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MTF Bulletin

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The US Treasury Guidance on State & Local Fiscal Recovery Funds: What Policymakers Need to Know

The United States Treasury recently released guidance concerning fiscal recovery funds (FRF) provided to states, counties and municipalities that were authorized in the American Rescue Plan. The guidance provides critical details on eligible uses for each of the four categories of FRF spending, as well as other use restrictions and reporting requirements. At the same time, Treasury released FRF guidance, it also provided final funding distributions. This bulletin provides a summary of critical aspects of the guidance and assesses policy implications for Massachusetts.

FRF Background

The American Rescue Plan includes $350 billion in total for state and local fiscal recovery funds, a portion of which will come to Massachusetts in four ways:

- $5.3 billion in direct aid to the state;
- $2 billion to municipalities
  - $1.7 billion in direct aid to 38 cities, based on the federal government's Metropolitan City designation;
  - $385.1 million in aid to 314 cities and towns based on population; and
- $1.3 billion in direct aid to Massachusetts' 14 counties
  - $945.8 million of which is dedicated to "inactive" counties and so will be distributed to the municipalities in those counties based on population.

The law also sets forth four pandemic-related categories of eligible uses for both states and municipalities:

1. To respond to the public health emergency or its negative economic impacts;
2. To provide premium pay to essential workers;
3. To provide government services, to the extent a recipient experienced a reduction in revenue due to the pandemic; and
4. To make investments in water, sewer or broadband infrastructure.

Beyond these broad categories of eligible use and several explicit restrictions, much of the detail on how FRFs could and should be used was left to the US Treasury to determine. On May 17th, the Federal Register published Treasury's Interim Final Rule (IFR) on fiscal recovery funds that provide many, but not all, of the details policymakers, will need in order to put forward a smart, equitable and sustainable plan to use these funds in a way that complies with federal requirements.

Understanding the IFR

The IFR is effective as of May 17th, though further adjustments and refinements are possible as Treasury solicits further feedback on the guidance through July 16th. The IFR provides background on the rationale for FRF support and then gives detailed guidelines related to eligible uses, spending restrictions, the mechanics of distribution and recoupment, and ongoing reporting requirements. What follows is a summary of MTF's key takeaways after our initial review and analysis,

Key Takeaways from the IFR

- ***Mitigation of disproportionate impact is a clear theme***

  A key focus of the IFR's guidelines and the context for them is the disproportionate impact of the pandemic on sub-populations and the importance of using resources to address that disproportionality. Disproportionate impact is discussed in two primary contexts: (1) the public health and economic effects of the pandemic on communities, workers, economic sectors, and employers; and (2) the compounding effect of the pandemic on already disadvantaged communities.

  As the IFR states in its initial overview:

  > *Finally, although the pandemic's impacts have been widespread, both the public health and economic impacts of the pandemic have fallen most severely on communities and populations disadvantaged before it began. Low-income communities, people of color, and Tribal communities have faced higher rates of infection, hospitalization, and death, as well as higher rates of unemployment and lack of basic necessities like food and housing.*

  Consistent with this overview, the IFR encourages recipients to use FRF resources in a variety of ways designed to mitigate these disproportionate impacts. Within the public health and economic impact eligibility category specifically, the goal of helping families, communities and employers who bore particular burdens since last March is emphasized. Recipients are granted significantly more flexibility in assisting communities disadvantaged prior to the pandemic.

- ***Revenue replacement is the most flexible use of FRF for the state and municipal recipients***

  Funds for "revenue replacement" (RR) provide states and municipalities with the most flexibility in how resources can be used. The IFR allows RR to be used to provide government services, which entails a broad range of activities. In fact, the IFR essentially defines what "government services" means, by way of exclusion, identifying uses that do not qualify. They include payment in support of debt service, payment of legal judgments or settlements or replenishing reserves. These activities are excluded because they do not directly provide a service to the public, but other activities performed by the government, from pay-go capital spending, to education, to public safety to health and environment explicitly qualify. In fact, almost all projects eligible for FRF support in one of the other three spending categories would also be eligible as a revenue replacement expenditure.

- ***The calculation to establish allowable revenue replacement spending is complicated***

  The IFR establishes a formula for all recipients to determine a cap on RR spending. Recipients are required to make this calculation annually for each calendar year from 2020 – 2023. Therefore, upon receipt of FRF resources, Massachusetts and its municipalities are able to calculate their revenue replacement amount associated with CY 2020, but will need to wait until January of 2022 to calculate any increase to the revenue replacement cap related to CY 2021 and then in subsequent years.

  The calculation to determine each year's RR cap is determined by comparing actual general revenues in each calendar year to fiscal 2019 general revenues adjusted for an assumed 4.1 percent annual growth rate.[1] General revenues are based on data reported by the state and municipalities to the Census Bureau. The IFR requires that the data be adjusted into a calendar year (instead of fiscal year) format and excludes certain revenues, most notably transfers from the federal government. It is likely that the state and local recipients will require time to finalize the initial CY 2020 calculation.

  The annual process of calculating RR creates a planning challenge for policymakers. Revenue replacement is the most flexible use of FRF and could be a vital revenue source for addressing future budget downturns. Therefore, FRF spending decisions must leave flexibility to apply revenue replacement funds to the state budget in future years.

- ***Massachusetts will be able to use a significant portion of its FRF for revenue replacement***

  As described above, the total amount of FRF resources the state will be able to spend on revenue replacement is unknown at the present time and even the 2020 cap is still being determined. However, MTF estimates that the initial cap will be in the $1.4 to $1.6 billion range based on tax revenue information in 2020. Essentially, this represents the floor on RR spending over the next several years, but the number could fluctuate depending on the annual RR calculation. This means that at least one-quarter of FRF resources can be used in the most flexible form as revenue replacement.

- ***The Revenue Replacement prohibition on rebuilding reserves has major budget implications***

  The IFR explicitly prohibits RR resources from replenishing reserves, but does allow their use to cover the vast majority of typical budget expenditures. Given that, and strong tax revenue collections, it is even more important for budget-makers to avoid any draws from the Stabilization Fund in this year or next year's budget.

  Both the FY 2021 and FY 2022 state budgets assume significant draws from reserves to balance the budget. Much, if not all, of these reserve draws should be replaced with higher than expected tax collections. To the extent that increased tax revenue collections in FY 2021 and upgraded tax

[1] The growth rate applied to FY 2019 revenues is the higher of 4.1% and a recipient's actual general revenue growth between 2015 and 2018. For the state award, the higher figure is likely to be 4.1%.

assumptions in FY 2022 are not sufficient to replace anticipated reserve draws, FRF funds, or other budget resources, should be used in place of the Stabilization Fund.

Given the magnitude of federal support through the American Rescue Plan and the strength of ongoing state revenues, now is the time to preserve, not diminish, reserves that can be used to mitigate future downturns. The prohibition on using FRF resources to rebuild the Stabilization Fund makes the importance of maintaining and growing reserves over the several years all the more clear.

- ***Massachusetts and local recipients have broad discretion to use funds to address disproportionately impacted communities***

  Another allowable use of the FRF is addressing the public health and economic impacts of the pandemic. For each, the IFR sets out eligible areas – five for public health and seven for economic impact – with examples of appropriate use.[2] There is greater flexibility in how the money is spent if directed to disproportionately impacted communities.

  Communities suffering from public health or economic disparities prior to the pandemic were particularly hard hit over the past year and so a wider array of programs can be supported under this category to mitigate those disparate impacts. The IFR does not set forth a definition of what constitutes a disproportionately impacted community, but incentivizes recipients to use Qualified Census Tracts (QCTs) as a proxy for impacted communities by presuming that programs provided to QCTs are responsive to the public health or economic impact of the pandemic and therefore, an eligible use provided they meet the general criteria put forth in the guidance.[3] If recipients use a different measure to designate disproportionately impacted communities, they must be able to provide supporting evidence as to why that designation is appropriate.

  The IFR outlines eligible spending areas for public health or economic impact, and provides some examples of acceptable uses, but the list is not exhaustive. In cases where recipients expend resources outside of the identified categories, they must be able to demonstrate how a program or service not identified in the IFR directly responds to the public health or economic impacts of the pandemic

- ***There is limited discretion for spending on premium pay and infrastructure***

  The ARP established relatively straightforward guardrails for premium pay and infrastructure spending.
  - Premium pay:
    - Must be additive to base pay
    - Cannot exceed $13 per hour
    - Cannot exceed $25,000 for any worker
  - Infrastructure spending is limited to water, sewer and broadband.

[2] See Appendix A for a list of eligible areas of use, with examples, for public health and economic impact.
[3] See Appendix B for more information on Qualified Census Tracts in Massachusetts

In the case of premium pay, the IFR adds two important pieces of information. First, it identifies seven professional categories that qualify as essential, but allows recipients to add additional categories provided they are critical to protecting the health and well-being of residents. Second, it makes clear that premium pay is intended to address disparities between the risks borne by workers and the pay they typically receive. Given this, premium pay is intended to be targeted to low-wage workers. Therefore, recipients must provide written justification in any cases where premium pay results in a workers compensation exceeding 150 percent of the average wage in the state.

With respect to infrastructure, the IFR provides details on how project eligibility will be determined. In the case of water and sewer, eligibility is aligned with criteria used for the Environmental Protection Agency's Clean Water State Revolving Fund or Drinking Water State Revolving Fund programs.

In the case of broadband, eligible programs must provide broadband capacity (defined as reliably providing upload and download speeds of 100 megabytes per second) to unserved and underserved communities. The IFR encourages projects that do not invest in areas with existing service agreements and also prioritizes affordability to improve access. The IFR makes clear that eligible broadband projects not only include building out broadband capacity in eligible areas, recipients can also provide direct assistance to affected households for internet access and digital literacy.

- ***The tax cut prohibition is more flexible than first thought***

The ARP prohibits states from using FRF resources, directly or indirectly, to offset a reduction in net tax revenue and one of the reasons the IFR has been so eagerly anticipated is to better understand how this prohibition would be assessed. First, the IFR clarifies what constitutes a tax reduction and makes clear that tax changes to conform to recent federal tax policy related to unemployment insurance and the Paycheck Protection Program do not qualify as tax cuts. Second, the IFR states that if aggregated tax reductions are less than 1 percent of baseline tax revenues (approximately $300 million for Massachusetts), the prohibition is not violated.

After establishing these criteria, the IFR essentially establishes a two-test approach to determine whether or not states have violated this prohibition:

1. *Do total tax revenues for a fiscal year exceed FY 2019 tax revenues as adjusted for inflation?*

   If a state is able to answer "yes" to this question, it is not in violation of the tax cut prohibition for that fiscal year. Under the IFR, a state in this situation would have sufficient organic tax revenue growth to pay for a tax cut without the direct or indirect use of FRF. As demonstrated in Figure 1, Massachusetts is likely to meet this criteria for FY 2021 given the strong rate of tax growth.

Figure 1. Estimate of Current Tax Revenues v. Adjusted FY 2019

Tax Cut Test 1	
FY 2019 tax revenues	$29,740
FY 2020 inflation	2.1%
FY 2021 inflation	2.3%
FY 2019 revenue adjusted for inflation	$31,063
FY 2021 tax revenue (current pace)	$33,028
Difference	***$1,965***

$ in millions

2. *Can the state identify non-FRF sources of funding or cuts that offset the value of tax reductions?*
   If states do not meet the "organic tax growth" test, they must document other revenue increases or cuts that were used to pay for any tax cuts. Spending cuts can only be used if total net spending (not including FRF) is less than FY 2019 spending (adjusted for inflation) and cannot apply to areas of the budget where FRF resources have been used. It is unlikely that Massachusetts will be able to demonstrate spending cuts that meet this criteria over the next several years.

   If a state cannot meet either of these criteria, it must repay the federal government the lesser of: the amount of any tax cuts (after offsetting for other sources of funding); and the reduction in tax revenues between FY 2019 (adjusted for inflation) and the relevant year. DOR is charged with collecting relevant data to conduct these tests.

The ability to avoid violating the tax penalty prohibition by demonstrating organic tax revenue growth would make it possible for Massachusetts to reduce taxes over the next several years without the need to pay back the federal government. Figure 1. shows Massachusetts is likely to easily meet this criteria through the end of FY 2021. However, if revenue growth falls short of inflation in future years, the tax prohibition could become a major factor.

- ***FRF Spending Comes with Five Years of Reporting and Compliance Requirements***

  The IFR sets forth several ongoing reporting requirements to ensure ongoing oversight and compliance:

  - State, Counties, and Metropolitan cities, must submit quarterly project and spending reports based on existing CARES Act reporting, that assign FRF monies to eligible categories.
    - Non-metropolitan cities are required to submit annual reports
  - States, and municipalities and counties with populations above 250,000 must submit annual recovery plan performance reports, which will provide information on FRF projects and how those projects achieve effective, efficient and equitable outcomes.
  - States must submit annual reports certifying compliance with the prohibition on using FRF resources to directly or indirectly pay for tax cuts

  The US Treasury will use these reports to ensure that FRF spending complies with program requirements. In instances when the federal government identifies disallowed spending, it will provide notice to the recipient and allow the recipient 60 days to apply for reconsideration. If Treasury reaffirms ineligible spending, the recipient must repay the amount within 120 days.

The process for compliance and oversight will continue until the end of 2026, meaning that the state and all municipal and county recipients will need to meet reporting and compliance requirements for the next five and a half years. The ARP requires that FRF costs be incurred no later than December 31, 2024, but Treasury's guidance allows FRF spending to occur through December 31, 2026, provided that all funds are obligated by the end of 2024.

Appendix A. Public Health & Economic Impact Eligible Categories

The IFR provides a non-exhaustive list of eligible spending categories for public health and economic impact spending, along with examples within most of those categories.

Eligible Public Health Categories

- COVID-19 Mitigation & Prevention
  - Example uses:
    - Medical care
    - Testing & contact tracing
    - Support for isolation & quarantine
    - Support for vulnerable populations to access medical care & public health services
    - Public health surveillance
    - Enforcement of public health orders & public communication efforts
    - Enhancement to health care capacity, which includes:
      - PPE purchase
      - Mitigation and other services in congregate living, schools and other settings
    - Ventilation improvements in congregate living, health care and other settings
    - Enhancement of public health data systems
    - Other public health responses
- Medical Expenses
  - This applies to care and services to address near and long-term needs related to the pandemic
- Behavioral Health Care
  - Example uses:
    - Mental health treatment
    - Substance misuse treatment
    - Overdose and infectious disease prevention
    - Services or outreach to promote access to behavioral health, primary care and preventative medicine
    - Hotlines and crisis intervention
    - Other behavioral health services
- Public Health and Safety Staff
  - Recipients may use FRFs to cover payroll and associated benefits for public safety, public health, health care, human services and other employees to the extent that there work is devoted to mitigating or responding to the pandemic
    - Public health and public safety personnel are considered to be fully devoted to COVID-19 mitigation and response if it is the primary aspect of their work
- Expenses to Improve the Design & Execution of Health and Public Health Programs
  - This apples to costs related to planning and analysis necessary to improvement COVID-19 related programs
- Addressing Disparities in Public Health Outcomes
  - Broader eligibility is allowed in low-income communities, include QCTs. Examples of broader uses:

        - Funding community health workers to assist community members access services to address social determinants of health
        - Funding public benefit navigators
        - Housing services
        - Remediation of lead paint or other lead hazards
        - Community violence intervention programs

Eligible Economic Impact Categories

- Assistance to Unemployed Workers
    - This applies to job training programs for unemployed workers, including workers unemployed before the pandemic began
- State Unemployment Insurance Trust Funds
    - The state can use FRF to bring the balance of its unemployment trust fund up to the level as of 1/27/2020
- Assistance to Households
    - Example uses:
        - Food assistance
        - Rent, mortgage or utility assistance
        - Counseling and legal aid to prevent eviction or homelessness
        - Cash assistance
        - Emergency assistance for necessary costs
        - Internet access or digital literacy assistance
        - Job training
- Expenses to Improve Efficacy of Economic Relief Programs
- Small Business & Non-profits
    - Example uses:
        - Loans or grants to mitigate financial hardship
        - Loan, grants and other assistance to implement COVID-19 prevention and mitigation tactics
        - Technical assistance
- Rehiring State, Local, and Tribal Government Staff
    - Recipients can use FRF for costs associated with rehiring up to pre-pandemic levels
- Aid to Impacted Industries
    - This applies to support for the tourism, travel, and hospitality industries as well as other industries that are demonstrated to have had similar levels of negative impact
- Addressing Disparities in Economic Impact
    - Broader eligibility is allowed in low-income communities, including QCTs. Examples of broader uses:
        - Investments in housing and neighborhoods
        - Addressing educational disparities
        - Promoting healthy childhood environments.

Appendix B. Qualified Census Tracts

The IFR includes a presumption that certain types of services are eligible when provided in a Qualified Census Tract. Recipients may provide these expanded services to other households and areas, but must be able to support the conclusion that those other areas experienced a disproportionate impact.

Each geographic region of the country belongs to a census tract, with each tract comprising approximately 4,000 residents. There are 1,478 census tracts in Massachusetts. Qualified Census Tracts are designated by the federal Department of Housing and Urban Development for tracts that meet one of the following criteria:

- 50 percent of households have an income below 60 percent of the Area Median Gross Income; or
- Poverty rate is 25 percent or more.

There are 311 Qualified Census Tracts in Massachusetts.

QCTs in Massachusetts by County

	2021 QTCs
Essex	50
Bristol	33
Berkshire	5
Barnstable	4
Franklin	2
Hampden	28
Hampshire	2
Middlesex	35
Norfolk	10
Plymouth	14
Suffolk	99
Worcester	29
Total	***311***