Policy Brief 11-2

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A More Equitable Approach to Cutting State Aid

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State aid plays an important role in local government finances in New England. For example, in Fiscal Year (FY) 2008, revenue transfers from state government made up 33 percent of local government general revenues across the region, ranging from 29 percent in New Hampshire to 67 percent in Vermont.[1] Local governments rely on state aid to provide essential public services, such as education, police and fire protection, and adequate road maintenance.

Yet in response to the recent and ongoing fiscal crisis, state governments across the region have deeply cut local aid.[2] For example, Massachusetts and New Hampshire both reduced non-school aid by 21 percent in FY 2010. The same year, Rhode Island and Connecticut cut total aid by about 12 percent and 2 percent, respectively.[3]

How states cut aid currently

States tend to cut local aid across the board, with each local community receiving the same percentage reduction. This approach ignores differences in underlying local fiscal health and places a larger burden on many resource-poor communities, as these communities tend to receive a larger amount of state aid. For example, in FY 2008, municipalities in the bottom 20 percent of per capita taxable property values among Massachusetts communities received an average per capita amount of $1,321 in state aid, compared with $339 for communities in the top 20 percent. Thus, across-the-board percentage cuts often result in larger per capita dollar aid cuts for resource-poor localities.

Across the board cuts in state aid also have greater impact on resource-poor communities than on more affluent cities and towns because state aid typically makes up a larger share of these communities' total revenues. In FY 2008, Massachusetts communities in the bottom 20 percent of per capita taxable property values received an average of 49 percent of their local general revenue from state aid, while communities in the top 20 percent received an average of 10 percent of their local general revenue from state aid. As a result, local officials have raised concerns that across-the-board aid cuts will widen the gap between resource-rich and resource-poor communities, effectively undoing years of fiscal equalization.

In response to these concerns, we recently proposed a new, more equitable approach to distributing reductions in state aid.[4] Our approach is based on two principles. First, all else being equal, it is better to cut less aid from communities that are in worse underlying fiscal health. And second, among communities with similar fiscal health, one should cut less from communities that received less state aid in the previous year.

A more equitable approach for distributing reductions in state aid

In order to distribute aid reductions based on underlying local fiscal health, we first must identify a way to measure a community's fiscal health. To this end, previous research developed a measure called the "need-capacity gap." It measures the difference between the underlying costs of providing local public services to a community and the capacity of that community to raise revenue from local sources to pay for those services. A larger need-capacity gap means that the community is in worse underlying fiscal health.

The costs and capacity of each community are not its actual levels of spending and revenues. Instead, they are based on local social and economic characteristics that are outside the direct control of local policymakers. Using uncontrollable factors as the basis for our measure can help avoid rewarding wasteful local spending or punishing efficient local operation. (In the next section, we explain how we calculate the need-capacity gap for Massachusetts communities.)

To illustrate the idea behind our gap-based aid-reduction approach, Figure 1 shows how the state could distribute aid cuts in a manner that is more equitable than the current across-the-board method. Under this new approach, policymakers would cap the maximum percentage aid cut to ensure that no community would lose so much aid that it would create a hardship, and communities with small need-capacity gaps would receive the maximum percentage aid cut from their previous year's aid.

Conversely, communities with the largest gaps would receive a minimum percentage aid cut. The minimum percentage cut ensures that all cities and towns would share some of the burden of the statewide aid cut, regardless of local fiscal health. All other municipalities would receive aid cuts inversely proportional to their gap. Adopting this method would ensure that communities in worse underlying fiscal health would lose less aid than those in better underlying fiscal health.

Example: Municipal Aid in Massachusetts

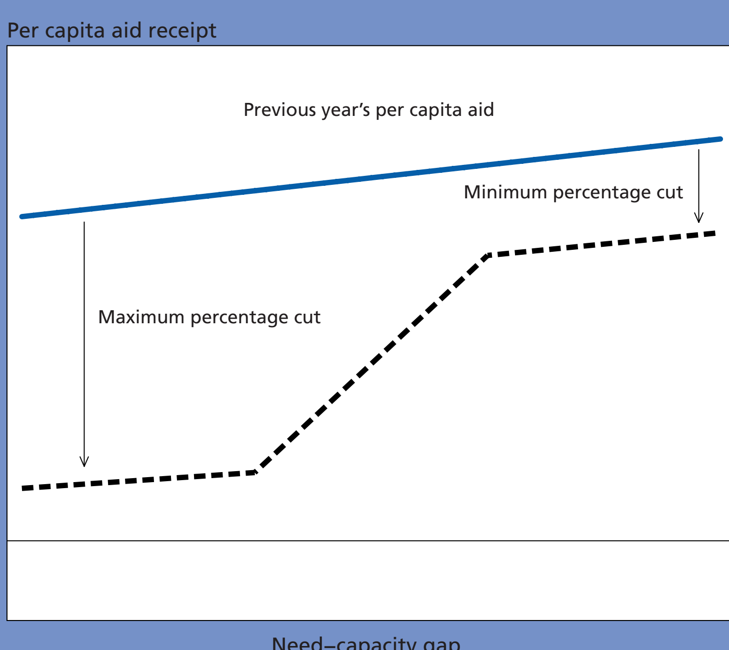
In principle, this aid-cut approach could be applied to all states that provide aid to local communities. As an example, we explore general municipal aid in Massachusetts and simulate the effect of the proposed gap-based approach to trimming local aid.

In Massachusetts, the state allocates general municipal aid to its 351 cities and towns, with a declared goal of helping to equalize their ability to provide municipal services. Prior to FY 2010, general municipal aid had two components: Additional Assistance and Lottery Aid. The sum of these aid disbursements reached a peak of $1.3 billion in FY 2008, before the recent recession. In FY 2009, the state cut general municipal aid by about 10 percent across the board. In FY 2010, the state combined Additional Assistance and Lottery Aid to form a new aid category called Unrestricted General Government Aid and cut 21 percent of its funding, mostly across the board. The state made an additional across-the-board cut of 4 percent in FY 2011. In total, general municipal aid lost 31.6 percent of its funding between FY 2008 and FY 2011. These aid reductions offer us an opportunity to simulate what the aid distribution would look like if the state had used a gap-based aid-cut approach.

To measure the need-capacity gap for municipal services (the municipal gap, for short), we focus on local social and economic characteristics that are outside the direct control of local officials in any given year. Our previous research points to four significant cost factors in Massachusetts: the poverty rate, the unemployment rate, population density, and the number of per capita jobs located in the municipality.[5]

This research finds that the capacity to raise revenue from local property taxes is determined both by taxable property values and by the personal income of local residents. We also include revenue capacity

Figure 1. Aid cuts under the gap based approach



Source: Authors' illustration.

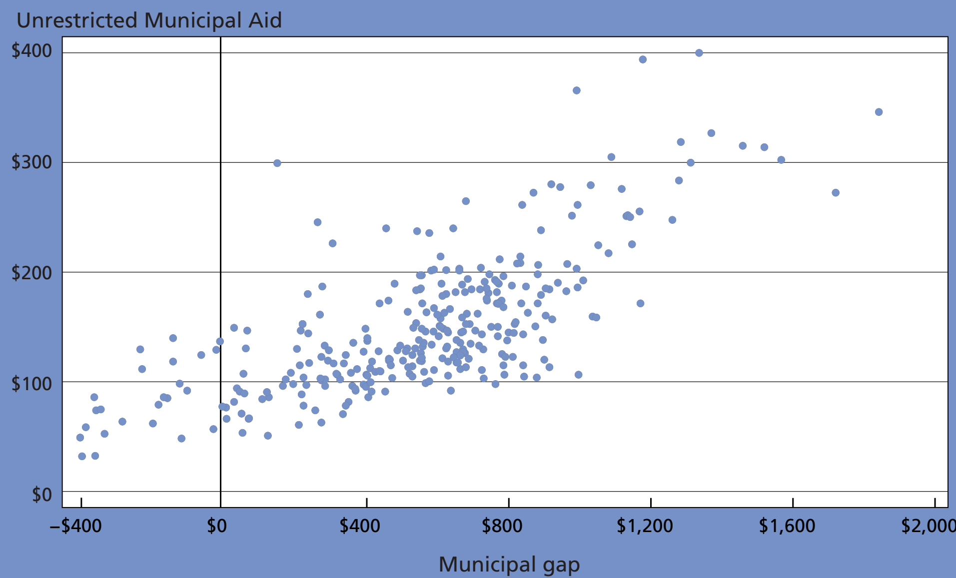
from various local excise levies, such as the motor vehicle excise tax and local hotel/motel excise taxes. However, we must subtract from municipal capacity state-required local contributions to public schools and other required assessments or charges, since these funds are not available to fund municipal services.[6]

Despite the goal of fiscal equalization, the distribution of municipal aid was not directly proportional to municipal gaps in Massachusetts in FY 2008 (see Figure 2). Communities with similar gaps received very different municipal aid amounts, and communities with similar aid receipts had different municipal gaps. The across-the-board cuts in FY 2009–2011 have only maintained this weak relationship, because they have treated each community the same way, regardless of the size of the municipal gap.

We ran a simulation to explore what the aid distribution might have looked like if the state had used the gap-based aid-cut approach. We distributed the actual statewide cuts in municipal aid in FY 2009 (10 percent), FY 2010 (21 percent), and FY 2011 (4 percent) through a gap-based aid-cut formula. In the following policy scenario, we set the maximum percentage aid cut for any community to 2.5 times the statewide aid cut, and the minimum percentage aid cut for any community to one-tenth of the statewide percentage cut in each year.

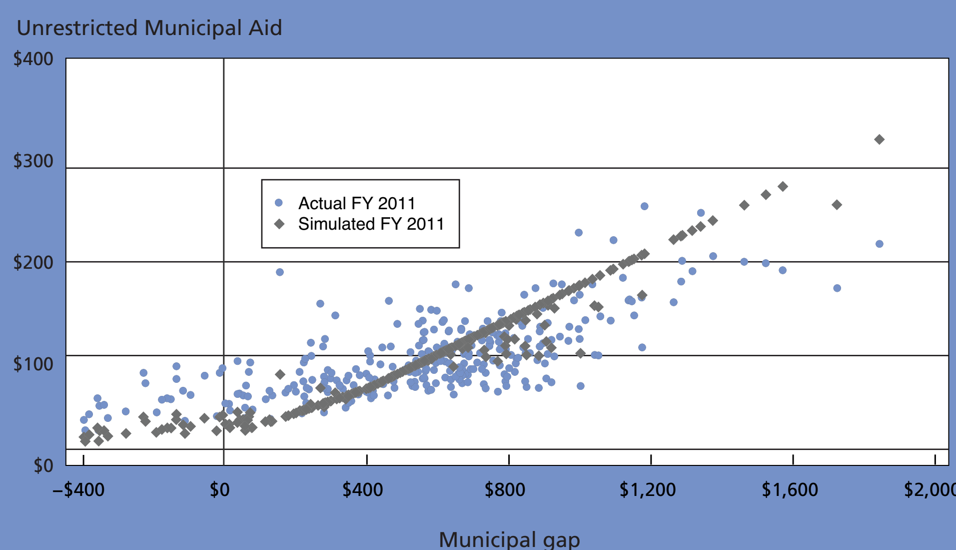
Under the actual aid cuts from FY 2008 to FY 2011, each community across the state lost roughly 31 percent of its aid. However, if Massachusetts had used the gap-based approach to cutting aid, higher-gap communities would have experienced a smaller percentage aid cut than lower-gap communities. Communities in the top 20 percent of the gap distribution—those in the worst underlying fiscal health—would have lost 24 percent of their aid, on average, in the simulated scenario. On average, communities in the bottom 20 percent of the gap distribution—those in the best underlying fiscal health—would have experienced a 66 percent reduction in aid over the three-year period.

Figure 2. Comparing municipal aid with municipal gaps in Massachusetts (FY 2008, per capita)



Note: To show the general pattern more clearly, 40 communities with a per capita gap below –$400 have been omitted.
Source: Authors' calculations.

Figure 3. Comparing simulated aid distribution with actual aid distribution in Massachusetts (FY 2011, per capita)



Note: To show the general pattern more clearly, 40 communities with a per capita gap below –$400 have been omitted.
Source: Authors' calculations.

Furthermore, over half of all communities in the state would have received smaller aid cuts under the gap-based approach than they did under the across-the-board cuts. These communities represent about 52 percent of the state's population and often have large municipal gaps. In practice, policymakers can change the policy parameters to increase the number of communities or percentage of population that benefits more from the gap-based approach.

Aid payments would have been more closely related to municipal gaps if the state had implemented the gap-based approach for the recent aid cuts. Figure 3 compares the actual FY 2011 municipal aid distribution and the simulated FY 2011 municipal aid distribution. We implemented the gap-based aid-cut approach in FY 2009 through FY 2011 to generate the simulated FY 2011 distribution. As the figure shows, the relationship between municipal aid and municipal gap under the actual cuts remains weak in FY 2011. However, implementing the gap-based approach creates a closer and stronger relationship between aid and the municipal gap.

Conclusion

Cutting aid across the board is widely considered unfair, because it ignores the relative fiscal health of local communities. It tends to put more burden on communities that have fewer resources and are already fiscally stressed. Thus, these across-the-board cuts work against the equalization goals of state aid.

This policy brief does not evaluate whether a state government should cut local aid. However, in the event the state does cut aid, we offer a more equitable approach to making those aid cuts. Using this gap-based aid-cut approach could help state governments continue to pursue fiscal equalization, even in difficult fiscal circumstances.

Endnotes

1 Source: Census Bureau's 2008 *Annual Survey of State and Local Government Finance*

2 It is outside the scope of this policy brief to assess and discuss whether states should or should not cut local aid. We take aid cuts as a given, and then seek to provide an approach of making those cuts more equitable.

3 Aid reduction numbers are calculated from the National Association of State Budget Officers' *The Fiscal Survey of States* in multiple years, The New Hampshire Municipal Association's *State Aid to Municipalities: History and Trends*, and Massachusetts Department of Revenue's *Cherry Sheets*.

4 Bo Zhao and David Coyne, "Designing Formulas for Distributing Reductions in State Aid" (New England Public Policy Center working paper 11-2, Federal Reserve Bank of Boston, August 2011).

5 Katharine Bradbury and Bo Zhao, "Measuring Non-School Fiscal Disparities among Municipalities" (*National Tax Journal* 62(1): 25-56, 2009).

6 A more detailed explanation of how we calculate the municipal gap for Massachusetts cities and towns can be found in a previous New England Public Policy Center working paper: Bo Zhao with Marques Benson, Lynn Browne, Prabal Chakrabarti, DeAnna Green, Yolanda Kodrzycki, Ana Patricia Muñoz, and Richard Walker, "Does Springfield Receive its Fair Share of Municipal Aid? Implications for Aid Formula Reform in Massachusetts" (New England Public Policy Center working paper 10-4, Federal Reserve Bank of Boston, July 2010).