Fiscal Effects of COVID-19 on State and Local Budgets

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Disclaimer

The opinions expressed are those of the authors and do not necessarily express the opinion of the Board of Governors of the Federal Reserve.

Why Worry About State and Local Budgets?

Balanced budget requirements: when revenues fall, need to cut spending or increase taxes.

This is bad for people in the state. Better to smooth through the cost of a shock.

Bad for the economy.

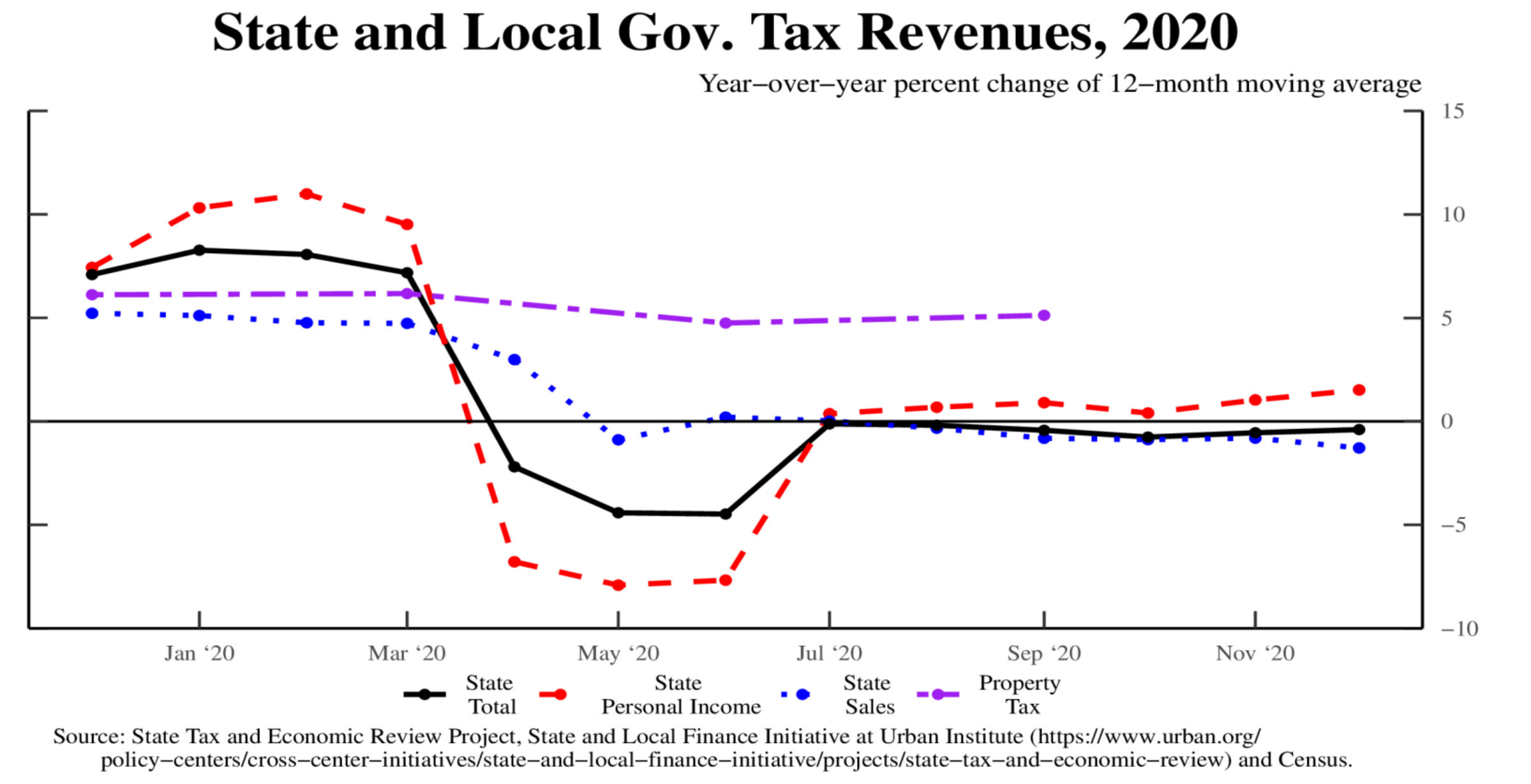
- State and local government a big player. Account for 13% of employment.
- Extremely slow recovery in state and local sector following Great Recession slowed overall economic recovery.

Roadmap

1. S&L revenue performance since onset of pandemic
    - Why have revenues have held up much better than expected?
2. Employment cuts
    - What explains unprecedented employment reductions?

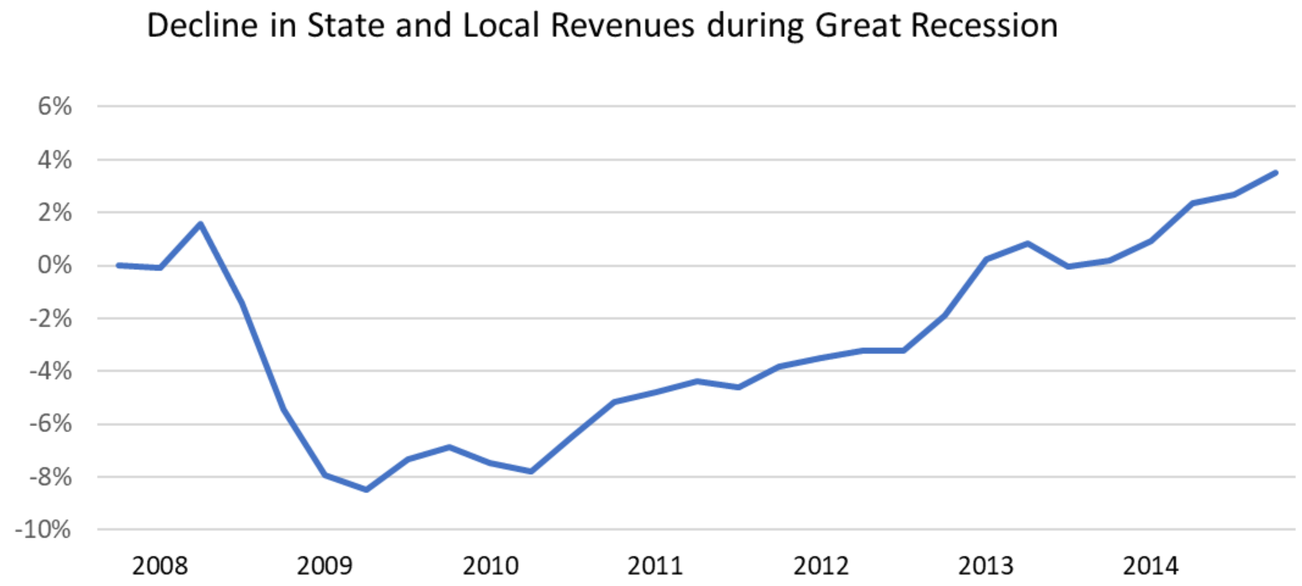
S&L Government Revenue Surprisingly Resilient

- State revenues fell sharply with the onset of the pandemic
  - Bounced back in the summer
- Local property taxes have continued to rise



Revenue Losses Much Smaller than in GR

- Great Recession: real own-source revenues (revenues ex. federal grants) fell about 8% and stayed below pre-recession level for years.



Percent decline in inflation-adjusted own source revenues (revenues less federal grants) relative to 2007 Q3.
Source: Bureau of Economic Analysis.

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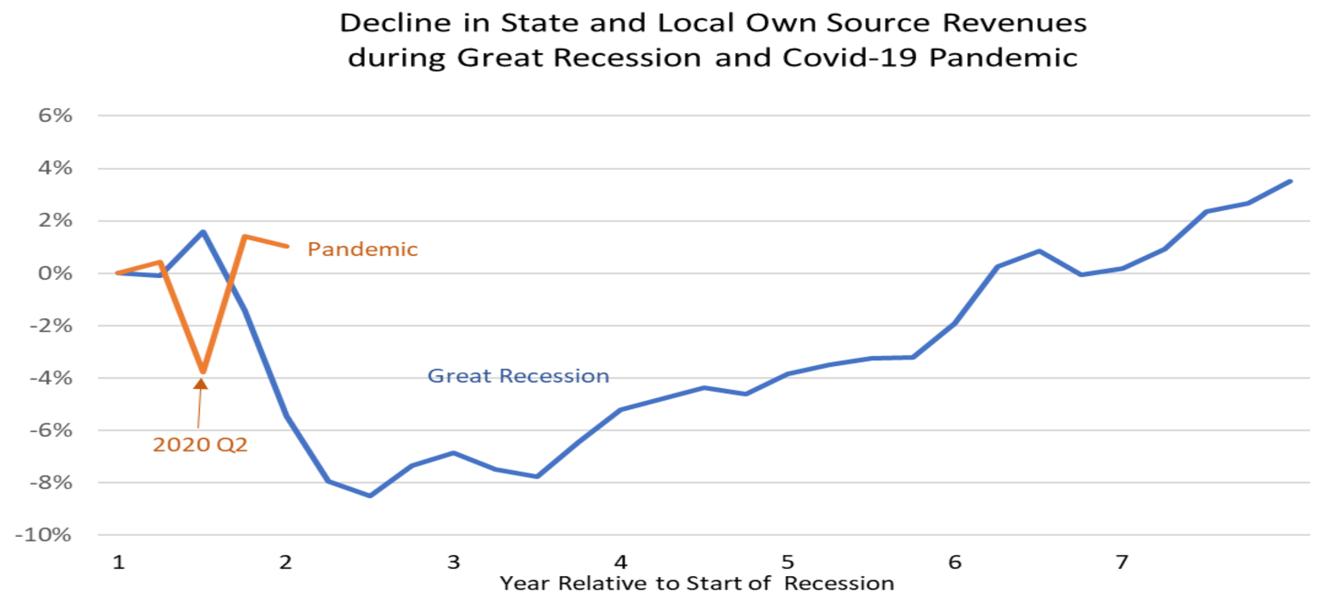
- Pandemic: 2020 about 0.5% below 2019 and 2020:Q4 is above 2019:Q4
    - BEA data subject to revision



Percent decline in inflation-adjusted own source revenues (current revenues less federal grants) relative to business cycle peak.
2020:Q4 corporate income taxes imputed as the average of 2020:Q2 and 2020:Q3 corporate income taxes.
Source: Bureau of Economic Analysis.

Why Are Revenue Losses Less than Feared?

- Last spring, many people were warning about huge revenue losses given surge in unemployment. But losses much smaller than anticipated.
- Why? Addressed in Auerbach, Gale, Lutz, Sheiner (2021) BPEA

1. Downturn less severe than anticipated, partly due to unprecedented fiscal support

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This recession is <u>very</u> different from past recessions.

2. Unemployment unusually concentrated among lower income individuals → less hit to income tax collections

3. Unprecedented level of UI benefits, taxable in most states

4. Durables consumption held up and more prone to taxation than services

5. Stock market has continued to rise

Examples

Changes in California State Revenue Projections (not including federal aid, billions)				
Projection Date	Fiscal Year			
	2020	2021	2022	2023
Nov-20	144.1	153.5	152.2	151.4
May-20	139.5	119.6	122.1	127.8
Pre-Pandemic Gov Budget	149.3	152.6	157.2	160.6

Changes in Texas State General Revenue Projections (not including federal aid, billions)				
Projection Date	Fiscal Year			
	2020	2021	2022	2023
Jan-21	56.9	55.5	58.4	61.1
Jul-20	55.8	53		
Jan-19	59.7	61.8		

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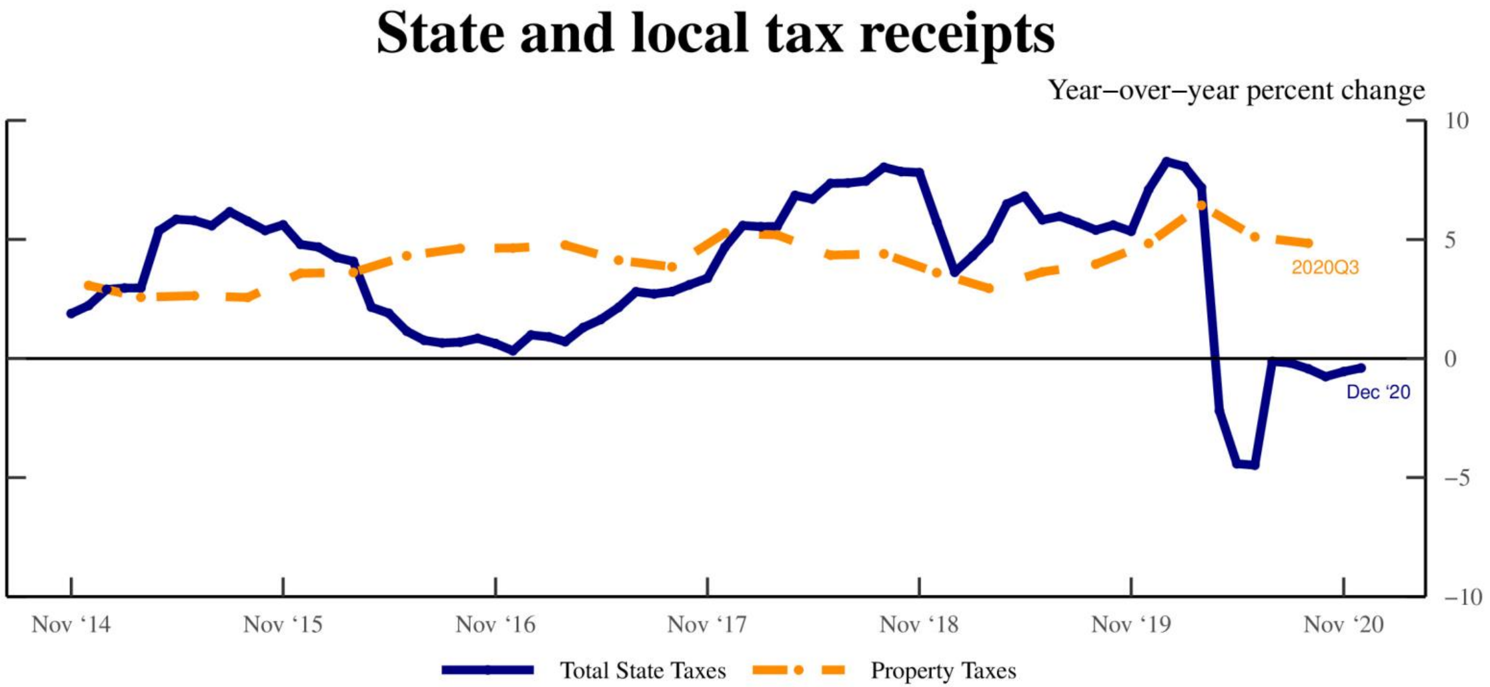
But Revenues Below Expectations and Lots of Variation

- States had generally budgeted for solid tax revenue growth



Note: Total state taxes are calculated as a 12–month moving average and property taxes are calculated as a 4–quarter moving average. State revenues are aggregated over all states except Wyoming, for which data are not available. Revenues from Washington, DC are also excluded. The last three months of data (Oct – Dec) are missing for New Mexico and Dec is missing for Nevada as these states have longer reporting lags than others.
Source: State Tax and Economic Review Project, State and Local Finance Initiative at Urban Institute (https://www.urban.org/policy–centers/cross–center–initiatives/state–and–local–finance–initiative/projects/state–tax–and–economic–review) and Census.

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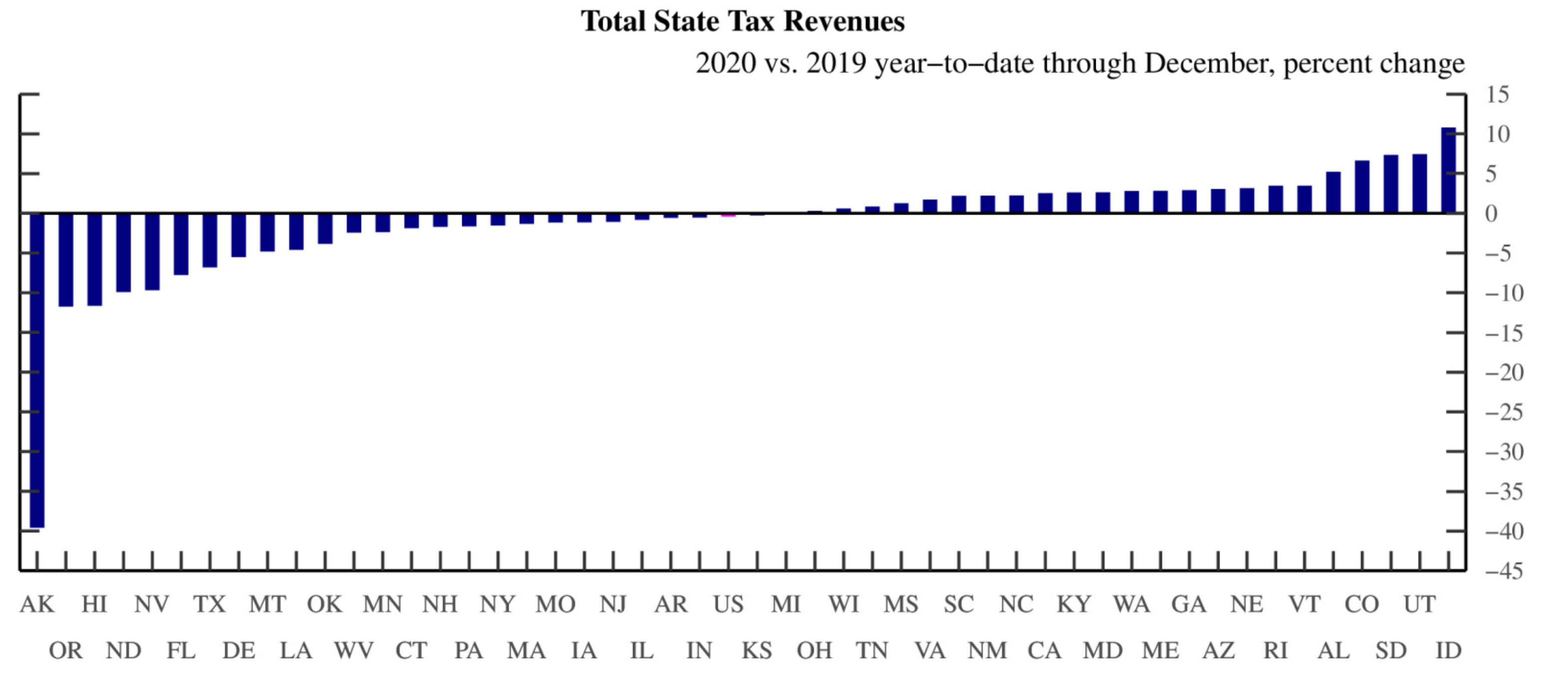
- Some states have seen sharp declines



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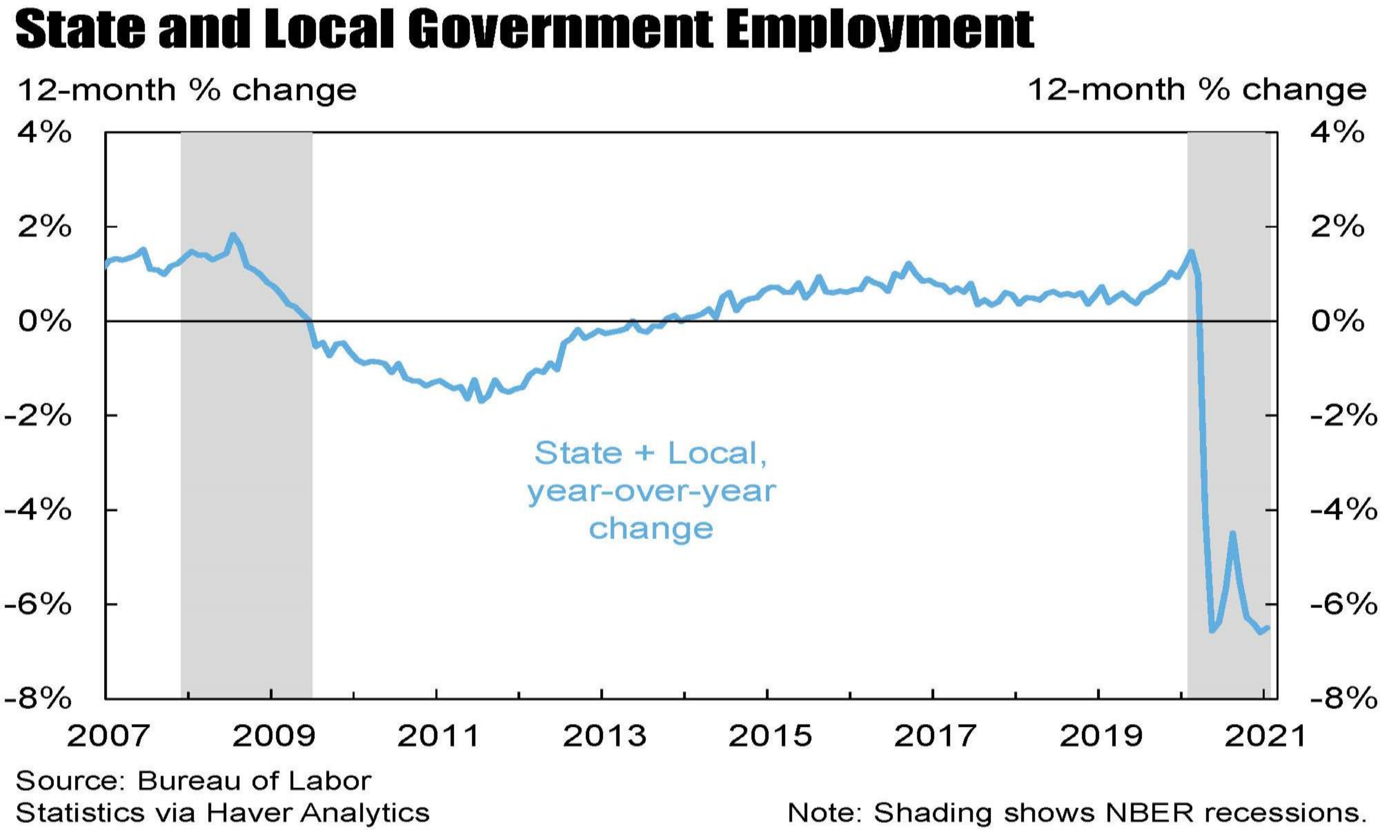
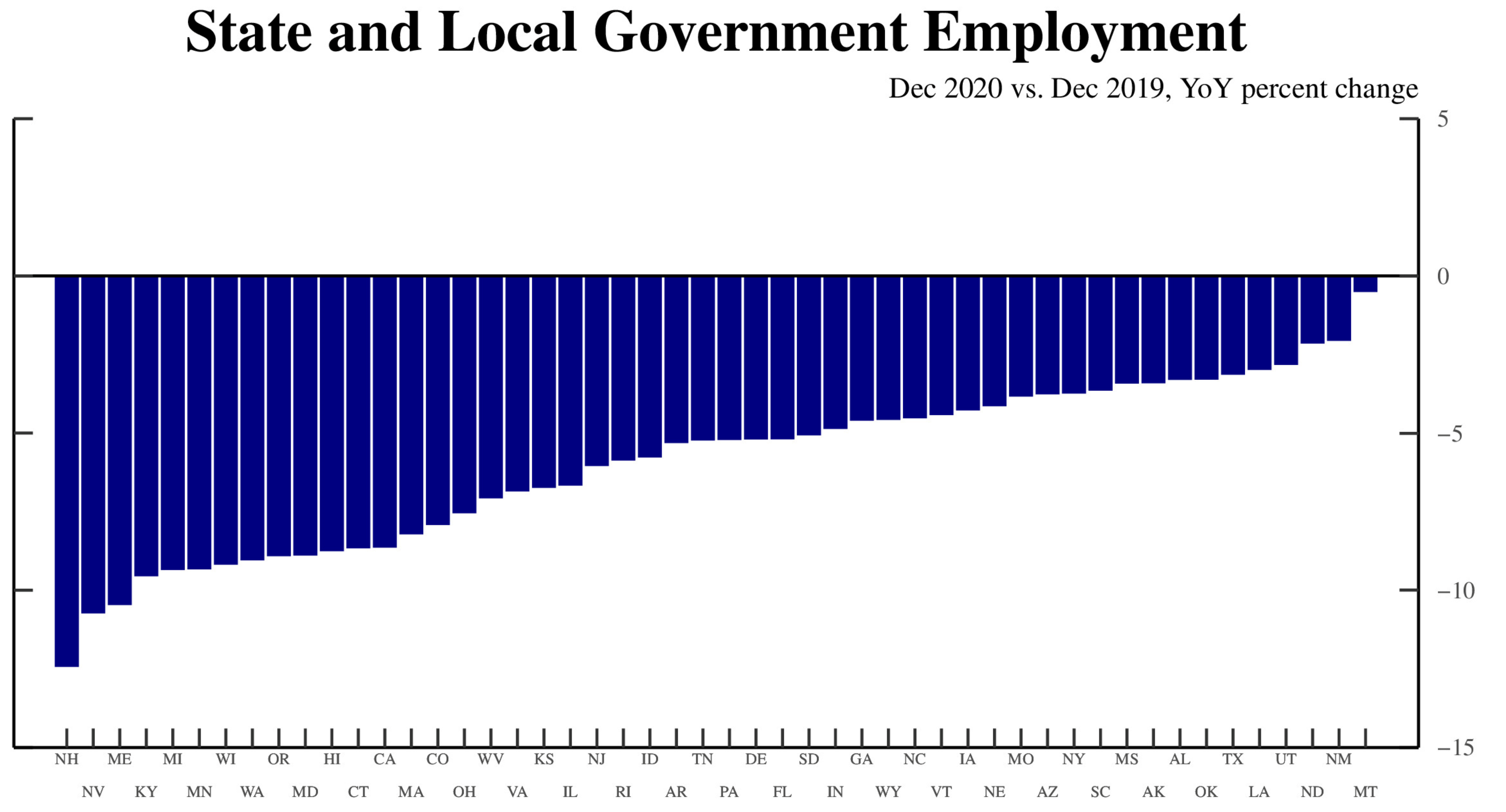
- States had generally budgeted for solid tax revenue growth
- Some states have seen sharp declines
- Certain segments of S&L governments very affected
  - E.g. Transit

S&L Employment Has Fallen Very Sharply

- Great Recession: Employment held up initially and then drifted lower for multiple years
- Pandemic: Immediate decline of over 6%

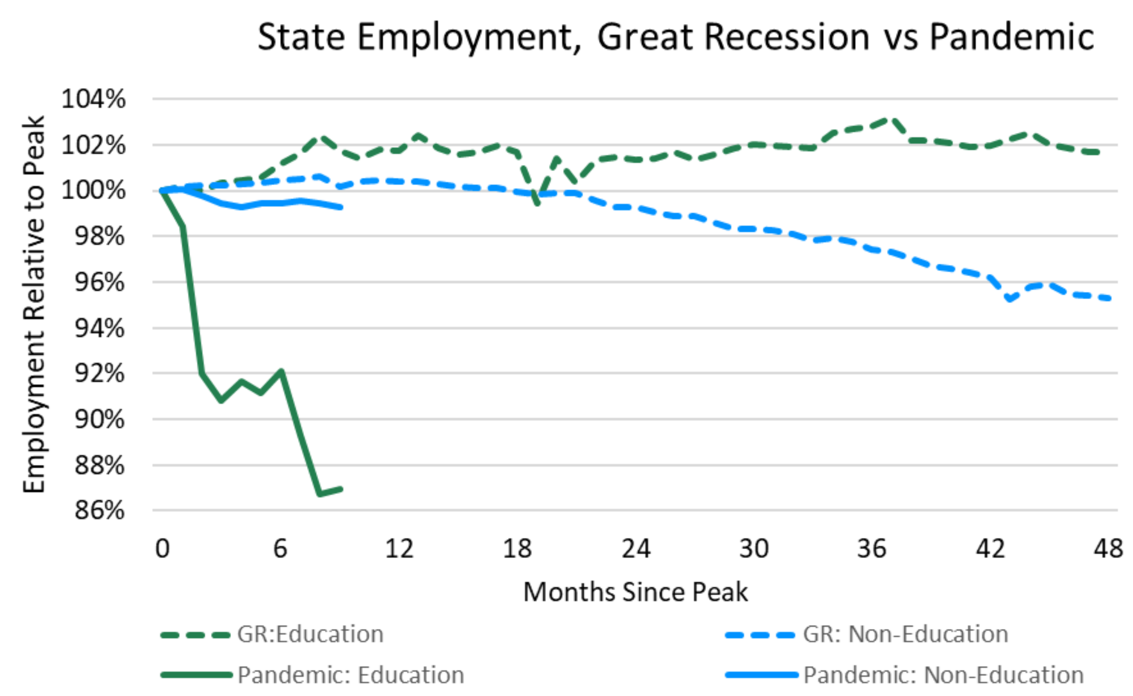


S&L Employment Declines More Uniform than Revenue Losses

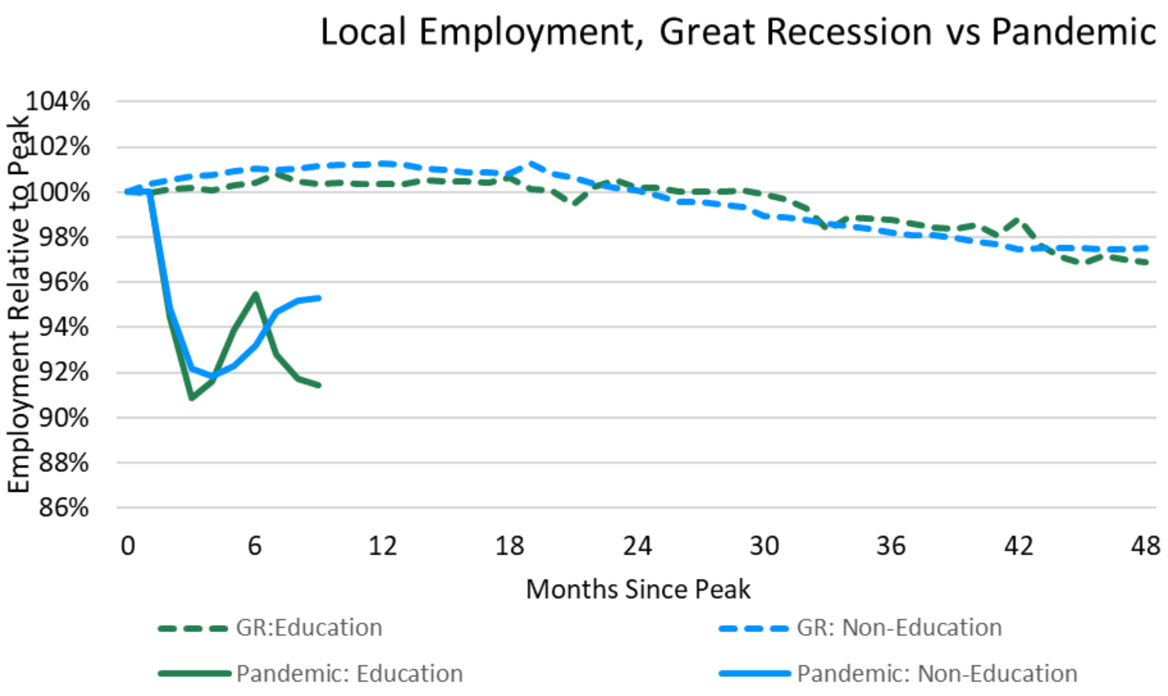


Source: Bureau of Labor Statistics.

Employment Losses Concentrated in Education
(Solid lines pandemic – dotted lines GR)
(Green is education – Blue is non-education)



Seasonally adjusted monthly employment relative to December 2007 for GR and February 2020 for pandemic.
Source: BLS.



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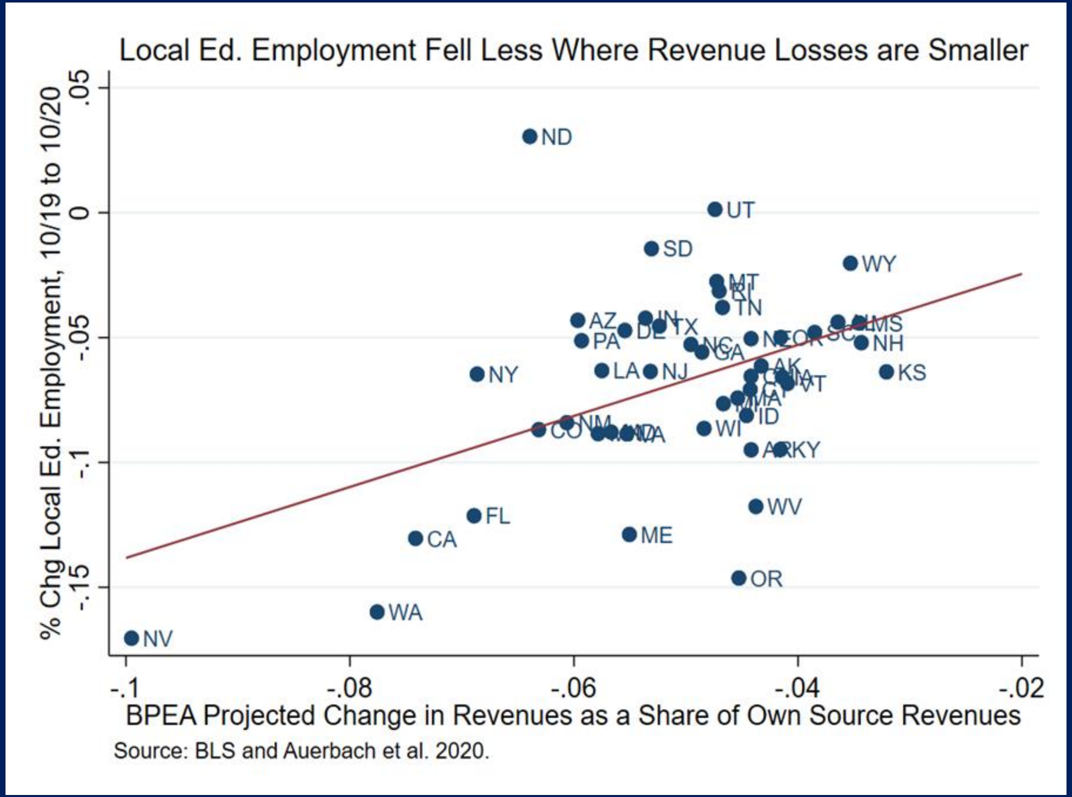
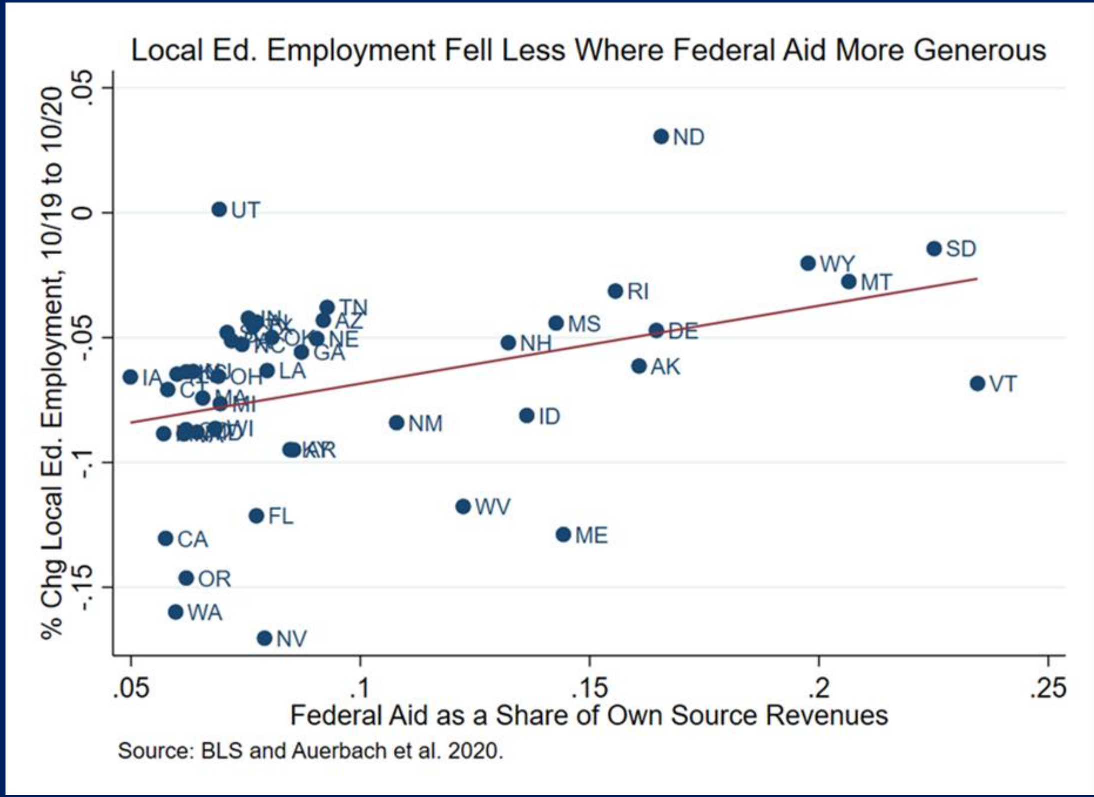
Why Such Large and Widespread Employment Losses?

Three Reasons

1. Contemporary Budget Strain

Some evidence tight budgets affected local education employment. Likely reflects cuts from states to local governments in the spring.





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2. Social Distancing / Virtual Learning

E.g. less need for bus drivers, janitors, cafeteria workers, etc.

3. Extreme Uncertainty over Future Budget Conditions

Given extreme uncertainty and the difficult experience following the Great Recession, S&L govs. moved quickly to adjust expenditures

Adding It All Up:
What is the Condition of State and Local Budgets?

- Auerbach, Gale, Lutz, Sheiner (2021) estimate revenue losses of around $500 billion over 3 years (2020-2022).
  - Based on CBO economic projection that proved much too pessimistic
- Rough current estimate based on GDP data and current CBO projection
  - Revenue losses of $200-$300 billion (2020-2022)
- States and local governments have received about $400 billion in aid—none of it meant to cover general revenue losses, but much of it probably relatively flexible.
- But comparing aggregate revenue loss to stimulus misses several factors

Adding It All Up: What is the Condition of State and Local Budgets?

- But comparing aggregate revenue loss to stimulus misses several factors

1. COVID also created new expenses. Unclear how much.
2. Extent to which stimulus can be used for general budget strain unclear.
3. Lots of variation in fiscal condition, with some governments facing significant strain

Would More Aid Help Increase S&L Spending? Yes.

- Some governments are facing significant strain

- Covid will continue to generate need for new expenditures. E.g. :
  - Given reduction in learning – especially of lower income children – need for remedial education may be high
  - HVAC systems

- Additional funding would help reduce budget uncertainty and reassure state and local governments that is ok to start spending again.