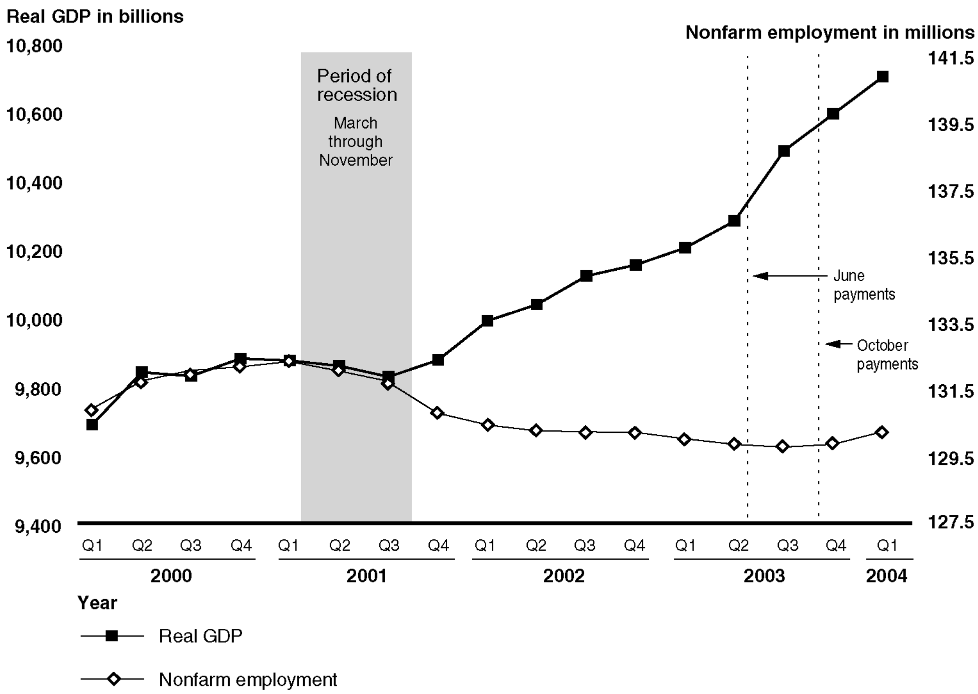
[13] Center on Budget and Policy Priorities, *Heavy Weather: Are States Rainy Day Funds Working?* (Washington, D.C.: May 13, 2003).

[14] U.S. General Accounting Office, *Budgeting for Emergencies: State Practices and Federal Implications*, GAO/AIMD-99-250 (Washington, D.C.: Sept. 30, 1999).

Payments Were Made After the National Economy Was in Recovery, but States Were Experiencing Lags in Employment Growth

The fiscal relief payments were first distributed to the states in June 2003, about 19 months after the end of the recession as measured by gross domestic product (GDP), but prior to recovery of employment levels (see figure 1). The National Bureau of Economic Research (NBER) determined that a peak in business activity occurred in the U.S. economy in March 2001.[15] This peak marked the end of an expansion and the beginning of a recession. NBER indicated an end of the recession in November 2001; however, employment levels continued to decline even after the economy entered an expansion period.

Figure 1: Levels of Real GDP & Nonfarm Employment, 2000 to 2004Q1



Source: GAO analysis of data from Bureau of Economic Analysis, Bureau of Labor Statistics, National Bureau of Economic Research, and the Department of the Treasury.

The Allocation of Fiscal Relief Funds Does Not Appear to Have a Systematic Relationship with State Fiscal Circumstances

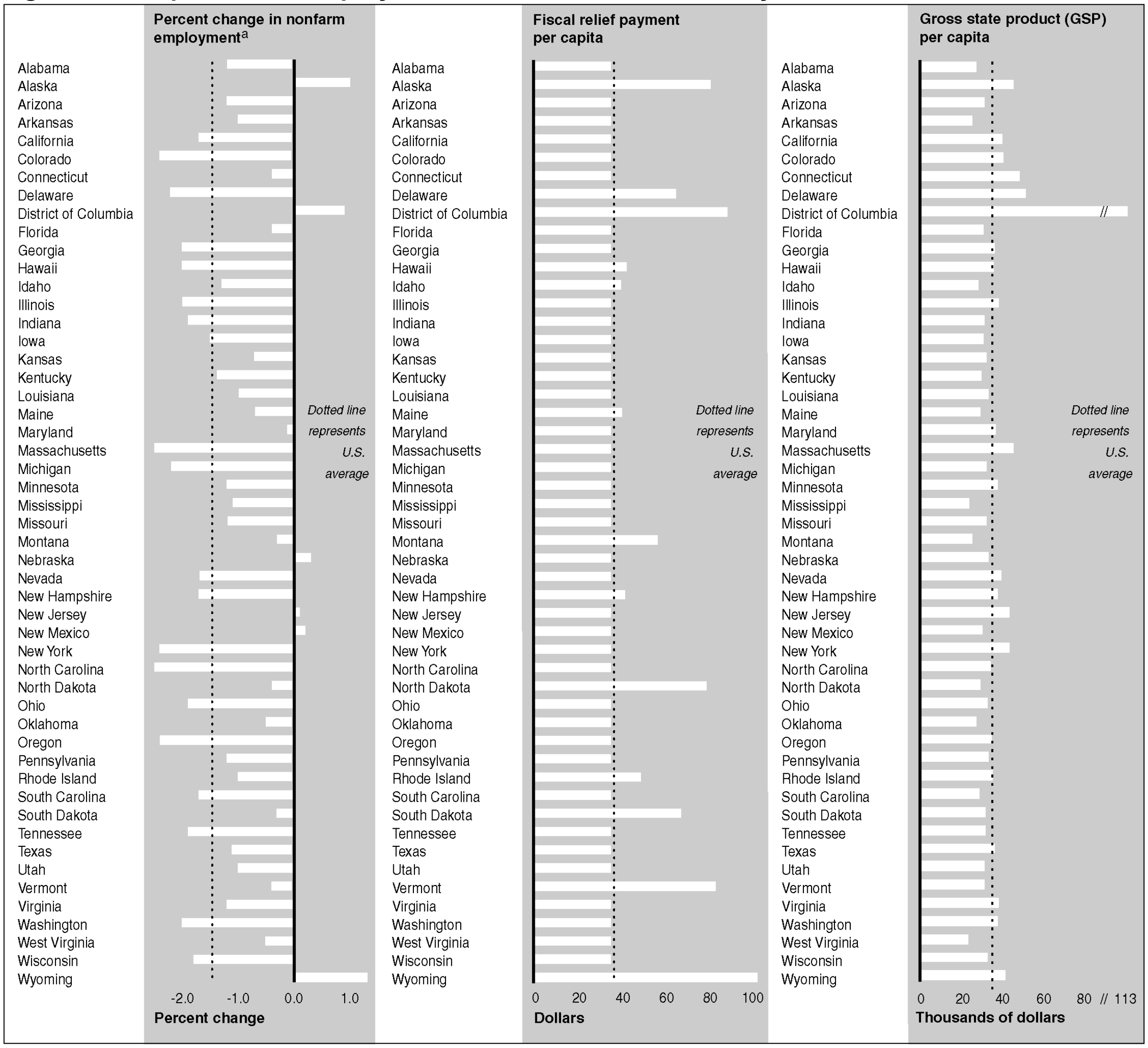
In looking at states' fiscal circumstances, we found large differences in indicators of the impact of the recession and fiscal capacity. Indicators of expenditure responsibilities, the level of public services provided by the average state fiscal system, are not readily available. We were able to draw upon employment and gross state product (GSP) data as indicators of the impact of the recession and state fiscal capacities, respectively. Changes in employment can serve as indicators of the magnitude of fiscal impact of the recession in that sales and income tax receipts are

[15] NBER, Business Cycle Dating Committee, *The Business-Cycle Peak of March 2001* (Cambridge, Mass.: Nov. 26, 2001).

closely tied to employment levels. GSP serves as an indicator of the ability of states to raise revenues from their own sources.

As figure 2 shows, the allocation of fiscal relief funds does not appear to be related to the indicators of impact of the recession on states or their ability to generate revenues from their own economic resources. For example, the recession had the least relative impact on Wyoming, as indicated by its percentage change in nonfarm employment, and it has a relatively strong tax base, as indicated by GSP per capita, however it received a larger fiscal relief payment per capita than the U.S. average. Other states, such as Indiana, Kentucky, and Michigan had much greater impacts from the recession and weaker tax bases than the U.S. average. These states all received slightly less than the U.S average per capita fiscal relief payment.

Figure 2. Comparison of Employment, Fiscal Relief, and GSP by State



Source: GAO analysis of data from Bureau of Economic Analysis, Bureau of Labor Statistics, and Department of the Treasury.

Note: The figure does not include the commonwealths and territories due to the lack of available employment and economic data.

[a] Percentage change in nonfarm employment was calculated for the identified period of the recession, March 2001 to November 2001.

There are large differences in the impact of the economic downturn among the states. The Bureau of Labor Statistics' (BLS) data on nonfarm employment is regarded as the only timely and high-quality state-level indicator for assessing economic downturns, although it has limitations. To assess the impact of the recession across states and identify those states most affected, we compared the percentage change in nonfarm employment by state during the national recession (see enclosure 1).[16] This indicator

[16] The National Bureau of Economic Research defines expansions and recessions in terms of whether aggregate economic activity is rising or falling, and it views real GDP as the single best measure of

shows that the downturn was greater in some states when compared to others. For example, Alaska had a 1 percent gain in nonfarm employment during this period, whereas North Carolina experienced a 2.5 percent loss. However, Alaska received $79.75 in fiscal relief per capita whereas North Carolina received $34.01.

There are large differences in the underlying strength of a state's tax base. A second indicator to assist targeting fiscal relief funds is the strength of the state tax base, in other words, the state's ability to generate revenues from its own economic resources. Leading indicators to measure state fiscal capacity are TTR and GSP. We chose per capita 2001 GSP to measure state fiscal capacity as it was the more recent and readily available data (see enclosure 2). The indicator shows that some states have a relatively greater ability to self finance than others. For example, Delaware had a per capita GSP of $51,696 whereas West Virginia had a per capita GSP of $23,429. However, Delaware received $63.81 in fiscal relief per capita payment while West Virginia received $34.01.

The cost of delivering an average level of services per capita varies by state. A third indicator to assist targeting fiscal relief funds is the differences among states in funding the cost of an average basket of public services. This indicator can assist in targeting fiscal relief funds to states with a higher cost of providing public services. However, this type of information is not readily available due to the sophisticated economic modeling required. However, we recently analyzed the fiscal condition of the District of Columbia in relation to other states using a representative expenditure model.[17] We reported that the District of Columbia and five states (New York, California, Massachusetts, Texas, and New Jersey) needed to spend more per capita than the 50-state average in order to fund an average basket of public services.

<u>Distribution Formula Provides Funds on a Per Capita Basis, with Minimum Payments to Smaller States</u>

The Jobs and Growth Tax Relief and Reconciliation Act of 2003 appropriated $5 billion for each of federal fiscal years 2003 and 2004. The act allocated funds to states on a per capita basis adjusted to provide for minimum payment amounts to smaller population states. The Treasury was responsible for making payments to states in two payments upon proper certification to the Treasury; the first was available in June 2003, and the second was available in October 2003. States were to certify to the Secretary of the Treasury that the use of the funds was consistent with the purposes of the act. These funds were only to be used for expenditures permitted under the most recently approved state budget. The minimum amount specified in the act for the states and the District of Columbia was $50 million and the minimum for the commonwealths and territories was $10 million.

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economic activity. Real GDP has risen substantially since November 2001. However, this growth in real GDP took the form of productivity growth. As a result, the growth in real GDP has been accompanied by falling employment.

[17] U.S. General Accounting Office, *District of Columbia: Structural Imbalance and Management Issues*, GAO-03-666 (Washington, D.C.: May 22, 2003).

As table 1 shows, 12 states, the District of Columbia, American Samoa, Northern Mariana Islands, Virgin Islands, and Guam received minimum payments, which ranged from $38.64 to $174.55 per capita. The remaining 38 states and Puerto Rico received $34.01 per capita. Although smaller states received more per capita funding in relation to larger population states, the total amount is relatively small. A total of $690 million, about 7 percent of the $10 billion in fiscal relief funds, was allocated as minimum payments.

Table 1: Total and Per Capita Fiscal Relief Payments, in Dollars

State	Total	Per capita	State	Total	Per capita
American Samoa	10,000,000	174.55	Kansas	91,420,224	34.01
N. Mariana Islands	10,000,000	144.46	Kentucky	137,441,212	34.01
Wyoming	50,000,000	101.26	Louisiana	151,968,477	34.01
Virgin Islands	10,000,000	92.07	Maryland	180,108,130	34.01
District of Columbia	50,000,000	87.40	Massachusetts	215,902,391	34.01
Vermont	50,000,000	82.13	Michigan	337,958,897	34.01
Alaska	50,000,000	79.75	Minnesota	167,287,927	34.01
North Dakota	50,000,000	77.86	Mississippi	96,733,199	34.01
South Dakota	50,000,000	66.24	Missouri	190,266,337	34.01
Guam	10,000,000	64.60	Nebraska	58,191,861	34.01
Delaware	50,000,000	63.81	Nevada	67,951,153	34.01
Montana	50,000,000	55.42	New Jersey	286,131,757	34.01
Rhode Island	50,000,000	47.70	New Mexico	61,857,045	34.01
Hawaii	50,000,000	41.27	New York	645,298,446	34.01
New Hampshire	50,000,000	40.46	North Carolina	273,718,596	34.01
Maine	50,000,000	39.22	Ohio	386,065,934	34.01
Idaho	50,000,000	38.64	Oklahoma	117,340,221	34.01
Alabama	151,224,579	34.01	Oregon	116,345,399	34.01
Arizona	174,468,230	34.01	Pennsylvania	417,619,847	34.01
Arkansas	90,909,534	34.01	Puerto Rico	129,512,591	34.01
California	1,151,812,577	34.01	South Carolina	136,429,319	34.01
Colorado	146,265,293	34.01	Tennessee	193,465,275	34.01
Connecticut	115,806,960	34.01	Texas	709,070,563	34.01
Florida	543,484,155	34.01	Utah	75,939,386	34.01
Georgia	278,382,071	34.01	Virginia	240,706,404	34.01
Illinois	422,320,693	34.01	Washington	200,430,835	34.01
Indiana	206,768,182	34.01	West Virginia	61,493,121	34.01
Iowa	99,510,268	34.01	Wisconsin	182,392,906	34.01
United States	**10,000,000,000**	**35.01**			

Source: Prepared by GAO with data from the Department of the Treasury and the Census Bureau.

Allocation of federal assistance based on population is not a novel concept and is used, at least in part, in some grant programs to apportion funding. Some advantages of using an allocation formula based on population is that the data are readily available and is meant to provide political equity among the states. However, as we have cited in previous work, using population alone in a grant formula is not an effective indicator of the relative economic circumstances of states or their fiscal capacity.[18]

State Budget Officials Report Using Fiscal Relief Funds in a Variety of Ways

The one-time federal fiscal relief funds provided by the Jobs and Growth Tax Relief Reconciliation Act of 2003 were available to help close budget gaps and reduce the pressure for tax increases or spending cuts. According to NCSL, state budget outlooks are improving, however, many states are continuing to face budget shortfalls.[19] In all of the states contacted, with the exception of New Mexico, budget officials indicated that they had already used their own reserve funds to help close budget gaps.

Some state budget officials interviewed indicated they were able to deploy these funds in state fiscal year 2003, but others planned to use these funds in state fiscal year 2004 or beyond. For example, in five states (Alabama, Louisiana, Maryland, New Jersey, and Ohio), budget officials indicated that they used their first disbursement in June 2003 to substitute for unrealized revenue or for other purposes in their state fiscal year 2003 budgets. Although North Dakota officials reported drawing upon state reserve funds in state fiscal year 2003, they were unable to budget any fiscal relief funds. Due to its biennial legislative session and accompanying budget, the North Dakota state fiscal year 2003-2005 budget was passed prior to the Jobs and Growth Tax Relief Reconciliation Act of 2003. As of our interview, the legislature was next scheduled to meet in January 2005.

In two states budget officials reported disagreement about whether the legislature or the governor could determine how the funds were to be used. Legislative budget officials in both Colorado and New Mexico indicated that the governor has not made the fiscal relief funds available to the legislature for appropriation in the respective states. In Colorado, subsequent to a State Supreme Court ruling and legislation passed by the General Assembly, the issue has been resolved. New Mexico officials have not indicated to us that the dispute has been resolved.

Most state budget officials we surveyed reported that the fiscal relief funds were placed in the General Fund, although others, such as Massachusetts and New Mexico, created a new account specifically for these funds. Some officials indicated that they dedicated funds for a specific purpose, while others told us that they have used the funds as general revenue. For example, state budget officials in Alabama indicated a portion of the funds was allocated for children's services and education. Maryland official reported some fiscal relief funds were dedicated for state police expenditures and Louisiana officials designated funds for the state's Minimum Foundation Program, a program that provides local fiscal assistance to support K-12 education.

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[18] U.S. General Accounting Office, *Federal Grants: Design Improvements Could Help Federal Resources Go Further*, GAO/AIMD-97-7 (Washington, D.C.: Dec. 18, 1996).

[19] National Conference of State Legislatures, *State Budget Gaps Shrink, NCSL Survey Finds*, http://www.ncsl.org/programs/press/2004/040428.htm (Denver: April 28, 2004).

However, as we cited previously, budget decisions are typically based upon total resources available to a government and once funds from different sources are commingled for budgeting purposes, it is difficult to verify the source of the dollars that fund an expenditure category or specific expenditures. Of the states we contacted, only Washington budget officials indicated they had allocated a portion of their fiscal relief funds directly to localities for use at their own discretion. Budget officials informed us that about $10 million of their $200 million was allocated to some localities for unrestricted use.

Table 2 provides a brief summary of state budget officials' responses to our questions about the timing of fiscal relief funds.

Table 2: State Budget Timing

State	State budget cycle and fiscal year	Legislative approval of the state fiscal year 2004 budget	State fiscal year in which relief funds were used
Alabama	Annual October 1 – Sept. 30	September 2003	2003 and 2004
Colorado	Annual July 1 – June 30	April 2003	2004 and future
Illinois	Annual July 1 – June 30	May 2003	2004
Louisiana	Annual July 1 – June 30	June 2003	2003 and 2004
Maryland	Annual July 1 – June 30	April 2003	2003 and 2004
Massachusetts	Annual July 1 – June 30	June 2003	2004 and future
New Jersey	Annual July 1 – June 30	July 2003	2003 and future
New Mexico	Annual July 1 – June 30	March 2003	2004
New York	Annual April 1 –March 31	May 2003	2004
North Dakota	Biennial July 1 – June 30	April 2003	Not budgeted yet
Ohio	Biennial July 1 – June 30	June 2003	2003 and 2004
Washington	Biennial July 1 – June 30	June 2003	2004 and 2005

Source: National Association of State Budget Officials (for state budget cycles and fiscal years) and interviews with state budget officials.

Note: Massachusetts officials indicated the date the Governor approved the budget.

Concluding Observations

The $10 billion provided to states by the Jobs and Growth Tax Relief Reconciliation Act of 2003 can be assessed from two perspectives–whether it provided fiscal stimulus that contributed to the nation's economic recovery and whether it helped states address budgetary shortfalls. It is too soon to fully assess the complete impacts of these payments. However, several observations are in order.

- The first fiscal relief payments were distributed to states when the economy was beginning to expand as measured by GDP growth. Consequently, it is doubtful that these payments were ideally timed to achieve their greatest possible economic stimulus.

- Employment growth lagged behind the economic recovery measured by GDP and state income and sale tax receipts are closely linked to employment levels. From the start of the recovery to receipt of the first fiscal relief payment overall, nonfarm employment continued to decline and therefore the fiscal relief payment likely helped resolve ongoing budgetary problems.

From an economic perspective, the allocation of relief payments among the states was less than optimal. The magnitude and timing of cyclical downturns in the economy affect states unevenly. Further, due to variations in their underlying fiscal capacities, states differ in their ability to weather economic downturns. Ideally, countercyclical fiscal assistance should take into account when and how severely states are effected by a recession and their fiscal capacities. Failure to take these differences in account reduces the effectiveness of such assistance in terms of facilitating economic recovery or in moderating fiscal distress at the state level.

Even if countercyclical assistance was well timed and targeted, its provision could have adverse consequences for how states manage their finances. Prior to the recent recession many states put away reserves which they were able to draw upon in order to help meet revenue shortfalls. However, several states put away little or no reserves. If states now believe that in response to any future recession the federal government will again provide unrestricted fiscal assistance, they could be less apt to fund budgetary reserves.

Agency Comments

We provided segments of this draft report to the state agency officials we interviewed and incorporated their comments in the report as appropriate.

Scope and Methodology

We used findings from our and other reports on unrestricted fiscal aid to describe the known potential impacts of such funds on the fiscal behavior of states. We also obtained data on the distribution of fiscal relief funds from the Department of the Treasury and compared this information to the selected indicators of state fiscal circumstances. We identified these indicators based on our and other reports on grant design.

Our selection of 12 states for this report was based in part on the indicators for fiscal capacity and impact of the recession, as well as some consideration of state population, geography, and fiscal relief minimums. However, this selection of states is not meant to be representative of the entire population and may not be extrapolated to all the states. We discussed the use of fiscal relief funds with senior budget officials from the following state offices:

- Alabama Executive Budget Office
- Colorado Joint Budget Committee and the Office of State Planning and Budgeting
- Illinois Governor's Office of Management and Budget
- Louisiana Office of Planning and Budget
- Maryland Department of Budget and Management
- Massachusetts Executive Office for Administration and Finance
- New Jersey Office of Legislative Services and the Office of Management and Budget
- New Mexico Legislative Finance Committee and the Department of Finance and Administration, Budget Division
- New York State Division of the Budget
- North Dakota Office of Management and Budget
- Ohio Office of Budget and Management and the Legislative Service Commission
- Washington Office of Financial Management, Budget Division

We conducted our review from February to April 2004 in accordance with generally accepted government auditing standards.

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As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Finance, House Committee on the Budget, and House Ways and Means Committee. We will also make copies available to appropriate congressional committees and to other interested parties on request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-6737 (daltonp@gao.gov) or Michael Springer at (202) 512-7035 (springerm@gao.gov). Jack Burriesci, Keith Slade, Robert Dinkelmeyer, and Jerry Fastrup made key contributions to this report.

Sincerely yours,

Patricia A. Dalton

Patricia A. Dalton
Director, Strategic Issues

Enclosures

Table 4: Percentage change in Nonfarm Employment, March 2001 through November 2001.

State	Percentage change	State	Percentage change
Alabama	-1.2%	Nevada	-1.7%
Alaska	1.0%	New Hampshire	-1.7%
Arizona	-1.2%	New Jersey	0.1%
Arkansas	-1.0%	New Mexico	0.2%
California	-1.7%	New York	-2.4%
Colorado	-2.4%	North Carolina	-2.5%
Connecticut	-0.4%	North Dakota	-0.4%
Delaware	-2.2%	Ohio	-1.9%
District of Columbia	0.9%	Oklahoma	-0.5%
Florida	-0.4%	Oregon	-2.4%
Georgia	-2.0%	Pennsylvania	-1.2%
Hawaii	-2.0%	Rhode Island	-1.0%
Idaho	-1.3%	South Carolina	-1.7%
Illinois	-2.0%	South Dakota	-0.3%
Indiana	-1.9%	Tennessee	-1.9%
Iowa	-1.5%	Texas	-1.1%
Kansas	-0.7%	Utah	-1.0%
Kentucky	-1.4%	Vermont	-0.4%
Louisiana	-1.0%	Virginia	-1.2%
Maine	-0.7%	Washington	-2.0%
Maryland	-0.1%	West Virginia	-0.5%
Massachusetts	-2.5%	Wisconsin	-1.8%
Michigan	-2.2%	Wyoming	1.3%
Minnesota	-1.2%	American Samoa	n/a
Mississippi	-1.1%	Guam	n/a
Missouri	-1.2%	N. Mariana Islands	n/a
Montana	-0.3%	Puerto Rico	n/a
Nebraska	0.3%	Virgin Islands	n/a
United States	**-1.5%**		

Source: GAO analysis of BLS data.

Note: BLS employment data are not available for the commonwealths and territories. Percentage change in nonfarm employment was calculated for the NBER identified period of the recession, March 2001 to November 2001.

Enclosure 2

Table 5: Gross State Product (GSP) Per Capita, 2001.

State	GSP per capita	State	GSP per capita
Alabama	$27,319	Nevada	$39,645
Alaska	$45,589	New Hampshire	$38,181
Arizona	$31,319	New Jersey	$43,424
Arkansas	$25,403	New Mexico	$30,470
California	$40,130	New York	$43,553
Colorado	$40,400	North Carolina	$34,241
Connecticut	$48,792	North Dakota	$29,594
Delaware	$51,696	Ohio	$32,917
District of Columbia	$112,679	Oklahoma	$27,199
Florida	$30,752	Oregon	$35,089
Georgia	$36,631	Pennsylvania	$33,252
Hawaii	$36,078	Rhode Island	$35,236
Idaho	$28,521	South Carolina	$28,715
Illinois	$38,291	South Dakota	$32,127
Indiana	$31,234	Tennessee	$32,080
Iowa	$31,077	Texas	$36,633
Kansas	$32,434	Utah	$31,529
Kentucky	$29,756	Vermont	$31,452
Louisiana	$33,273	Virginia	$38,577
Maine	$29,374	Washington	$37,826
Maryland	$36,818	West Virginia	$23,429
Massachusetts	$45,330	Wisconsin	$33,066
Michigan	$32,245	Wyoming	$41,350
Minnesota	$38,226	American Samoa	n/a
Mississippi	$23,597	Guam	n/a
Missouri	$32,437	N. Mariana Islands	n/a
Montana	$25,089	Puerto Rico	n/a
Nebraska	$33,289	Virgin Islands	n/a
United States	**$35,492**		

Source: GAO analysis of Bureau of Economic Analysis (BEA) and Census data.

Note: BEA gross state product data are not available for the commonwealths and territories.

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