POLICY ISSUES

Local Government Revenue Loss[161]

Issue Summary. Areas struck by disasters or terrorist acts often experience a decline in economic activity, and, consequently, a reduction in tax collections for affected local governments. However, the financial and public service obligations of local governments persist and may actually increase after the catastrophe. The unexpected loss of revenue, coupled with the increased financial burden of responding to a terrorist act or natural disaster, often leads local governments to request assistance from both the state government and the federal government.

The Stafford Act authorizes financial assistance to local governments that face tax revenue losses as a result of a major disaster. Congress might elect to modify the existing authority in light of the needs of communities that could be devastated by terrorist attacks.

Issue Analysis. Generally, local governments maintain a capital budget and an operating budget. The capital budget, which is financed with debt for public infrastructure spending, is usually kept separate from the operating budget. The operating budget matches current expenditures with current revenues and is meant to be balanced every fiscal year. Deficits in the operating budget are not usually financed with debt. As a result, a sudden loss of revenue, without a corresponding drop in current expenditures, is difficult for local governments to overcome.

The Community Disaster Loan (CDL) program, authorized by the Stafford Act and administered by FEMA, assists local governments that lose tax revenue after a major disaster. The objective of the CDL program is to help

> ... any local government which may suffer a substantial loss of tax and other revenues as a result of a major disaster, and has demonstrated a need for financial assistance in order to perform its governmental functions.[162]

The loans are intended to help local governments finance governmental functions by replacing lost tax revenue after a disaster interferes with or diminishes economic activity.

The CDL program allows for loan forgiveness when it is apparent (in the judgment of the independent auditors hired by FEMA and FEMA staff) that the affected government will not be able to service the loan. Loan forgiveness, or the anticipation of a cancelled loan, may be one significant reason local governments participate in the CDL program.

Application to Terrorist Attacks. The effect of terrorist attacks on economic activity is similar in many ways to the effect of natural disasters. Revenue

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[161]Written by Steven Maguire, Government and Finance Division.

[162]42 U.S.C. 5184

from local income, property, and sales taxes will almost certainly decline when terrorist attacks take lives, destroy buildings, and disrupt commerce. If, as occurred in New York and Virginia after September 11, a major disaster declaration is issued after a terrorist attack, affected local governments may be eligible for CDL assistance. Attacks as significant as those of September 11 may merit greater aid (more than the current CDL program allows) given the magnitude of the destruction. For example, the New York City comptroller estimated that tax revenues in FY2002 would be "... $738 million less than currently projected," as a result of the attacks.[163]

To date, unlike some natural disasters, the physical effects of recent terrorist acts have been concentrated in relatively small geographic areas. The physical impact of the September 11 attacks affected concentrated areas of New York City, NY, Arlington, VA, and Stony Creek Township, PA. Similarly, the destruction in 1995 of the Murrah federal building affected a portion of Oklahoma City. In contrast, some natural disasters, such as severe hurricanes, tornados, and floods have affected many local governments in several jurisdictions. The limited boundaries of areas affected by terrorist attacks may change. In the future, terrorist acts may affect larger and less defined areas across political jurisdictional boundaries. The effect of these types of terrorist acts would more closely resemble that of large natural disasters, such as those affected by catastrophic earthquakes and hurricanes.

Background. Local governments in a declared major disaster area (states are not eligible) can apply for a CDL of up to 25% of their operating budget for the fiscal year in which the disaster occurred. The implementing regulation stipulates that the loan application

> ... shall include ... copies of the local government's financial reports (Revenue and Expense and Balance Sheet) for the 3 fiscal years immediately prior to the fiscal year of the disaster and the applicant's most recent financial statement must accompany the application.[164]

The maximum loan amount is $5 million; before 2000, there was no limit.[165] In general, the jurisdiction may draw down the loan in increments as prescribed in the promissory note for up to five years. The associate director of FEMA, under special circumstances, may extend the loan term to 10 years.[166]

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[163]New York City Comptroller, "Trade Center Attack Could Cost City Economy More Than $100 Billion Over 2 Years: City Will Need Additional Federal Aid To Recover," press release, Oct. 4, 2001. The press release is available at the following website: [http://comptroller.nyc.gov/press/2001_releases/print/01-10-064.shtm], visited May 15, 2002. The Federal Reserve Bank of New York seems to agree with the $738 million estimate, noting that the "New York City Comptroller's initial estimate of the attack-related tax revenue losses to the city, on the order of $600 million in the fiscal year ending in June, appears reasonable; a similar amount is expected to be lost in the next fiscal year." From document accompanying a letter from William J. McDonough, President, Federal Reserve Bank of New York, to The Honorable Carolyn B. Maloney, April 18, 2002, p. 7.

[164]44 CFR 206.364(b)(1).

[165]P.L. 106-390 imposed the $5 million limit.

[166]According to 44 CFR 206.361(e), the loan can be extended even beyond the 10 years
(continued...)

The interest rate on CDLs is based on the five-year Treasury bill rate on the date of the loan approval. On June 7, 2002, the average interest rate (yield) on five-year municipal bonds was 3.40% and for five-year Treasury notes the average yield was 4.32%.[167] The interest rate on CDLs is higher than the average rate on municipal (state and local) bonds. Generally, municipal debt carries a lower interest rate because the interest is not included in the holder's taxable income. The tax exemption of state and local government bond interest allows the issuing governments to issue bonds with lower interest rates.

Since 1976, officials administering the CDL program have approved 64 loans (four of which were withdrawn by the applicant before any funds were disbursed, thus only 60 loans were made) to local governments that experienced significant revenue losses from a declared disaster (see Table 3, below, for summary information on the CDL program).[168] Of the 60 loans made, 12 have been completely cancelled; all principal and any interest owed by the borrower was forgiven. Cancellation is allowed under the statute.[169] Regulations governing implementation of the Stafford Act provide that FEMA shall:

> "... cancel repayment of all or part of a Community Disaster Loan to the extent that the Associate Director determines that revenues of the local government during the full three fiscal year period following the disaster are insufficient, as a result of the disaster, to meet the operating budget for the local government, including additional unreimbursed disaster-related expenses for a municipal operating character."[170]

Pursuant to this regulation, FEMA has the discretion to cancel all principal and interest due on a CDL or on some portion of CDL principal and interest. As of December 31, 2001, $97.9 million of principal and interest on CDLs had been cancelled (almost 42% of total disbursements).[171] Table 3 shows the amount of cancelled principal and interest as a percentage of disbursed funds.

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[166](...continued)
under extenuating circumstances. Also, as exhibited in Table 3 of this report, the entire loan or parts of the loan principal and interest can be cancelled.

[167]The two interest rates (or yields) are from the following web sites: municipal bonds, [http://www.bloomberg.com/markets/psamuni.html]; and five-year Treasury notes, [http://www.bloomberg.com/markets/C13.html]. Sites visited April 23, 2002. Since 1976, the average monthly rate on mixed grade municipal bonds with long term maturity (20 years) was 7.1%; for five-year Treasury bills, the average monthly rate was 8.0%. Data are from: [http://www.federalreserve.gov/releases/H15/data.htm#top], site visited April 23, 2002.

[168]FEMA Program Specialist Gerry Miederhoff said in an interview with CRS on March 23, 2002, that no application has been declined.

[169]42 U.S.C. 5184(c).

[170]44 C.F.R. 206.366.

[171]Four cancellations account for almost four-fifths of the total. Those loans were issued to the U.S. Virgin Islands after hurricane Hugo ($33.2 million); Kauai, HI, after hurricane Iniki ($19.1 million); Homestead City, FL, after hurricane Andrew ($13.5 million); and American Samoa after hurricane Val ($12.0 million).

Table 3. Summary of CDL Program, 1976 to 2001

		Amount of Principal and Interest:		Principal and Interest as Percent of Disbursed Funds	
Total Loans	Amount Disbursed	Paid	Cancelled	Paid	Cancelled
60[A]	$233,523,691	$13,436,376	$97,901,526	5.75%	41.92%

Source: FEMA data provided by FEMA program specialist Gerry Miederhoff, and CRS calculations, as of Dec. 31, 2001.

[A] Four additional loans were approved but later withdrawn by applicants.

Cancellation authority under the CDL program follows on the precedent enacted by Congress in the Disaster Relief Act of 1970 (the 1970 Act).[172] The deferred grants authorized by the 1970 Act were in response to the "... extensive property damage and a loss of tax base ..." in the aftermath of Hurricane Camille.[173] After a series of hearings following Hurricane Agnes in 1972, the deferred grant program was converted into a loan program under the Disaster Relief Act of 1974 (the 1974 Act).[174] In the 1974 Act, the original deferred grant program "... was retained as the cancellation feature of the [new CDL] program."[175]

It appears that the current CDL program is significantly underutilized given the number of disasters and affected jurisdictions.[176] Since 1976, there have been 906 declared major disasters, many of which affected multiple jurisdictions per disaster. However, only 64 loans resulting from 19 separate disasters have been approved.[177] If the policy objective of the CDL program is to help "... ***any*** [emphasis added] local government which may suffer a substantial loss of tax and other revenues as a result of a major disaster," the relatively low utilization rate of CDLs may indicate that this objective has not been achieved.

[172]Disaster Relief Act of 1970, P.L. 91-606, 84 Stat. 1756.

[173]U.S. Congress, House Committee on Appropriations, Subcommittee on VA, HUD, and Independent Agencies, *Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations for 1998,* hearings, part 4, 105th Cong., 1st sess., March 6, 1997 (Washington: GPO, 1997), p. 91.

[174]P.L. 93-288, 88 Stat. 158.

[175]*Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations for 1998*, p. 91.

[176]Alternately, the low utilization rate may indicate that few local governments need assistance following a declared major disaster.

[177]FEMA, *Total Major Disaster Declarations*, at: [www.fema.gov/library/dis_graph.htm], visited April 2, 2002.

Another possible contributing factor to the low utilization of CDLs is the FEMA guidance that participants establish a sinking fund for the CDL.[178] (Sinking funds are generally used for eventual retirement of a loan.) The money allocated to the recommended sinking fund would increase the cost of the CDL to the local government. In addition to the sinking fund, the relatively higher interest rates for CDLs and the uncertainty surrounding the probability of a loan cancellation may be other explanations for the low ratio of loans made to disasters. Table 4 provides more details of the outcomes of loans made under the CDL program.

Table 4. Summary of CDLs by Current Status, 1976 to 2001

Number of FEMA Loans by Status	Amount of Loan:		Amount of Principal and Interest:	
	Approved	Disbursed	Paid	Cancelled
32 repaid	$5,719,016	$3,674,330	$5,260,467	$415,093
12 cancelled	$38,495,768	$38,490,768	$0	$48,818,933
10 outstanding	$141,057,218	$139,718,593	$112,160	$11,975,667[A]
4 suspended	$1,968,895	$0	$0	$0
4 withdrawn	$965,922	$0	$0	$0
1 debt collection	$1,540,000	$1,540,000	$0	$3,523,789
1 written off	$89,912,000	$50,100,000	$8,063,750	$33,168,044
60 total[B]	$279,658,819	$233,523,691	$13,436,376[C]	$97,901,526[C]

Source: FEMA data and loan status information provided by FEMA program specialist Gerry Miederhoff, and CRS calculations, as of Dec. 31, 2001.

[A] Reflects amount of principal and interest cancelled for loans still in repayment as of December 31, 2001.
[B] Total number does not include four loans withdrawn by applicants.
[C] As of December 31, 2001, a significant amount of principal and interest on loans still in repayment was still accruing. Therefore, the amount of principal and interest paid and cancelled accounts for only a portion of the total amount approved and disbursed.

Policy Options. In the short run, reduced economic activity in the aftermath of a natural disaster or major terrorist act typically leads to reduced local tax revenue. However, the need for government services does not decline along with the drop in tax revenue, but may increase after a disaster. Through the Disaster Relief Act of 1974, Congress created the current CDL program for the short term budget crises that often arise following natural disasters. It may be argued that the CDL program could be reshaped to meet the challenge likely to be presented by terrorist acts because of the similar budget crises attacks have on economic activity and local tax revenue. Following are some policy options that Congress might consider.

Maintain the Status Quo. The current CDL program has approved 64 loans from 1976 through December 31, 2001. Over this same period, there have been 906

[178] 44 CFR 206.365(a)(2).

declared major disasters. The data provided by FEMA and presented in Table 3, seem to show that the CDL program is better characterized as a grant program with a loan component due to the high rate of loan cancellation. Almost 42% of disbursed funds for CDLs have been cancelled. One option for Congress is to continue with the current CDL rules and procedures without modification, including the ineligibility of states for CDL assistance.[179]

Pro. Maintaining the status quo could be achieved with little or no additional federal cost. The relatively tight federal budget suggests that additional spending for an expanded CDL program would necessarily lead to: reduced spending on other priorities, higher taxes, more debt, or some combination of the three. Thus, continuing the current CDL without changes would have minimal impact on the federal fiscal position.

Con. Many local governments would not benefit significantly from the existing CDL program in the event of a disaster because of the recently imposed $5 million limit per disaster. For example, the New York City comptroller projected that tax revenues in FY2002 will be "... $738 million less than currently projected."[180] Even though all of the projected shortfall in New York City tax revenue may not be directly attributable to the terrorist acts, even 25% of the revenue loss generated by the attacks would greatly exceed the current $5 million CDL cap. In addition, state revenue loss needs continue to be unmet.

Authorize Grants, Not Loans. The current CDL program has served as a de facto grant program for the 12 jurisdictions whose CDLs have been fully cancelled. Replacing the current loan mechanism with a direct grant program is another option.

Pro. With a grant program, immediate revenue relief could be provided without saddling the affected areas with additional debt. Because the cost of the grant would be shared by all federal taxpayers, the burden on the affected government would be minimized. In addition, federal monitoring of loan compliance and loan repayment may not be necessary with grants. Thus, relative to the current CDL program, lower administrative costs per dollar of aid delivered are likely with a grant program. In

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[179]The Fiscal Policy Institute reports that, according to the New York state budget director, state "...tax revenue will be down by up to $9 billion over the course of the next 18 months as a direct result of the September 11th attacks." Fiscal Policy Institute, "New York and the Federal Fisc in the Aftermath of September 11th: The State and Local Impacts of Federal Policy Options," (New York: January 23, 2002), p. 11.

[180]New York City Comptroller, "Trade Center Attack Could Cost City Economy More Than $100 Billion Over 2 Years: City Will Need Additional Federal Aid To Recover," press release, Oct. 4, 2001. The press release is available at the following Web site: [http://comptroller.nyc.gov/press/2001_releases/print/01-10-064.shtm]. The Federal Reserve Bank of New York notes that the "New York City Comptroller's initial estimate of the attack-related tax revenue losses to the city, on the order of $600 million in the fiscal year ending in June, appears reasonable; a similar amount is expected to be lost in the next fiscal year." From document accompanying a letter from William J. McDonough, President, Federal Reserve Bank of New York, to The Honorable Carolyn B. Maloney, April 18, 2002, p. 7.

1997 congressional testimony, then FEMA Director James Lee Witt asked rhetorically,

> "... then let it be a grant program if they can't pay the money back. Why spend all the money we are having to spend administratively to support these loans and to have accounting firms go in and do audits of the cities or governments that are getting the loans if they are not being repaid?"[181]

Con. A grant program would likely be used by more applicants and could be potentially more expensive for federal taxpayers. The greater cost would also redistribute more revenue from non-affected areas to affected areas. Even though administrative costs would decline with grants, the grants might require more federal control and oversight on the use of funds. Administrative compliance might increase the implicit cost of the grant program.

Change the CDL Interest Rate. Modification of the CDL program to make the loans more attractive would serve more governments that have experienced revenue shortfalls after declared major disasters. Greater use of the program could result from lower CDL interest rates.

Pro. Existing administrative structures could easily be adapted to allow for lower interest rates. For example, FEMA could implement a different interest rate base, such as a fixed amount (basis points) below the host state's (or local government's) current five-year bond rate. Such a change would reduce the burden on the borrowing government.

There would be other benefits to modifying the interest rate on the CDLs. Linking the CDL interest rate more clearly to the underlying credit rating of the borrowing government would reduce the adverse selection that may exist under the current program.[182] As noted previously, the average municipal bond interest rate is lower than the CDL rate. Thus, it seems that only those jurisdictions with lower than average credit ratings, and higher than average interest rates, would be attracted to the CDL program.

Con. A lower interest rate would, by design, increase the attractiveness of the CDL program to more units of local government. The increased demand that might result would increase the federal cost of the program. Also, some might question whether the federal role should be expanded when the benefits of the federal expenditure would flow to a relatively narrow constituency.

Eliminate the $5 Million Cap. The current CDL program limits the total amount of a loan to $5 million per jurisdiction, per event. The recently established

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[181] *Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations for 1998*, pp. 64-65.

[182] The term "adverse selection" refers to the concept in insurance markets where only those who are likely to need insurance will purchase policies. For borrowing, only jurisdictions with budget trouble will need to borrow.

limit would prevent large jurisdictions from benefitting significantly from the CDL program.

Pro. Increasing or removing the $5 million limit would likely deliver more federal aid to large jurisdictions than would otherwise be allowed under current authority. Because of the limit, assistance has not significantly benefited large jurisdictions. Thus, the limit leads to a redistribution of benefits from large to small jurisdictions that receive CDLs. Eliminating the cap would minimize this redistribution effect. In addition, some would argue that the other cap, 25% of the borrowing government's operating budget in the fiscal year of the event, achieves the objective of capping the federal exposure, albeit at a higher level.

Con. The primary argument against eliminating the cap is the greater potential cost to the federal government. Five of the 64 CDLs approved exceeded the $5 million cap and together accounted for almost 80% of the cancelled interest (see Table 5). The large loans seem more likely to be cancelled. As a result, removing the $5 million cap would further increase the federal cost. Another argument against removing the cap is the increased local reliance on federal financing of primarily local expenditures.

Table 5. CDLs Greater than $5 Million
(in $ millions)

Event	Date of Event	Principal Approved	Amount Disbursed	Principal and Interest Cancelled
Hurricane Hugo, U.S.V.I.	9/20/1989	$89.9	$50.1	$33.2
Hurricane Val, American Samoa	12/13/1991	$10.7	$10.2	$12.0
Hurricane Andrew, Homestead, FL	8/24/1992	$10.3	$10.3	$13.5
Hurricane Iniki, Kauai, HI	9/12/1992	$15.0	$15.0	$19.1
Hurricane Marilyn, U.S.V.I.	9/16/1995	$127.2	$127.2	$0.0
Total for CDLs over $5 million (5 loan approvals)		$253.1	$212.8	$77.8
Total for all CDLs (64 loan approvals)		$279.7	$233.5	$97.9

Source: Data are from Gerry Miederhoff, FEMA program specialist, as of Dec. 31, 2001.

Eliminate the CDL Program. Some argue that direct federal assistance for lost local tax revenue via a loan program is not an efficient means of providing assistance to affected local governments. Thus, eliminating the CDL program might be considered a viable policy alternative.

Pro. Elimination of the CDL program would also eliminate the direct federal revenue loss and the related FEMA administrative burden. In the absence of a federal program, states might assume a larger role in relief efforts for communities suffering after a natural disaster or terrorist act. State control over revenue

replacement could be a more efficient allocation and redistribution of revenue given that the benefits of such spending will likely remain in the state.

Con. The CDL program, even with the previously noted criticisms, has provided needed aid to several communities. Supporters of a federal role in helping stricken communities cope with revenue losses note that "By definition, disasters exceed the capacity of the governments whose jurisdiction they strike."[183]

[183]Amy K. Donahue and Philip G. Joyce, "A Framework for Analyzing Emergency Management with an Application to Federal Budgeting," *Public Administration Review*, vol. 61, Dec. 2001, p. 728.