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PUBLIC INTEREST COMMENT

HOW TO CLOSE THE LOOPHOLES IN THE AMERICAN RESCUE PLAN'S STATE AND LOCAL PANDEMIC RELIEF

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Coronavirus State and Local Fiscal Recovery Funds
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The US Department of the Treasury has proposed the interim rule titled "Coronavirus State and Local Fiscal Recovery Funds," which was published to the *Federal Register* on May 17, 2021.[1] I am grateful for the opportunity to submit a comment to the Treasury about this proposed rule. The Mercatus Center at George Mason University is dedicated to advancing knowledge about the effects of regulation and policy on society. Accordingly, my comment seeks to aid the Treasury as it considers the impact of this rule.

EXECUTIVE SUMMARY

My comment focuses on the harm done by economic development subsidies to the local, state, and national economies and to local and state government finances. I highlight a way that the Treasury can prevent the use of the Coronavirus State Fiscal Recovery Fund and the Local Fiscal Recovery Fund (together, the Fiscal Recovery Funds) on such subsidies. This issue is relevant to the American Recovery Plan Act (ARPA) because economic development subsidies are commonly granted via targeted tax reductions for particular corporations or industries. The tax benefits can also be indirect (having the effect of reducing taxes via fungibility) when the subsidies take the form of public grants of land or resources, regulatory exceptions, or other economically valuable privileges not generally available to all enterprises. ARPA forbids the use of the Fiscal Recovery Funds to reduce taxes, but loopholes in the Treasury's interim rule could indirectly enable their use for economic development subsidies.

If the Treasury does not address these oversights, state and local governments will likely misspend the Fiscal Recovery Funds on their decades-long economic development arms race. This

1. Department of the Treasury, Coronavirus State and Local Fiscal Recovery Funds, 86 Fed. Reg. 26786 (May 17, 2021).

means that Congress (read: federal taxpayers) will likely end up underwriting every competitor in this race to the bottom. To aid the Treasury in addressing this problem, I suggest the following enhancements to the interim rule:

Expand the interim rule by

1. disallowing the use of the Fiscal Recovery Funds for any direct or indirect tax reductions not generally available to every enterprise and
2. empowering whistleblowers to bring anonymous information to the Treasury regarding violations of the final rule and authorizing compensation for their doing so.

Close loopholes in the interim rule by

3. applying the net present value of economic development subsidies provided after 2024 in the year in which such subsidies are approved,
4. requiring that any funds transferred from recipients to subrecipients must not be used to provide economic development subsidies, and
5. preventing subdivisions of governments from shifting programs and responsibilities to evade application of the final rule.

Bolster the interim rule's information requirements by

6. integrating the interim rule's information reporting requirements with those already required by statement no. 77 of the Governmental Accounting Standards Board (GASB 77) and
7. creating and maintaining a centralized Treasury website collecting all of the Recovery Plan Performance Reports.

THE PROBLEMS WITH ECONOMIC DEVELOPMENT SUBSIDIES

State and local governments spend an estimated $95 billion each year on economic development subsidies, and yet the broad body of academic research consistently finds that such subsidies have a negligible—or even harmful—economic effect.[2] Only one of every eight subsidies is likely to change a company's decision of where to locate or expand, meaning that most subsidies are a complete waste of money.[3] However, when a subsidy does sway a company's decision, it results in less efficient production from a national perspective.[4] Unfortunately, local and state policymakers face political pressure to signal to voters that they are actively working to improve economic

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2. Matthew D. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy* (Arlington, VA: Mercatus Center at George Mason University, 2019), 5; Timothy J. Bartik, "Who Benefits from Economic Development Incentives? How Incentive Effects on Local Incomes and the Income Distribution Vary with Different Assumptions about Incentive Policy and the Local Economy" (Upjohn Institute Technical Report No. 13-034, W.E. Upjohn Institute for Employment Research, March 1, 2018); Cailin Slattery and Owen Zidar, "Evaluating State and Local Business Tax Incentives," *Journal of Economic Perspectives* 34, no. 2 (2020): 90–118; Kenneth Thomas, "The State of State and Local Subsidies to Business" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, October 2019); Dennis Coates, "Growth Effects of Sports Franchises, Stadiums, and Arenas: 15 Years Later" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, September 2015); Dennis Coates and Brad R. Humphreys, "Do Economists Reach a Conclusion on Subsidies for Sports Franchises, Stadiums, and Mega-Events?," *Econ Journal Watch* 5, no. 3 (2008): 294–315; Matthew D. Mitchell, Daniel Sutter, and Scott Eastman, "The Political Economy of Targeted Economic Development Incentives," *Review of Regional Studies* 48, no. 1 (2018): 1–9.
3. Michael D. Farren and Matthew D. Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2020), 7.
4. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 24.

growth, which motivates a runaway economic development arms race.[5] In short, economic development subsidies do not lead to greater economic growth—they instead produce political capital for the policymakers who claim credit for the jobs that the subsidies "create."

The first shot of this arms race was fired by Mississippi while attempting to jump-start economic recovery during the Great Depression, and since then, states have rushed to embrace economic development subsidies after every economic downturn.[6] The personal political value gained from providing economic development subsidies, irrespective of the actual economic harm they cause, means that local and state policymakers will be motivated to find ways to use the Fiscal Recovery Funds to provide subsidies as a way to signal to voters that they are actively engaged in rebuilding the economy after the pandemic-related recession.

It is therefore critical that the Treasury revise the interim rule to ensure that states cannot use the Fiscal Recovery Funds to provide targeted tax cuts under the guise of economic development subsidies. Importantly, these restrictions should go beyond the Treasury's current interpretation that ARPA forbids states from reducing their *overall* net tax revenue and specifically prohibit *any individual reduction to gross tax revenue* that arises from an economic development subsidy granted after March 3, 2021.[7]

EXPANSIONS TO THE INTERIM RULE

DISALLOW THE USE OF THE FISCAL RECOVERY FUNDS FOR ECONOMIC DEVELOPMENT SUBSIDIES

The most straightforward means of addressing the problem of inadvertently funding every competitor in the economic development arms race would be for the Treasury to specifically prohibit the use of the Fiscal Recovery Funds to directly or indirectly fund economic development subsidies. And because the fact that most economic development subsidies fail to achieve their stated goal of sparking widespread growth enjoys consensus among academic economists—a rare occurrence—any subsidy-related expenditures should be regarded as the absolute lowest government funding priority. Such "bottom of the list" projects would be funded last under any best-practices paradigm, meaning that any spending on subsidies that does occur should be reasonably assumed to have been indirectly enabled by the expanded budget headroom provided by the Fiscal Recovery Funds.

This prohibition would necessitate a clear definition of what constitutes an economic development subsidy. I define such subsidies as any government-granted privilege that creates exclusive economic benefits for its recipient(s), but more detailed legislative language also exists.[8] Regardless, the definition needs to be all-encompassing because rent-seeking entrepreneurs will almost inevitably discover loopholes in a more narrowly tailored definition.

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5. Farren and Mitchell, "An Interstate Compact," 13.
6. Connie Lester, "Economic Development in the 1930s: Balance Agriculture with Industry," *Mississippi History Now*, May 2004.
7. This kind of restriction is well within Congress's power under the Commerce Clause. Michael D. Farren and John Mozena, "Federal Pandemic Relief Could End the Interstate Economic Development Arms Race" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2020).
8. See the legislative text of the Distorting Subsidies Limitation Act of 1999 and Utah's Interstate Compact for Mutually Beneficial Economic Development (neither of which was passed), as well as a recent policy brief by the Mackinac Center. H.R. 1060, 105th Cong. (1999); S.B. 190, 64th Leg., 2021 Gen. Sess. (Utah 2021); Byron Schlomach, Stephen Slivinski, and James Hohman, *Multilateral Disarmament: A State Compact to End Corporate Welfare* (Midland, MI: Mackinac Center for Public Policy, 2019); Farren and Mitchell, "An Interstate Compact," 5; Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 5.

EMPOWER WHISTLEBLOWERS TO PROVIDE NOTICE OF VIOLATIONS

Furthermore, a rule is only as effective as its enforcement or the threat of its enforcement. To enforce the prohibition, the Treasury should explore methods of increasing the likelihood that the improper use of the Fiscal Recovery Funds would be uncovered. Empowering private citizens and government officials to serve as informants would increase this likelihood, thus reducing the probability that unscrupulous government officials would try to improperly spend the Fiscal Recovery Funds in the first place. The Treasury should create systems via which individuals with knowledge of unscrupulous behavior can anonymously flag potential violations, motivated by the promise of substantial financial compensation if a violation is indeed determined to have occurred.

CLOSING LOOPHOLES IN THE INTERIM RULE

Unfortunately, the interim rule contains several loopholes that would make the use of the Fiscal Recovery Funds for economic development subsidies quite easy. Importantly, these loopholes would still need be addressed even if the Treasury were to decide to specifically prohibit the use of the Fiscal Recovery Funds for economic development subsidies.

CARRY FORWARD THE FUTURE VALUE OF ECONOMIC DEVELOPMENT SUBSIDIES TO THE YEAR THEY ARE GRANTED

The first loophole is the interim rule's interpretation of ARPA that any spending done after December 31, 2024, is not subject to ARPA's restrictions. Most expenditures on economic development subsidies occur multiple years (or even decades) after the initial contract is signed. The interim rule's spending restrictions—even if economic development subsidies were specifically prohibited—would be largely ineffective because subsidy-seeking corporations and government officials could agree to back-load all subsidies to occur in 2025 and afterward.

The simplest solution to this loophole is to require that any subsidy contracts finalized before the end of 2024 must apply the net present value of the future subsidies to the current year's spending. Combined with a prohibition of the use of the Fiscal Recovery Funds on economic development subsidies, this revision would provide greater confidence that ARPA's funding would not be misspent.

REQUIRE THAT SUBRECIPIENTS COMPLY WITH ANY PROHIBITION REGARDING THE USE OF THE FISCAL RECOVERY FUNDS ON ECONOMIC DEVELOPMENT SUBSIDIES

Multiple state governments have spun off their economic development programs to quasi-private entities that typically fail to comply with transparency rules to which government departments must adhere. To address question 35—because the interim rule allows for recipients of the Fiscal Recovery Funds to pass along the funding to subrecipients, the final rule should stipulate that any subrecipients (even nongovernmental entities) that accept such funds must comply with all state and federal transparency and reporting requirements, as well as restrictions on use, that would bind the primary recipient.

CLOSE INTERAGENCY AND STATE OR LOCAL FUNGIBILITY LOOPHOLES

In the interim rule the Treasury recognizes that the inherent fungibility of the Fiscal Recovery Funds could enable governments to spend the money in nonapproved ways.[9] The Treasury should address at least two additional fungibility mechanisms in its final rule.

In question 29, the Treasury recognizes that it needs to address the possibility of interagency programmatic horse trading wherein a spending cut in one department is balanced by other government departments assuming responsibility for the reduction in programs or initiatives, using the Fiscal Recovery Funds to do so.[10] In such instances, empowering and motivating whistleblowers, who possess the localized information that the Treasury would need to police such violations, would be very helpful.

Even more importantly, the Treasury should apply all restrictions regarding the use of Fiscal Recovery Funds on economic development subsidies to local governments as well as state and territorial governments. In aggregate, local governments spend around as much on economic development subsidies as states collectively do; and often when there is a limitation on state subsidies, local governments step in to sweeten the pot. As a result, any restriction on using the Fiscal Recovery Funds for economic development subsidies at the state level can be expected to promote additional spending on economic development subsidies at the local level, with the state potentially increasing grants to the local government as a quid pro quo. Additionally, this restriction on the particular use of the Fiscal Recovery Funds by local governments can be justified in the legislative language of ARPA because local governments are technically subdivisions of state governments, and ARPA explicitly restricts states' use of the Fiscal Recovery Funds.

BOLSTERING INFORMATION DISCLOSURE REQUIREMENTS IN THE RULE

The Treasury could provide a vital service by requiring information disclosures, in conjunction with ARPA's implementation, that improve policymakers' and the public's understanding of how much state and local governments spend on economic development subsidies every year. The following suggestions address questions 32 and 33 in the interim rule, particularly the creation of a standardized template to facilitate existing information disclosure mandates.

INTEGRATE THE FINAL RULE WITH GASB 77

Most state and local governments are required to comply with the generally acceptable accounting principles set forth by the Governmental Accounting Standards Board (GASB). For example, the standardization of government financial reporting by statement no. 34 of the GASB in 1999 created the modern format of the Annual Comprehensive Financial Report (ACFR).[11] More recently, statement no. 77 of the GASB mandated that governments must disclose information and spending related to tax abatements for economic development as part of the ACFR.

9. Coronavirus State and Local Fiscal Recovery Funds, 86 Fed. Reg. 26807.
10. Coronavirus State and Local Fiscal Recovery Funds, 86 Fed. Reg. 26810.
11. Note that the GASB recently proposed that the Comprehensive Annual Financial Report be renamed the Annual Comprehensive Financial Report. Governmental Accounting Standards Board, "Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments" (report no. 171-A, Governmental Accounting Standards Board, Norwalk, CT, June 1999); Governmental Accounting Standards Board, "GASB Proposes to Rename the Comprehensive Annual Financial Report," press release, April 13, 2021, https://www.gasb.org/cs/Satellite?c=GASBContent_C&cid=1176176489231&pagename=GASB%2FGASBContent_C%2FGASBNewsPage.

Unfortunately, many state and local governments' compliance with GASB 77 has been desultory at best.[12] In conjunction with ARPA-related information disclosures, the Treasury could enhance compliance with GASB 77 through the creation of standard disclosure templates for every existing project that is funded via economic development subsidies. Such disclosures would be necessary under ARPA for state and local governments to assert that the direct and indirect tax reductions provided through the economic development subsidies are the result of pre-ARPA subsidy agreements. Such disclosures are already mandated via GASB 77, which means that this requirement would not create an extra burden on state and local government officials. The standardization of such disclosures should reduce total compliance costs over the long term.

CREATE AND MAINTAIN A TREASURY WEBSITE FOR THE COLLECTION AND PUBLIC DISTRIBUTION OF ALL INFORMATION DISCLOSURES AND CREATE A DATABASE OF ASSOCIATED INFORMATION

The interim rule requires that each annual Recovery Plan Performance Report be posted on the public-facing website of the recipient. In the interest of transparency and public accountability, the Treasury should create and maintain its own dedicated website for the centralized collection and public dissemination of each recipient's Recovery Plan Performance Report.

Furthermore, in addition to providing an annual Recovery Plan Performance Report, each recipient should be required to provide such information in a standardized and easily usable format, so that all such data can be aggregated together in a single database housed on the Treasury's dedicated website.

The justification for this additional step can be found in the problems facing researchers using ACFR-sourced data, which must be manually or algorithmically extracted from the ACFR .pdf files. The complexity and difficulty in comparing data—even standardized data—using such methods cannot be overstated, and the GASB should consider revising its ACFR submission requirements in light of 21st-century data processing capabilities. The Treasury can showcase how this may be done and enhance researchers' access to data regarding an unprecedented era of federal government grants by ensuring that such data are provided in a standardized and easily usable format, rather than hidden in .pdf files.

CONCLUSION

The Treasury interim rule regarding the Fiscal Recovery Funds impressively manages to thread the needle in complying with Congress's stated goals in ARPA while also recognizing the importance of fiscal federalism and the sovereignty of the states that created the federal government. The authors of the interim rule should be commended.

There is one issue in particular that the Treasury should investigate more closely before finalizing the rule: economic development subsidies. Congress cannot have intended for the Fiscal Recovery Funds to underwrite an arms race between the states, especially one that *reduces* net national economic growth. That understanding, combined with the fact that regulating state policies that interfere with interstate commerce falls squarely under Congress's purview, empowers the Treasury to address economic development subsidies more directly in its final rule. Doing so will ensure a swifter economic recovery from the COVID-19 pandemic, which is the explicit intent of the American Rescue Plan.

12. "Special Blog Series on GASB 77 Compliance," *Good Jobs First*, July 6, 2020.