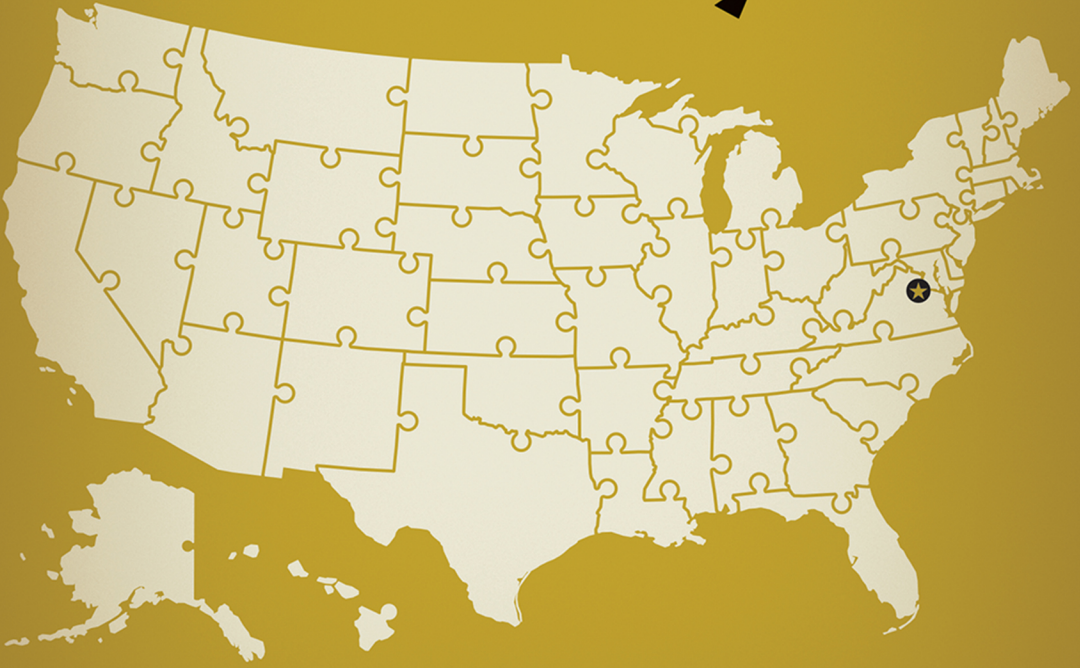


Perspectives on Political and Economic Governance

# American Federalism Today



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# 10

## When Are State Liabilities Federal Liabilities? Social Insurance and Federalism

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### *Introduction*

In recent decades, the United States has seen a trend toward increasing federalization of the financing of government programs, even as states continue to control the administration of those programs. This can be seen in the most basic fact that federal spending as a share of total government spending has increased from 65 percent to 71 percent between 1993 and 2021 (see figure 10.1). In keeping with the theory of cyclical ratcheting, which states that spending increases during recessions and remains high during the expansions that follow (Hercowitz and Strawczynski 2004), central government spending has accelerated during major crises such as the global financial crisis of 2008 and the COVID-19 pandemic and has not returned to pre-recession levels in the years that followed.

Programs that are to a large extent administered by the federal government but funded by states are numerous. In this essay, we examine the increasing federal financing of state-run programs via two examples—unemployment insurance (UI) and Medicaid. We then consider the extent to which there has been greater implicit centralization of state and local government debt and unfunded pension liabilities. We conclude that many state liabilities have become de facto federal liabilities, despite states' status as sovereign entities with taxation and debt issuance authority.

Much of the discussion around federalism traces back to Oates (1972), who argued the optimal degree of centralization versus decentralization in a federal system depends on a trade-off between the benefits of tailored service provision and the costs of providing public goods and services at a local level. On one hand, Oates suggested that decentralization can lead to improved

public-sector efficiency, because local governments are closer to the people and thus have a better understanding of their needs and preferences. This proximity allows local governments to provide goods and services that are better tailored to local conditions and preferences, which Oates referred to as the “decentralization theorem.” On the other hand, Oates notes that centralization can result in cost savings due to economies of scale and the ability to manage spillover effects across jurisdictions. The optimal degree of centralization or decentralization, therefore, depends on balancing these competing considerations.

The level at which public goods should be financed is a separate question. The footloose nature of tax bases offers a justification for raising some revenues at a more centralized level than the level of service provision, especially for non-benefit taxes, which are taxes that are not directly related to the benefits that the taxpayer receives (McLure et al. 1983; Gordon 1983; Gamkhar and Oates 1996). The programs we look at in this paper often involve conditional grants, in which the federal government picks up some share of a program administered by state governments. The rationale for such grants is usually that the local services have some spillover benefits for residents of other jurisdictions (Oates 1999). Unconditional grants, or programs that involve an unconditional component, are generally viewed as serving a purpose of fiscal equalization based on differing fiscal needs or fiscal capacity.

Economic justifications of the increased centralization would therefore have to fall under one of three categories: (1) tax bases have become more responsive to taxation for a given level of positive spillover effects across jurisdictions; (2) spillover effects of the public programs have become stronger for a given level of behavioral response to taxation; or (3) there is a greater need for fiscal equalization, perhaps due to increased inequality across jurisdictions. While it is beyond the scope of this paper to assess whether these conditions are met, it is also difficult to see strong evidence of any of these trends in practice. Furthermore, as we show when we consider pensions and unfunded debts, implicit guarantees by the federal government on the liabilities of the most indebted jurisdictions do not translate into implicit guarantees for the poorest regions or those with the least fiscal capacity.

This essay proceeds as follows. The first section considers spending shares of federal versus state governments over time, as well as the evolution of the federal funding share of state expenditures. The following sections address

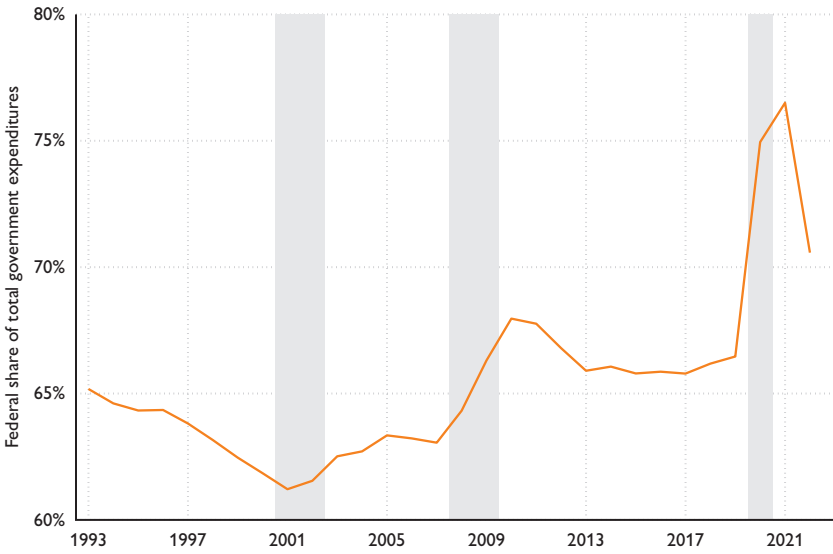
unemployment insurance and Medicaid specifically as examples of programs where the federal role has ratcheted up during times of crisis and does not recede afterward. The fourth section considers the evolution and distribution of pension liabilities and debt, and it is followed by a concluding summary of the trends described.

### *Role of the Federal vs. State Governments over Time*

As shown in figure 10.1, the federal share of total government expenditures tends to rise in crises and not subside to pre-crisis levels thereafter over the last thirty years. Measurement of the federal share of total government spending is possible using the National Income and Product Accounts (NIPA) of the US Bureau of Economic Analysis (BEA). The graph shows three local peaks: first after the national security buildup following the 2001 terrorist attacks, second following federal government expansions in the wake of the global financial crisis of 2008–9, and third as a result of the federal government’s response to the COVID-19 virus. Importantly, in these data series, programs with rules-based shared financing such as UI and Medicaid are apportioned to the federal or state government based on the source of financing. Direct transfers from the federal government to states without an expectation of specific services that states then spend are counted as state spending. This includes transfers for programs financed by federal government block grants, such as the federal funding of the Temporary Assistance for Needy Families program.

The increase in the federal share of expenditures in figure 10.1 therefore could reflect both increases in federal spending on federal programs (that are larger than increases in state spending on state programs) or increases in federal financing of state-administered programs such as UI and Medicaid. Increases in federal transfers to states without specific strings attached would, in contrast, tend to depress this line.

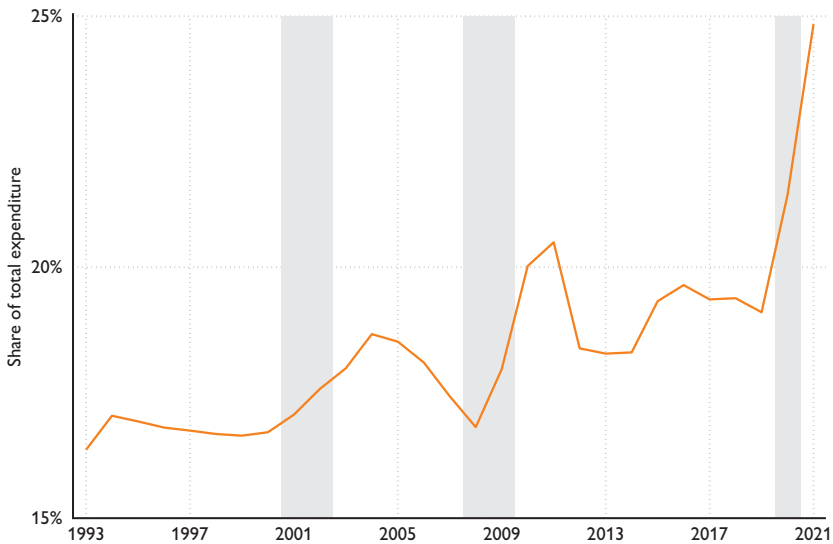
Figure 10.2 shows that federal payments to US state and local governments have in fact increased dramatically as a share of total expenditures by those states, rising from 16 percent in 1993 to 25 percent in 2021. So, while figure 10.1 shows that federal expenditures as a share of total expenditures have increased, figure 10.2 shows that states are increasingly relying on federal transfers to finance their own spending. In sum, the federal government is controlling more of the spending, as well as financing more of the expenditures, of the state and local governments.



**Figure 10.1** Federal spending as a share of total government spending

Note: Total Government Spending is measured as the sum of federal and state and local government expenditures less the sum of current and capital grants-in-aid. Shading indicates recessions as defined by the NBER.

Source: US Bureau of Economic Analysis NIPA Tables 3.1 and 3.2.



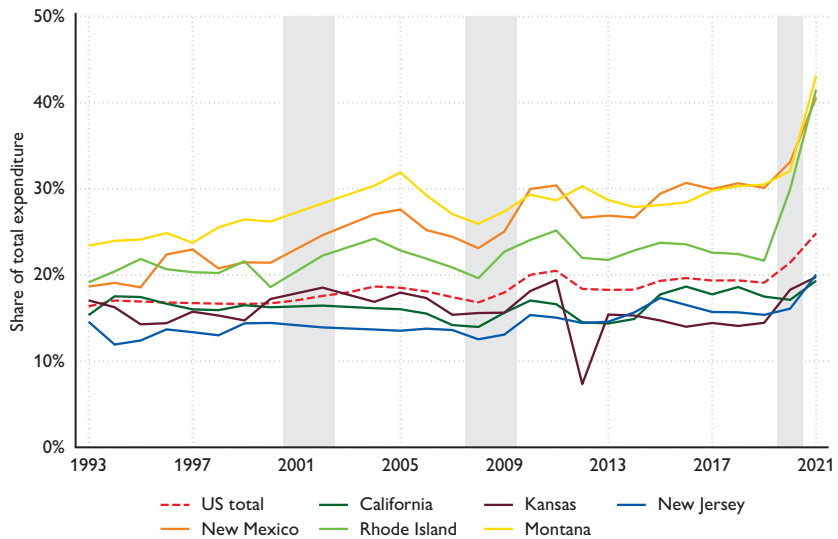
**Figure 10.2** Intergovernmental revenue from the federal government as a share of total state and local expenditures, US total

Note: Shading indicates recessions as defined by the NBER.

Source: US Census Bureau's State and Local Government Finance Historical Datasets.

Figure 10.3 shows the heterogeneity across states in the federal government’s support of state-level expenditures by highlighting the three states that as of 2021 had the largest federal intergovernmental revenue to state expenditure ratio and the three that had the smallest. States with high ratios may devote a larger share of their expenditures to jointly financed programs such as Medicaid and UI while also generally having relatively lower revenue from own-sources compared to what they are receiving from the federal government. While states experience different intergovernmental revenue-to-expenditure ratios over time, these ratios have broadly trended upward in recent years across states.

A separate but related question is the extent to which residents of different states benefit on net from federal programs of taxing and spending. Schultz and Holland (2023) consider this “balance of payments” question by considering total federal direct payments, grants, contracts, and other transfers on a per capita basis by state. States with relatively more low-income residents pay lower federal taxes per capita and receive more in federal benefits per capita,

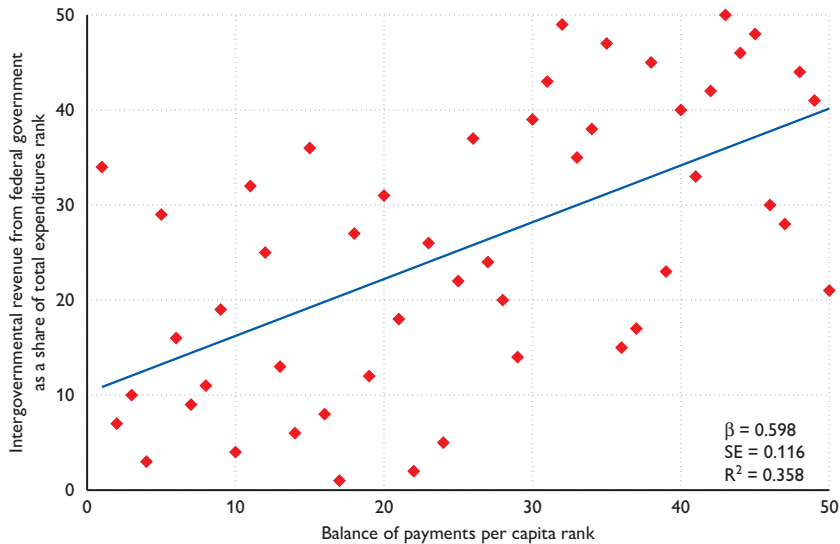


**Figure 10.3** Intergovernmental revenue from the federal government as a share of total state and local expenditures, highest and lowest states

Note: Displays states with highest and lowest federal intergovernmental revenue-to-expenditure ratio as of 2021. Shading indicates recessions as defined by the NBER.

Source: US Census Bureau’s State and Local Government Finance Historical Datasets.





**Figure 10.4** Intergovernmental revenue from the federal government as a share of total state and local expenditures rank vs. balance of payments per capita rank, 2021

Note: States are ranked based on federal intergovernmental revenue-to-expenditure ratio and balance of payments per capita in order from largest to smallest.

Sources: Revenue and expenditure data from US Census Bureau's State and Local Government Finance Historical Datasets; balance of payments data from Rockefeller Institute of Government.

giving them large net benefits. However, some higher income states also have a substantially favorable balance of payments with the federal government due to state businesses' receipts of federal contracts. As a result, as shown in figure 10.4, there is an imperfect mapping between the level at which a given state benefits from redistribution, as measured by the balance of payments per capita, and the extent to which state expenditures are financed by the federal government.

### Unemployment Insurance

The unemployment insurance (UI) program in the US, which provides benefits for eligible workers during involuntary spells of unemployment, is one example of a program that is jointly administered by states and the federal government yet has become increasingly federalized over time. The entitlement program is designed to pay benefits to covered workers based on their earnings over a fifty-two-week period, up to a limit set by states, for as long

as twenty-six weeks in most states.<sup>1</sup> In general, UI eligibility is determined by labor search efforts, reason for job separation, and previous earnings. Weekly benefit amounts are determined by the state but typically replace up to half of an individual's previous wages. Beyond the regular UI program, there is a permanent extended benefits (EB) program offering an additional thirteen to twenty weeks of benefits. States are required to provide EB coverage during periods of elevated unemployment. Individuals then become eligible to receive EB after exhausting regular UI benefits. While the federal government provides a broad framework for UI, state officials have some amount of autonomy in designing programs in their states.<sup>2</sup>

The UI program is funded by both federal and state employer payroll taxes (FUTA and SUTA, respectively), which are levied on most businesses.<sup>3</sup> While FUTA revenues mainly cover the administrative costs of UI and a 50 percent share of EB costs, SUTA revenues are much larger, funding the payment of regular benefits in each state and the remaining half of EB costs.

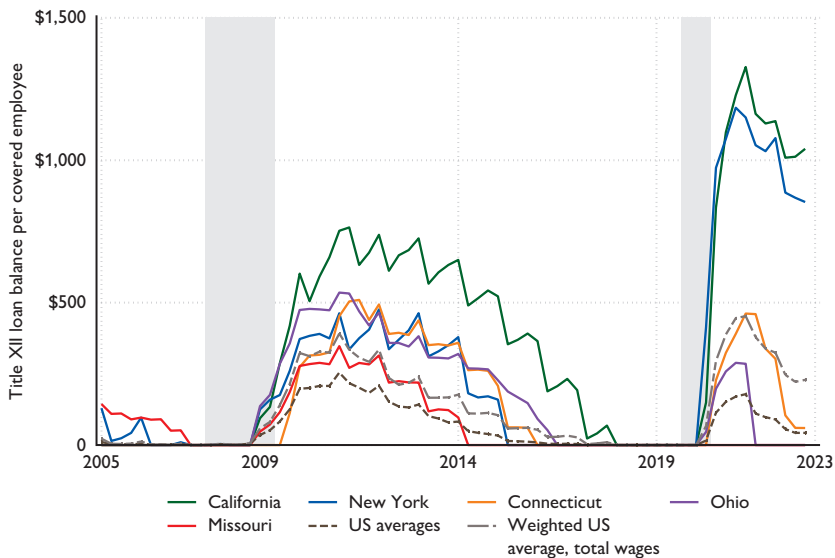
The gross FUTA rate for all taxable businesses is 6 percent on the first \$7,000 of wages paid to each employee, but the net FUTA rate is just 0.6 percent, since employers in states that are fully compliant with federal guidelines receive a 5.4 percentage point tax credit.<sup>4</sup> SUTA is a variable-rate tax, and states select both the rates and bases of the tax.<sup>5</sup> States are induced to use an experience rating system whereby employers are charged differing SUTA rates based on the amount of UI benefits paid to previous employees, or otherwise face FUTA credit reductions and increased SUTA rates for all employers in the state (Anderson and Meyer 2000).<sup>6</sup> Under this structure, firms that have undergone layoffs or have experienced downturns face higher SUTA payroll taxes, meaning that state UI taxes are in effect pro-cyclical (Johnston 2021).

### Unemployment Trust Funds and Solvency

Revenues generated by states' UI payroll taxes are held in separate accounts within the Unemployment Trust Fund (UTF), housed at the US Treasury. The solvency of a state's trust fund is measured by comparing a state's reserve ratio (trust fund balance divided by total wages) to its benefit cost rate (benefits paid divided by total wages). This ratio is called the average high cost multiple (AHCM). According to the US Department of Labor (DOL), a state's UTF is adequately solvent and prepared for a recession when its AHCM is at least 1.0.<sup>7</sup>



Some states, however, consistently fail to achieve UTF solvency, let alone adequate solvency levels for recession. In these cases, the federal government provides loans called Title XII advancements so insolvent states can continue to pay out UI entitlement benefits. Figure 10.5 displays the Title XII loan balances per eligible employee of select states over time. Intuitively, loan balances typically increase during economic downturns when the incidence and duration of claims are likely to rise, trust funds are depleted, and state revenues may be lower. States are required to pay regular benefit payments as well as the balance and interest on the loan, which accrues daily, once a Title XII advancement has been taken out. States are incentivized to do this in a timely manner or face a 0.3 percentage point reduction in the standard FUTA payroll tax credit for each additional year there is an outstanding balance.<sup>8</sup> For example, employers in a state with an outstanding Title XII loan balance for five consecutive years would be subject to a FUTA tax rate of at least 1.8 percent compared to the usual 0.6 percent net rate with the full tax credit. To avoid this, states often choose to broadly raise SUTA payroll tax rates or charge employers special assessments in order to make principal and interest payments on Title XII loans and replenish their UTFs following an



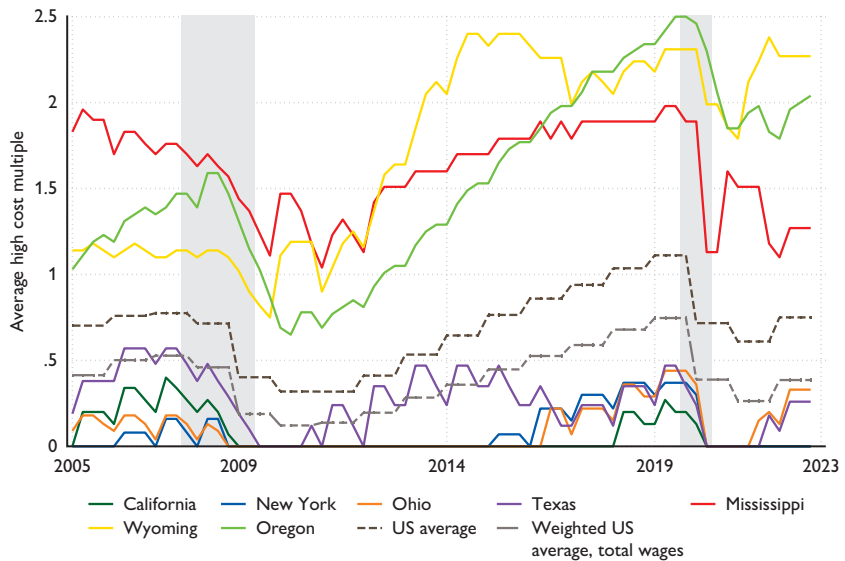
**Figure 10.5** Title XII loan balance per covered employee (quarterly)

Note: US averages are calculated yearly. Shading indicates recessions as defined by the NBER.

Source: US Department of Labor.

economic downturn. This payroll tax increase, however, may slow economic recovery and cool employers' hiring efforts, especially for distressed firms who face mechanically increased SUTA rates due to layoffs (Weiner et al. 2012; Johnston 2021).

Regardless of the incentive to maintain adequate reserves in the UTF to prepare for a future rise in UI claims, recent recessions have revealed that many states have been unprepared for crisis. Figure 10.6 displays the solvency levels of a selection of states from 2005 to the end of 2022. In the quarter preceding the start of the global financial crisis, thirty-one states did not meet the threshold for adequate solvency of their UTF account (AHCM of at least 1.0). Prior to the recession sparked by COVID-19 lockdowns, twenty-two states did not reach 100 percent solvency based on their AHCM levels.<sup>9</sup> California, for example, has maintained a solvency level well below 100 percent for over twenty years and has frequently been completely insolvent during that period. In fact, the Golden State's AHCM never went above



**Figure 10.6** UI trust fund solvency levels (quarterly)

Note: Average High Cost Multiple compares a state's quarter reserve ratio (trust fund balance as a percent of total wages) to the average of the state's three highest calendar year benefit cost rates (total benefits paid as a percent of total wages) in the past twenty years or a period including three recessions, whichever is longer. US Averages are calculated yearly. Shading indicates recessions as defined by the NBER.

Source: US Department of Labor.

40 percent between 2000 and 2023. By contrast, Wyoming had an average solvency level of nearly 170 percent over the same time period—even their lowest AHCM during this period was 35 percentage points higher than California’s highest solvency level.

### UI in Times of Crisis

Despite the fact that many states consistently underfund their UTF, the federal government often steps in to bolster UI programs during financial crises in an effort to stabilize the economy. In both the global financial crisis and the COVID-19 recession, unemployment rose significantly, and the incidence of UI claims increased substantially across the country. During the COVID-19 crisis, the volume of initial claims peaked at over six million claims in one week in April 2020 compared to a weekly average of just 218,000 during 2019, according to US DOL data. Likewise, continuing claims reached over twenty-three million in May 2020, nearly fourteen times higher than the weekly average level of continuing claims in the previous year. Given the high volumes of claims, increasingly long spells of unemployment for workers, and under-prepared state UI trust funds, the federal government opted to substantially expand its role in the UI program, enacting large-scale changes to its operation in both recent recessions.

### *Global Financial Crisis*

In response to the global financial crisis, the federal government enacted the Emergency Unemployment Compensation (EUC08) program in June 2008 and subsequently amended the law with various other legislation, producing the largest ever extension of UI benefits at the time of its passage. After several expansions, EUC08 allowed eligible workers to claim UI benefits for up to fifty-three additional weeks following exhaustion of twenty-six weeks of regular UI and twenty weeks of EB, for a total of ninety-nine weeks of benefits as of late 2009.<sup>10</sup> The emergency program persisted at this level through late 2012 and tapered off through the end of 2013. The federal government bore the full cost of both the EUC08 extension and the permanent EB program throughout this time, and interest on Title XII advances was waived in 2009 and 2010.

From mid-2008 to the end of 2013, the federal government paid a total of \$230.1 billion of EUC08 benefits based on DOL data, more than 8.5 times the amount of benefits paid through emergency programs during the dot-com recession of the early 2000s (Nicholson and Needels 2011). At the same

time, thirty-six states depleted their trust funds from 2007 to 2009 and accumulated over \$50 billion in debt to the federal government in aggregate. By the end of 2014, twenty-three states still had \$15 billion in outstanding federal debt and \$10 billion in private debt due to UI.<sup>11</sup>

### COVID-19

While the EUC08 extension of benefits was historically significant, the policy was similar in nature to federal UI interventions in previous recessions (Simon 2021). The UI provisions included in the federal response to COVID-19, and especially in the Coronavirus Aid, Relief, and Economic Security (CARES) Act, however, dwarfed previous policies in terms of outlays and were largely unprecedented in form.

The Families First Coronavirus Response Act (FFCRA), signed into law on March 18, 2020, was the first federal COVID-19 response to include UI provisions. The law suspended cost sharing for EB and shifted 100 percent of costs to the federal government, offered additional administrative funding for states, and waived interest on Title XII loans to insolvent states throughout 2020.<sup>12</sup>

That same month, the CARES Act expanded on FFCRA policies and created three new UI programs: Pandemic Emergency Unemployment Compensation (PEUC), Pandemic Unemployment Assistance (PUA), and Federal Pandemic Unemployment Compensation (FPUC). PEUC, like previous federal interventions during recessions, extended the duration of benefits for those who had exhausted regular UI benefits. Initially, PEUC offered thirteen additional weeks of benefits, but after subsequent extensions, claimants could receive an additional fifty-three weeks of UI.

PUA, a novel federal intervention, expanded UI coverage to traditionally ineligible workers, substantially increasing the pool of claimants during the pandemic. Newly eligible workers included gig economy workers, self-employed individuals, and recent entrants into the labor market who were previously unable to receive UI due to lack of employment history. PUA-eligible workers were able to claim regular, PEUC, and EB benefits. By mid-May 2020, initial PUA claims rose to over 2.2 million, nearly matching the number of seasonally adjusted regular initial claims in that same week.

Another unprecedented policy, FPUC, provided an extra \$600 per week in benefits for all claimants. The program was designed to replace 100 percent of the US mean wage when combined with the average state UI benefit, yet

due to wage heterogeneity across states and sectors, the additional benefit often resulted in significantly higher replacement rates. According to Ganong et al. (2020), 76 percent of workers nationally saw replacement rates above 100 percent, and the median national replacement rate was 145 percent between April and July 2020. Some states with lower pre-pandemic wage levels such as Georgia and Oklahoma saw rates over 160 percent. This high replacement rate prompted serious distributional concerns, given that workers who claimed UI benefits during the pandemic were likely to receive a raise compared to previous earnings, yet those who maintained employment likely did not see similar increases in weekly wages.

CARES Act provisions were extended multiple times during and after the height of the COVID-19 crisis. The Lost Wages Assistance program, the Continued Assistance Act, and finally, the American Rescue Plan Act extended PEUC, PUA, and FPUC through September 2021. As of mid-2023, the US DOL estimates that the federal government spent over \$675 billion on COVID-19-related UI programs. At the same time, states paid out \$175 billion in UI benefits from the start of the pandemic through September 2021, leaving state UTFs with a negative aggregate balance of -\$11 billion due to accrued Title XII loan debt (Walczak and Funkhouser 2021).

## UI and Federalism

The federal government's efforts to stabilize the economy during recent crises have accelerated the financial and administrative centralization of the UI program and brought to light structural issues that affect states' labor market dynamics as well as UTF funding behavior and program administration.

### *Experience Rating*

Unlike in any other country, the UI program in the United States relies on revenue from payroll taxes with variable individualized rates, as discussed above (Guo and Johnston 2021). Whereas most countries use a uniform payroll tax to fund unemployment compensation, states in the US are essentially required to use an experience rating system based on unemployment risk or otherwise tax all employers at a 5.4 percent rate (Anderson and Meyer 2000; Guo and Johnston 2021). Though this structure is intended to deter employers from engaging in layoffs and reward firms that avoid them, the payroll tax in practice functions as a tax on employment by raising the cost of an additional employee for a firm. Because rates are linked to layoff activity, taxes are likely to be higher for firms following economic downturns and

especially high for the most distressed firms, effectively discouraging hiring when unemployment is already elevated.

In fact, Johnston (2021) estimates that the reduction in hiring resulting from increased unemployment tax rates accounted for 12 percent of unemployment following the global financial crisis. Likewise, Guo (2023b) estimates a labor demand elasticity of  $-2.4$  to UI tax rates, with more pronounced employment effects for younger, low-earning workers. While there is evidence that experience rating is effective at reducing downsizing behavior (Duggan, Guo, and Johnston 2023), the impact of reduced hiring in the face of increased state UI tax rates may lead to so-called jobless recoveries, as experienced during the global financial crisis (Johnston 2021).

The experience rating system also affects the role of employers in claims decisions. Firms are acutely impacted when previous employees make unemployment claims, producing an incentive for firms to appeal UI claims of former employees and to “police the system” (Anderson and Meyer 2000). Anderson and Meyer (2000) and Lachowska, Sorkin, and Woodbury (2022) find that experience rating systems reduce the number of claims made while increasing the number of appeals and claim denials. This may lessen the positive effects of UI if eligible workers are not able to make claims or receive benefits, and may produce a cost for employers who have to contest invalid claims to ensure they are not charged higher payroll tax rates.

Despite the fact that states are, in essence, required by the federal government to use experience rating systems for UI taxes, it remains an open question whether this is an optimal design for every state, given the policy’s trade-offs (Guo and Johnston 2021).

### *UTFs and Moral Hazard*

As seen during both the global financial crisis and the COVID-19 pandemic, states are frequently unprepared for economic downturns and the associated rise in unemployment claims. Though there are ex post disincentives for states that accrue Title XII loan balances due to insufficient reserves, they evidently do not deter states from underfunding their UTFs during stable economic periods. Rather, shortsighted policymaking and federal bailouts produce an incentive for states to keep reserve levels low (Galle 2018).

To build up trust funds in the long term, states must choose between raising unemployment payroll tax rates and cutting UI benefits in the short term, both economically and politically undesirable options (Galle 2018). On one hand, high SUTA rates, like high corporate tax rates, increase the likelihood



that footloose firms will relocate to states with more preferential payroll tax regimes (Giroud and Rauh 2019). Multi-establishment firms are shown to be significantly more likely to close locations in high-unemployment tax states in the face of economic downturns (Guo 2023a). In the event that firms do not relocate to states with lower rates or close establishments altogether, increased rates dampen hiring efforts and impact employment levels, particularly when job growth is needed most. On the other hand, states can limit duration or amount of benefits in an effort to shore up reserves (Smith and Wenger 2013). Reducing benefits during slumps, however, may weaken the countercyclicality of the UI program, hurt state economies during downturns, and constitute an unpopular policy decision for state officials. Rather than enact these policies, shortsighted policymakers choose to underinvest in their state's unemployment reserves.

This decision is made easier because states know that the federal government will step in and supply Title XII advances to cover benefits in the event that claims surpass reserves, thus lowering the perceived risk of trust fund insolvency. While interest may be accrued on some federal advances, loans taken out and repaid between January and September of a given year, called cash-flow advances, are interest-free. Furthermore, as was the case during both the global financial crisis and the COVID-19 pandemic, interest is often waived on loans altogether during recessions. Ultimately, these bailouts to states with insolvent trust funds produce significant moral hazard, effectively encouraging imprudent policy when it comes to building UTF reserves (Galle 2018).

### *Labor Disincentives and Income Dynamics*

Moral hazard associated with the UI program exists not only at the state level but also at the individual level. Perhaps the most common debate surrounding the optimal design of UI is about the potential labor disincentives that excessively generous benefits may produce. The primary concern is that the provision of unemployment benefits may discourage individuals from working or may lessen search efforts. While states generally have the ability to set benefit levels as they see fit, we have seen that the federal government greatly expands benefits during recessionary periods, and this may impact local labor markets.

For example, the CARES Act provisions discussed previously were authorized to continue through September 2021, however, by that time, twenty-six states had already opted to withdraw from the federal programs. Some

states noted that a tighter labor market and increased hiring efforts made the extended UI benefits unnecessary.<sup>13</sup> Others specifically highlighted that work disincentives caused by pandemic UI programs hindered economic recovery in their state.<sup>14</sup>

Research on the distortionary effect of UI, however, is somewhat mixed. Chetty (2008) argues that UI is not as distortionary as many perceive it to be, given that unemployment durations caused by UI benefits are largely produced by a liquidity effect rather than a substitution effect or distortions on job search incentives. Dube (2021) similarly finds that reductions in benefit amounts after the expiration of the \$600 weekly FPUC payments did not produce large changes in employment, suggesting that the generous benefits did not have significant distortionary effects during that period. Conversely, Meyer and Mok (2014) show that an increase in weekly benefit amounts in New York resulted in a significant increase in UI claims as well as an increase in the duration of claims. Studying a reduction in maximum benefit duration in Missouri following the global financial crisis, Johnston and Mas (2018) find that a cut in potential duration resulted in a reduction of time spent unemployed, suggesting that the benefit cut produced increased job search efforts.

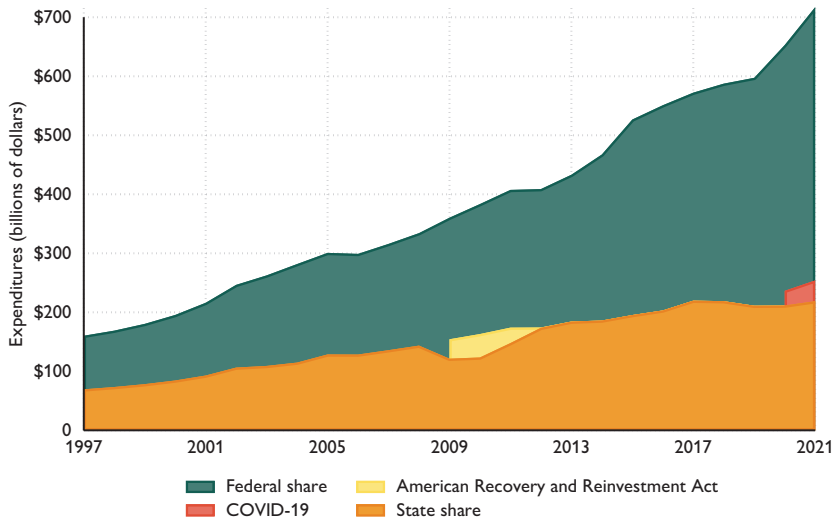
While there is not a consensus on the work incentives associated with unemployment benefits, the universal approach used by the federal government when enacting UI interventions during the pandemic resulted in unprecedentedly high average replacement rates, affecting income dynamics in all states (Ganong et al. 2020). The additional FPUC payment more than doubled the normal maximum weekly benefit amounts in forty-five states. For example, Mississippi's maximum weekly benefit amount grew from \$235 to \$835 per week with FPUC. This extra benefit likely stretches much further in a state with a low cost of living like Mississippi, where the average home cost is \$128,000, than it does in Hawaii, where the average home cost is five times that.<sup>15</sup> Because it ignored the crucial state-by-state variation in normal weekly benefit amounts, cost of living, and other economic conditions, the federal government's COVID-19 UI response likely resulted in large-scale inefficiencies and changes to state income dynamics.

## *Medicaid*

The Medicaid program, like UI, is a joint federal and state program that administers medical services to certain low-income populations. While state participation in the program is voluntary, every state participates and

therefore follows certain federal guidelines to receive the federal share of Medicaid funding. Similar to UI, the federal framework for Medicaid offers some design flexibility, resulting in different programs across the country.

Since its creation in the 1960s, Medicaid expenditures, especially federal Medicaid expenditures, have grown every year with few exceptions, as displayed in figure 10.7.<sup>16</sup> Much of this increase can be attributed to eligibility expansions and subsequently higher rates of enrollment. As Medicaid is a means-tested program, eligibility is determined by financial need; however, there are also categorical criteria that affect eligibility. Prior to the passage of the Affordable Care Act (ACA), only certain groups, such as low-income families with children, pregnant women, and individuals with disabilities were required by federal law to be eligible for a state's Medicaid program. After ACA was implemented in 2014, though, states could opt into a Medicaid expansion that made adults with income up to 138 percent of the federal poverty level eligible, regardless of other categorical criteria. This expansion alone resulted in an estimated 8.8 percent rise in enrollment nationally in fiscal year 2014, significantly increasing Medicaid expenditures ever since, especially for the federal government.<sup>17</sup> According to the Centers for Medicare and Medicaid



**Figure 10.7** State and federal Medicaid expenditures

Note: Medicaid expenditures based on total net expenditures for the Medical Assistance Program reported in Medicaid Financial Management Reports.

Source: Centers for Medicare and Medicaid Services.

Services, as of 2021, the federal government spent more than \$498 billion on the Medical Assistance Program while state governments spent \$219 billion.

The federal government finances a majority of Medicaid spending through reimbursements to states, who pay service providers directly. Each state's reimbursement rate is determined by its federal medical assistance percentage (FMAP) rate, which is calculated annually. By statute, FMAP rates must fall between 50 percent and 83 percent, but the exact percentage is based on the state's per capita income in relation to the overall US per capita income. States with lower income levels receive a higher rate of federal reimbursement. In 2019 (the last year before COVID-19-related measures were enacted), fourteen states received the minimum 50 percent reimbursement rate, while Mississippi had the highest reimbursement rate at 76.39 percent.<sup>18</sup> The state share of the Medical Assistance Program then is at most 50 percent of the total cost of the program. States have some discretion in terms of funding sources for their shares of Medicaid expenditures, but most state funding comes from state general funds.

### Medicaid in Times of Crisis

Medicaid is countercyclical in nature—enrollment typically rises during recessions, when unemployment rates increase and wages decline, making more people eligible for coverage. Indeed, in both the global financial crisis and the COVID-19 pandemic, Medicaid enrollment expanded significantly. Between 2007 and 2009, enrollment grew by 9.7 percent while unemployment rose to 9.5 percent and state tax collections fell by 10.2 percent.<sup>19</sup> Similarly, from February 2020 to September 2020 alone, enrollment increased by 10.3 percent, coinciding with a dramatic increase in unemployment in April 2020, resulting in a significant increase in Medicaid expenditures. To account for greater demand during times when state governments are also likely to see a decline in revenues, the federal government often assists states during recessions by raising FMAP rates.

### Global Financial Crisis

During the global financial crisis, the federal government made an effort to stabilize the economy and ensure continued service despite depleted state revenues through the American Recovery and Reinvestment Act (ARRA). The legislation included \$103 billion in federal aid to states, primarily in the form of increased FMAP rates for all states from October 2008 through June 2011. During that period, every state received a 6.2 percentage point

increase in their federal matching rates, and states experiencing particularly high levels of unemployment received further increases. Rate increases were phased down in the final two quarters of the program. A hold-harmless provision was also included in ARRA, meaning that a state's FMAP rate could not decrease below its 2008 level for the duration of the relief program. To be eligible for enhanced FMAP rates through ARRA, states needed to comply with "maintenance of effort" requirements, which ensured that states did not restrict their Medicaid eligibility standards or procedures while receiving federal aid. The law also instituted requirements for states to expedite claim payments to providers.

By the first quarter of fiscal year 2011, state ARRA-increased FMAP rates ranged from 61.59 percent in states that would have received 50 percent match rates regularly to 84.86 percent in Mississippi. In 2011, twenty-seven states benefited from the hold-harmless provision, meaning ARRA allowed states to avoid drops in their FMAP rates that would have come about using the regular rate formula due to increased per capita income levels (KFF 2011).

### COVID-19

The COVID-19 pandemic led to a surge in Medicaid enrollment that resulted in a significant increase in expenditures. Through the FFCRA, enacted in 2020, the federal government again increased FMAP rates by 6.2 percentage points and required maintenance of effort standards and continuous coverage for the duration of the pandemic public health emergency (PHE). The continuous coverage requirement prohibited states from disenrolling individuals from Medicaid unless it was requested, regardless of any Medicaid eligibility reviews. This allowed people to remain covered without interruption for the duration of the pandemic emergency. In December 2022, Congress enacted legislation that delinked continuous coverage provisions from the PHE, and states were allowed to end coverage beginning in April 2023, prior to the formal end of the PHE in May 2023. The act also allowed for sunset provisions that would gradually phase out the FFCRA FMAP increases by the end of 2023 to avoid significant losses in coverage and large increases in state Medicaid spending.<sup>20</sup>

Over the course of the continuous coverage period, it is estimated that states received over \$117 billion in enhanced federal funding. At the same time, state expenditures on Medicaid remained stable and even dipped below pre-pandemic levels despite the fact that enrollment was considerably larger during the continuous coverage period (Williams, Burns, and

Rudowitz 2023). According to the Congressional Budget Office (CBO), of the 73.6 million people it estimated to be enrolled in Medicaid in 2022, 12.9 million were enrolled because of the continuous coverage provisions, suggesting nearly a fifth of enrollees would have been otherwise ineligible for coverage (CBO 2022a).

### Medicaid and Federalism

Through both economic downturns and legislative reforms, the role of the federal government in the provision of Medicaid has grown substantially in recent decades. Concretely, federal Medicaid expenditures increased nearly 450 percent between 1997 and 2021, while state expenditures have grown by about half as much. Medicaid expenditures account for a significant portion of state general funds—18 percent nationally as of state fiscal year 2021.<sup>21</sup> Decisions made by the federal government regarding Medicaid, therefore, have substantial budget implications for state governments.

### *Medicaid Expansion and the Affordable Care Act*

The Affordable Care Act (ACA), signed into law in 2010, constitutes the largest federal healthcare reform law since Medicare and Medicaid were created in 1965. While the ACA includes a number of other healthcare provisions, perhaps the most significant change made to Medicaid through the ACA was the expansion of eligibility to include all adults with incomes up to 138 percent of the federal poverty level regardless of other categorical criteria. Although expansion was originally set forth as a requirement, a 2012 Supreme Court decision made Medicaid expansion optional for states. Beginning in 2014, twenty-five states opted in to expand eligibility, resulting in an 8.8 percent increase in enrollment in 2014 and a 7.2 percent increase in 2015 (MACPAC 2022). As of 2023, just ten states have not opted to expand.<sup>22</sup>

To fund the expansion, the federal government initially offered a 100 percent matching rate for newly eligible enrollees through the ACA until 2017. In the following years, the matching rate declined slightly each year until it reached 90 percent in 2020, where it remains currently for all states that have opted into Medicaid expansion. Accordingly, the federal share of Medicaid expenditures grew significantly following expansion, while the state share remained relatively stable even for states that opted in. In 2015, total federal Medicaid spending grew by 18 percent to \$331 billion, with ACA expansion funding accounting for about one-fifth of the total expenditures (Clemens and Ippolito 2018). Meanwhile, the state share of



spending grew by 5 percent in 2015, according to Centers for Medicare and Medicaid Services (CMS) data.

The impact of ACA funding on states that have opted into expansion is significant, although heterogeneous. In 2021, ACA funding as a percent of total federal Medicaid spending in expansion states ranged from 4 percent in Oklahoma (opted in to expansion in 2021) to 54 percent in Washington (opted in to expansion in 2014) with a median of 32 percent according to CMS data. While research suggests that Medicaid expansion has not significantly impacted state budgets, expansion does make states highly reliant on the federal government, as evidenced by analysis of potential reform efforts at the federal level (Gruber and Sommers 2020).

In a report on options to reduce the federal deficit, the CBO concluded that reducing the federal matching rate for ACA enrollees to the standard FMAP rate would likely cause states to discontinue coverage for those enrollees because of the strain expanded coverage would put on state budgets (CBO 2022b). In fact, many states included provisions in their expansion legislation to unwind expansion if federal matching falls below certain thresholds (Clemens and Ippolito 2018).

### *Targeting and Timing of Federal Aid*

As discussed above, the federal government frequently provides aid to states during economic downturns to ensure that countercyclical programs like Medicaid can continue in the face of state budget constraints. Similar to emergency programs for UI, federal Medicaid assistance offered to states during recessions is often one-size-fits-all in the form of enhanced FMAP rates for all states, yet this misses crucial variation in state economic conditions. For example, between February 2020 and September 2020, the increase in Medicaid enrollment per state resident ranged from 0.009 to 0.054 people. States like New York and Nevada experienced greater increases in enrollment per resident, while Alabama and Wyoming saw smaller increases in enrollment per resident (Clemens, Ippolito, and Veuger 2021).

Despite this heterogeneity, each state received a blanket 6.2 percent increase in FMAP rates through FFCRA. Indeed, Clemens, Ippolito, and Veuger (2021) find that FFCRA Medicaid relief funds were not strongly correlated to enrollment shocks during the COVID-19 pandemic. This suggests that rather than providing aid to states that likely needed it most, the enhanced FMAP reimbursements actually benefited states with higher baseline expenditures instead. In contrast, Clemens, Ippolito, and Veuger (2021) also assess

the state aid delivered through the American Rescue Plan Act (ARPA) during the pandemic and find that because this assistance was tied to state unemployment rates, the aid was somewhat better targeted to states in need.

As pandemic-era Medicaid rules wind down, it is unclear how states will be impacted. The end of the continuous coverage period is likely to result in a decrease in enrollment in many states. Williams, Burns, and Rudowitz (2023) estimate that enrollment will fall by 18 percent nationally between March 2023 and March 2024, yet disenrollment rates will vary by state. Once enhanced FMAP rates are also phased down, it is likely that states will see a sharp increase in their own Medicaid spending, as was the case when the enhanced FMAP rates provided during the great recession concluded. In fact, state Medicaid spending grew by 19.8 percent in fiscal year 2012 compared to the previous year, following the end of ARRA FMAP rate increases (Williams 2022). States similarly expect that a decrease in federal Medicaid spending post-FFCRA will impact their own budgets greatly, particularly if enrollment remains high.

### *Pensions and Debt*

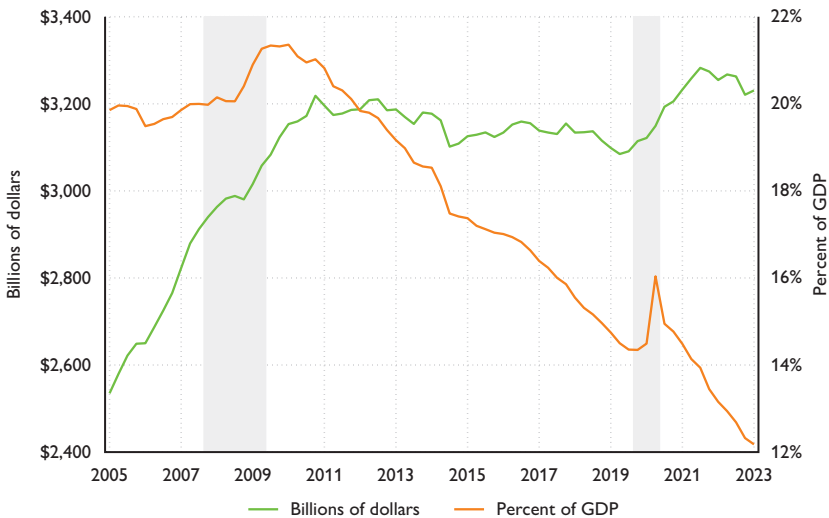
The previous sections have shown how the increased costs of state-administered programs have been accompanied by an increase in the federal share of the financial burden of those programs. While it would require substantial political will, such programs could be reformed. Less flexible are the debts and unfunded liabilities that state and local governments have acquired over time. Concerns during the COVID-19 panic about state and local government finances drove over \$900 billion of federal “relief” for state and local governments (Clemens and Veuger 2023). States accepting such aid were under no requirement to renegotiate any debts or outstanding obligations or reform any programs. The unconditional nature of these transfers raises the question of the extent to which state and local debts and liabilities are also implicitly federal liabilities.

The stable nature of state and local debts may be attributable to balanced budget requirements and other fiscal rules, such as state controls on local debt, which vary across states but overall limit the extent of the growth of municipal bond debt (Epple and Spatt 1986). In addition, over 60 percent of municipal bond debt is in the form of revenue bonds that are backed by a specific revenue stream and hence have a dedicated source of funding for repayment. With that said, there are significant differences in indebtedness across states.

As shown in figure 10.8, state and local government bonds and loans outstanding rose in the first decade of the 2000s and have remained largely stable at around \$3.2 trillion since 2010, yet declined as a share of GDP from 20 percent to 12 percent during the same period.

Figures 10.9a and 10.9b show on a logarithmic scale the relationship between the share of total municipal debt outstanding and the size of the states' populations and economies as measured by gross state product. Over 90 percent of the variation in the debt share is captured by state size, leaving 6 percent to 10 percent unexplained and thus reflecting differences in relative debt burdens. The slopes of the lines of best fit are 1.091 and 1.063, respectively, suggesting that larger states have somewhat more debt than would be predicted by a perfect linear relationship between debt and population with a slope of 1.

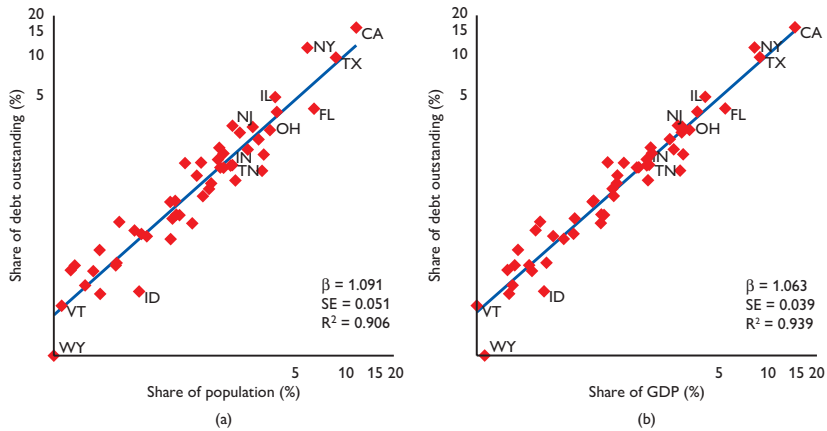
More significant than the evolution of bond indebtedness has been the growth of unfunded pension liabilities, which according to Federal Reserve statistics, reached \$4.4 trillion in the first quarter of 2023. Figure 10.10 shows this evolution over time, with data from the Federal Reserve's Financial Accounts of the United States (Table L.120.b).



**Figure 10.8** State and local governments' debt securities and loan liabilities

Note: Shading indicates recessions as defined by the NBER.

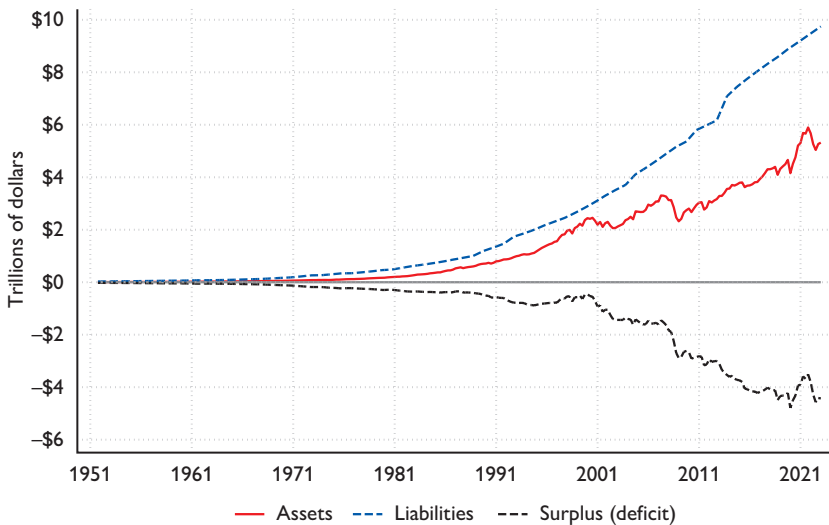
Sources: Liability from St. Louis Fed FRED Economic Data; GDP data from US Bureau of Economic Analysis.



**Figure 10.9** State share of total debt outstanding, 2021

Note: Displays line of best fit. Log scales.

Sources: Debt data from US Census Bureau's State and Local Government Finance Historical Datasets; population data from US Census Bureau; GDP data from US Bureau of Economic Analysis.



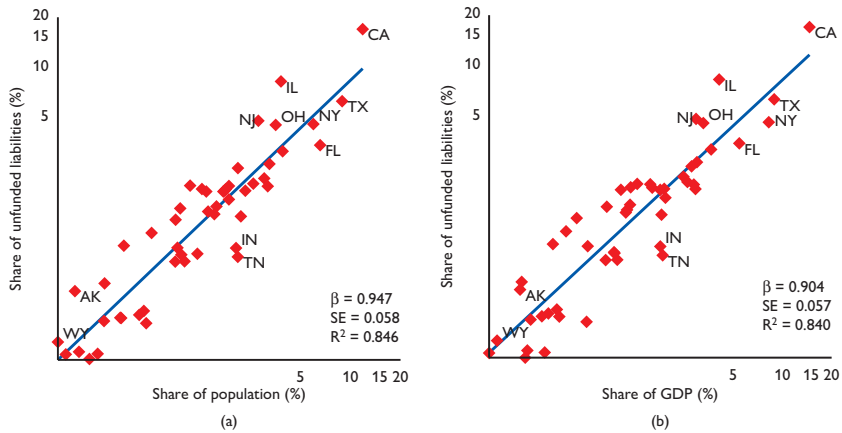
**Figure 10.10** Federal reserve state and local pension assets and liabilities

Source: Federal Reserve Flow of Funds Z.1 (L.120.b).

As discussed in Giesecke and Rauh (2023), these official figures from the Federal Reserve are larger than the liabilities that state and local governments disclose in their annual financial reports, due largely to the use of lower discount rates. The Federal Reserve figures, however, do not represent a true value of the liability as a guaranteed payment, which would require discounting using a default-free yield curve. Default-free market value pension valuation treats pension promises as similar in their default characteristics to low-risk government bonds, as opposed to either the Federal Reserve's approach (fixed discount rates periodically updated based on corporate bond yields) or the approach of the systems themselves (fixed discount rates based on expected returns on plan assets). Nonetheless, despite increases in the value of plan assets from around \$2 trillion in the year 2000 to over \$5 trillion in 2022, unfunded liabilities grew from less than \$1 trillion to the current \$4.4 trillion in this period, as the rate of growth of liabilities substantially outpaced the rate of growth of assets. This is remarkable given that pension fund assets tend to have heavy risk loadings on the US stock market, which increased in value by a factor of over three times over this time period based on the S&P 500 index level.

To a somewhat greater extent than the overall level of debt, unfunded pension liabilities are unequally distributed across states. As shown in figures 10.11a and 10.11b, the coefficients on lines of best fit are below 1, in the range of 0.90–0.95, and the fit as measured by R-squared is 0.84–0.85. There is thus significantly more variation in unfunded liabilities not explained by state size. Among medium- to large-size states, California, Illinois, New Jersey, and Ohio sit above the lines of best fit, while Texas, New York, Florida, Indiana, and Tennessee sit below it.

In aggregate, the underlying risk factors involve the evolution of benefits on the liability side, the exposure of assets to market risk on the asset side, and the extent to which pension funding will be increased. These risk factors also have cross-sectional components, although to some extent the federal government may view unfunded pension liabilities as a common problem. Given the reaction of the federal government to shocks such as COVID-19, as well as dynamics surrounding union pension rescue packages, it would not be unreasonable to think that state and local government pension liabilities will be rescued as well. Such a possibility raises moral hazard on the part of states, removing incentives to address their own fiscal challenges.



**Figure 10.11** State share of total unfunded pension liabilities (market value), 2021

Note: Displays line of best fit. Log scales.

Sources: Pension data from [publicpension.stanford.edu](http://publicpension.stanford.edu); population data from US Census Bureau; GDP data from US Bureau of Economic Analysis.

The political dynamics of pension bailouts from the recent rescue of union pension plans foreshadow what might occur if a state or local government seeks federal government support. In 2022, the Biden administration applied \$36 billion in federal funds to cover the deficit in the Teamsters’ Central States Pension Fund. This follows a \$10 billion 2019 rescue of coal miners’ pensions, all part of a system of multiemployer pensions covering unionized workers in the private sector (Rauh 2018).

## Conclusion

The optimal extent to which services are provided at a federal versus local level and funded at a state versus local level is a long-standing research question. This essay has explored the increasing federalization of government programs and the implications for state and federal liabilities. Despite states’ status as sovereign entities with taxation and debt issuance authority, many state liabilities appear to have become de facto federal liabilities, since the federal government’s support role expands dramatically when state and local systems come under pressure. Thus, programs that may ex ante have appeared to be largely state-funded have increasingly proven to be federally funded. This will be even more so the case if the unfunded liabilities that have financed an expansion in state and local government expenditures also prove to be federal liabilities.



## Notes

1. While Montana offers more than twenty-six weeks of benefit payments, thirteen states offer fewer than twenty-six weeks. For more information, see *Policy Basics: How Many Weeks of Unemployment Compensation Are Available?*, updated December 18, 2023. Washington, DC: Center on Budget and Policy Priorities.

2. See Congressional Research Service (hereafter CRS), *Unemployment Insurance: Programs and Benefits* (RL3362), October 18, 2019.

3. Employers with at least one employee for at least twenty weeks of the year or who have paid at least \$1,500 to employees in any quarter of that year pay FUTA and SUTA.

4. See CRS, *The Unemployment Trust Fund (UTF): State Insolvency and Federal Loans to States* (RS22954), updated January 13, 2023.

5. SUTA rates range from 0 to over 14 percent, with bases ranging from \$7,000 to \$62,500 as of tax year 2022.

6. For an explanation of SUTA experience rating requirements, see Conformity Requirements for State UC Laws on the US Department of Labor website (n.d.), [https://oui.doleta.gov/unemploy/pdf/uilaws\\_exper\\_rating.pdf](https://oui.doleta.gov/unemploy/pdf/uilaws_exper_rating.pdf).

7. The latest Department of Labor solvency report can be found at the US Department of Labor website (March 2023), <https://oui.doleta.gov/unemploy/docs/trustFundSolvReport2023.pdf>.

8. A full explanation of FUTA rates and credits can be found on the Congressional Research Service (CRS) website: <https://crsreports.congress.gov/product/pdf/RS/RS22954>.

9. States below 100 percent solvency in quarter three of 2019 include Arizona, California, Colorado, Connecticut, Delaware, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Minnesota, Missouri, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Tennessee, Texas, West Virginia, and Wisconsin.

10. See Katelin P. Isaacs and Julie M. Whittaker, *Emergency Unemployment Compensation (EUC08): Status of Benefits Prior to Expiration* (R42444), Congressional Research Service, August 11, 2014.

11. See US DOL's 2014 State Unemployment Insurance Trust Fund Solvency Report.

12. CRS, *Unemployment Trust Fund*.

13. See Iowa Workforce Development memorandum, May 10, 2021, <https://governor.iowa.gov/sites/default/files/documents/2021-05-10--MEMORANDUM.pdf>.

14. See South Carolina governor Henry McMaster to Daniel Ellzey, May 6, 2021, [https://governor.sc.gov/sites/default/files/Documents/5-6-21 Gov McMaster to Dir Ellzey re Federal UI benefit termination.pdf](https://governor.sc.gov/sites/default/files/Documents/5-6-21%20Gov%20McMaster%20to%20Dir%20Ellzey%20re%20Federal%20UI%20benefit%20termination.pdf).

15. See World Population Review, "Cost of Living Index by State 2023," <https://worldpopulationreview.com/state-rankings/cost-of-living-index-by-state>.

16. See CRS, *Medicaid Financing and Expenditures* (R42640), updated November 10, 2020.
17. CRS, *Medicaid Financing and Expenditures*. See also CRS, *Medicaid: An Overview* (R43357), updated February 8, 2023.
18. A full list of FMAP rates can be found at Kaiser Family Foundation (hereafter KFF), <https://www.kff.org/medicaid/state-indicator/federal-matching-rate-and-multiplier>.
19. See CRS, *Medicaid Recession-Related FMAP Increases* (R46346), May 7, 2020.
20. For details on unwinding FFCRA Medicaid provisions, see Suzanne Wikle and Jennifer Wagner, *Unwinding the Medicaid Continuous Coverage Requirement*, Center for Law and Social Policy, updated April 28, 2023.
21. For state-by-state breakdowns, see KFF, *Medicaid Expenditures as a Percent of Total State Expenditures by Fund*, SFY 2021.
22. Nonexpansion states include Alabama, Florida, Georgia, Kansas, Mississippi, South Carolina, Tennessee, Texas, Wisconsin, and Wyoming. For information on Medicaid expansion, see KFF, *Status of State Medicaid Expansion Decisions*, October 4, 2023.

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