Chapter 1
Countercyclical Fiscal Policy During the COVID-19 Pandemic:
Federal Stimulus Funding for State and Local Governments

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ABSTRACT

The COVID-19 pandemic has posed a monumental economic and fiscal challenge to state and local governments. Their ability to use fiscal policies to address these challenges is limited due to structural and capacity issues. Only the federal government has the resources and capacity to implement meaningful countercyclical fiscal policies to mitigate the severe economic and fiscal disruption in the states caused by the pandemic. This chapter presents data on the amount of direct financial assistance provided to state and local governments through the CARES Act of 2020, Coronavirus Relief Fund, and the American Rescue Plan Act of 2021 and describes how the State of Illinois, Cook County, and the City of Chicago are utilizing those funds.

INTRODUCTION

The COVID-19 pandemic has posed a monumental economic and fiscal challenge to American federal, state and local governments. The impact on revenues has been particularly acute for state and local governments. Their ability to use fiscal policies to address these challenges is quite limited due to structural and capacity issues. Only the federal government has the resources and capacity to implement meaningful countercyclical fiscal policies to mitigate severe economic and fiscal disruption in the states caused by the pandemic.

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Since the inception of the pandemic, the federal government has embarked on a massive countercyclical fiscal policy program that has provided billions of dollars in funding to individuals, schools, universities, nonprofit organizations and businesses. Much of this funding has been provided directly to state and local governments.

The primary purpose of this chapter is to present data on the amount of direct financial assistance provided to state and local governments through the CARES Act of 2020 Coronavirus Relief Fund and the American Rescue Plan Act of 2021 and to describe how the State of Illinois, Cook County and the City of Chicago are utilizing those funds. To provide a framework for those discussions, this chapter provides a brief review of the monetary and fiscal policies that the federal government uses to stabilize the economy in times of serious disruption and examines the limitations that states face in implementing fiscal policies in times of economic distress.

A Brief Overview of Monetary vs. Fiscal Policy

Governments seek to stabilize the economy, mitigate unemployment, control inflation and improve economic opportunity by means of monetary and fiscal policies.

Monetary policy is conducted by the Federal Reserve Bank of the United States. It involves manipulating the money supply and setting the terms under which credit may be provided (Mikesell, 2018, p. 17).

Monetary policy can be either expansionary or contractionary. As an independent government agency, the Federal Reserve Bank can work quickly to stabilize the economy. It does not have to work through political approvals by the executive and legislative branches.

Expansionary monetary policy is designed to increase the money supply, injecting liquidity into the economy. The Federal Reserve Bank implements monetary policy by reducing interest rates on the premise that the ability to borrow funds at lower rates will spur increased business investment and consumer spending. Another tool is the use of quantitative easing, which involves the Bank purchasing long-term securities in order to increase the money supply and encourage both lending and investment (Investopedia, 2021).

Implementing expansionary monetary policy is made complex by the fact that the Federal Reserve Bank has a dual mandate: to maintain stable prices and to achieve maximum sustainable employment. The Fed has adopted a 2% target for inflation as the goal for price stability (Federal Reserve Bank of Chicago, 2020). The Bank does not have a definitive target for maximum employment; rather it seeks to implement policies that can lead to the lowest unemployment rate that is consistent with its inflation goal (Stone, 2017). The Bank estimated this rate to be 4.1 percent recently (Federal Reserve Bank of Chicago, 2020) (Federal Reserve Bank of Chicago, 2021).

Contractionary monetary policy is designed to slow the rate of growth in the money supply or decrease it in order to combat high rates of inflation. This is achieved by the Federal Reserve Bank increasing interest rates. This type of action can trigger a recession (Investopedia, 2021).

Fiscal Policy

Fiscal Policy involves changing tax burden and/or levels of spending to influence aggregate demand in the economy. It is primarily based on the economic theories of John Maynard Keynes, who argued that these types of policies could stabilize the business cycle in times of economic stress. The federal government as well as state and local governments develop and implement fiscal policy on a regular basis.