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Recession Remedies Podcast

"What was unexpected about the state and local sector during COVID-19?"
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Episode Summary:

The COVID-19 pandemic posed a particular dilemma to state and local governments. The federal government provided close to $1 trillion to state and local governments to help them meet this dilemma—far more than the roughly $275 billion provided during the Great Recession. But something unexpected happened. On this episode, Brookings Senior Fellow Louise Sheiner joins host David Wessel to discuss what the last couple of years can teach us about state and local governments during recessions.

WESSEL: Welcome to the Recession Remedies podcast, exploring lessons learned from the economic policy response to the COVID-19 pandemic and how those lessons should inform policy when the next recession hits. I'm David Wessel.

In response to the pandemic, the federal government provided about a trillion dollars to state and local governments. My colleague Louise Sheiner did the chapter on aid to state and local governments for our *Recession Remedies* book, a joint venture of the Hutchins Center and The Hamilton Project at Brookings. Louise joins me today to talk about why Washington sent so much money to state and local governments, whether we overdid it, and what state and local governments did with the money. You can read her chapter and the whole book at Brookings dot edu slash Recession Remedies.

So, Louise there's for good reason a lot of focus on what Congress does, the federal budget, the Federal Reserve. But your chapter focuses on state and local governments. So why is that something we should think about? How big a factor are they in the economy?

SHEINER: So, the state and local sector is actually quite a large sector of the economy. It accounts for about 13% of employment, which is far more than the federal government. Looked at a different way, if you look at sort of tax revenues, tax revenues as a share of GDP for state and local governments are about 9%, and the federal government is somewhere between 18 and 20%. And so it's about half the size of the federal government terms of tax revenues, but much larger in terms of employment.

WESSEL: Interesting. So, at the beginning of the pandemic, there were lots of forecasts that state and local revenues would be devastated. After all, that's what usually happens in a recession. But that didn't seem to happen this time. How come?

SHEINER: So, I think two main reasons. At the beginning of the pandemic, most analysts thought the recession was going to be long and hard. The unemployment rate rose to close to 15% in April, and people did not expect it to come down that quickly. For example, in May of 2020, CBO projected that by the end of 2020, so the whole end of the whole year, the unemployment rate would be over 11%. And by the end of 2021, it would be over eight and a half percent.

Instead, by the end of 2020, the unemployment rate was back down to 6.8%. And by the end of 2021, it was down to 4.6%. So, the big, big reason is that the recession really was just a lot less severe than people had projected in the spring of 2020. When the recession is less severe, then revenues are also not going to be devastated as much.

The other reason, though, is that this recession was really very different from previous recessions. First of all, what people had been using was the relationship between the unemployment rate and tax revenues, and that proved to not be a very good guide this time. First of all, it was a very low-income recession. Typically, recessions are low-income, but this was particularly so. So, that meant for any given change in the unemployment rate, the loss in wages and therefore in income taxes was quite a bit lower.

Secondly, high-income workers did very well and high-income households did very well because actually the stock market and the housing market were very strong, which is not typical of recessions. So that meant that usually when unemployment is high, the stock market is doing terribly, another reason revenues are low. But that didn't happen this time.

Third, sales taxes were held up by a number of factors. First of all, people switched to goods a lot during this recession, and those are actually taxed more heavily than services for sales taxes that state and local governments collect.

And finally, the very big difference between this recession and other recessions was this huge degree of fiscal support that helped households. So, people lost their jobs, but because of very generous unemployment insurance, they didn't lose income. So, first of all, some states tax unemployment insurance, so that was a direct source of tax revenue, but also it supported spending, which is a direct source of sales tax revenue.

WESSEL: So, it's interesting, some of the things you said are very pandemic specific. We can't count on the stock market and housing prices always being strong in the next recession. But some of them are more generalizable, like if we give people a lot of money in unemployment insurance or lose their jobs or send a check to almost every household, then obviously state and local governments will be better off than if we don't do that.

SHEINER: Exactly. And so one of the things it's sort of a broad lesson that you learn by looking at the state and local sectors, when you think about what kind of aid the state and local governments get, you have to think about the whole fiscal package, not just each piece individually.

WESSEL: So, in the end, as you say in your chapter, we spend about $1 trillion from Washington to state and local governments, which was enough to, and as far as we can tell, compensate them for all the losses that they suffered because of the pandemic. So that was a lot more money than we sent them during the Great Recession of 2008 and '09. Do you think we sent them too much? Did we make a mistake here, or is it just that there was just so much uncertainty that we had to overpay because it was better than underpaying?

SHEINER: So, I think most people think that the amount of federal aid that we gave to state and local governments during the Great Recession was too little. So, that was one lesson that we learned, it was too little. And people think that the recovery from the recession was impeded because of that state and local sector was actually a factor holding back the recovery. So we didn't want to make that mistake again.

Second, at the beginning of the pandemic, we really had very little idea—in fact, we still have not very much idea—of the costs of dealing with the pandemic itself. We knew that state and local governments needed to buy PPE. They needed to do tracing and testing. So they were really in charge of most of the infrastructure for handling the public health emergency. We didn't really know how much that cost. And so we wanted to give a lot of money. We were really worried about schools—schools were going virtual or they needed to put in new ventilation systems. And so we wanted to give money for that reason.

I think we expected revenue losses to be a lot larger than they were, as we talked about, even, I mean, in the spring of 2020 the revenue loss estimates kept on ratcheting down over time more and more and more. When I look at it, if I think about 2020 and 2021 together, they actually didn't really lose revenue. They were basically where they were, at least on average, not every state and every locality, but they basically didn't really lose much revenue.

So we gave them a lot of money. I think many people said even at the time it was more than they needed. I think it was clear by the spring of 2021 that the money that we were giving to state and local governments was going to be larger than any plausible estimate of what they were spending on public health emergency and their revenue losses. So, we did give them a lot of money.

Whether or not that was a mistake, it's too early to say. We don't know what they're going to do with it. If they use it wisely, if they use it to invest in schools and getting ready for the next pandemic and other important infrastructure, then we might look back on that and say it was money well spent. But it definitely was more money than they needed for the purposes of combating the pandemic.

WESSEL: Yet the big mystery is, as you point out in your chapter, state and local employment did not recover. They got rid of a lot of workers and they still haven't gotten back to where they were. So if they have all this money, why do you think they're not increasing their payrolls?

SHEINER: So, yeah, that is the big mystery or the big irony, which is that one of the reasons we give them so much money is so that they wouldn't lay off a lot of workers. And what happened? They still did. I spent a lot of time in the chapter trying to sort of answer that question. I'm not sure I quite have an answer, but there's some things I learned.

First of all, I learned a lot of my hypotheses didn't really show up in the data. So, I looked at things like, well, maybe the states that really were scarred from the Great Recession that they'd lost a lot of revenues were the ones who cut employment more. No. Maybe the ones that sort of were projecting very big losses or that were oil states or tourism states who actually did suffer more because again, it would cut more employment. No. So, a lot of the things that I looked at really didn't pan out. What I found and what I think is that a lot of the employment losses were very pandemic specific.

So, in the Great Recession, state and local governments did lay off a lot of workers, but they didn't do it immediately. Right. It took a while. Here, you see, like just when all the layoffs occurred in the private sector, you see that happening in the state and local sector as well, and particularly at schools and other local offices.

And so I think what happened was basically they shut down—they shut down the schools, they shut down their offices, and they sent people home. They didn't need bus drivers, they didn't need cafeteria workers. And so they laid off a lot of people at the beginning of the pandemic.

As the pandemic went on, one of the things that I find is one of the predictors of whether or not sort of employment recovered faster or not from those losses were the attitude towards COVID itself. So, states where people were quite concerned about COVID—and the way I measure that is by vaccination rates—so, states with high vaccination rates had longer lasting reductions of state and local employment. And I think that's because they didn't move right away to opening up offices and opening up schools. And also, like when you are really worried about how I'm going to convert everything to virtual, it's not a time where you're sort of focused on hiring, right? So, I think that's part of it.

And then what happened is, so they got a lot of money and schools were all open and offices were open and they wanted to hire. You could see that in the job openings. But what had happened by then is that private sector wages, especially at the low end, which is where they were trying to hire, had increased a lot and state and local governments did not keep up with that. So, everybody's been having trouble hiring, but they particularly had trouble hiring because their wages just were not keeping pace. So, I think at first they didn't want to hire because of the pandemic, and then when they wanted to hire, they couldn't.

I do find some evidence of things related to budgets having an effect on employment. For example, some governors announced hiring freezes right at the beginning of the pandemic because they were afraid of huge revenue losses and they kind of let those go. They didn't say, Oh, okay, we don't need it, we have a lot of money. I don't know exactly why that happened, but it took a long time for them to be lifted. And so you can see that effect. The states that did that definitely had lower employment in state government.

Another factor that I find is if you look at local governments, the local governments that were more dependent on states for financing of their schools seem to have lower employment, too. So there's like hints that money matters. But if you look at, well, the states that got a lot more money relative to their GDP or relative to their budgets, did they not have layoffs? No, they did, too. It doesn't really explain it.

WESSEL: Hmm. Interesting. So, one of the lessons you draw from the chapter is if Washington is going to give states some money, let them know early on that they're going to get the money so they don't make stupid decisions or have to be paralyzed by waiting for Congress to do something. So that's one lesson. What else would you tell policymakers when the next recession arrives, especially since it might be coming sooner than we thought when we started this project?

SHEINER: So, I think the most important lesson is a lesson not to take. I think it's important to not say, Oh, well, you know, people have always said that if you give state and local governments money, they won't lay off workers. But look, we gave them a lot of money and they did. So we don't need to do that anymore. That would be the wrong lesson. I think that's why I said I really think that the layoffs are about the pandemic and that wouldn't be something that would happen in other recessions.

But as you mention, state and local governments are not very nimble. They don't move quickly. They don't change course very quickly. They had a lot of changing course to do this time, and it was hard. So if you want to sort of minimize layoffs, I think, as you said, or as I wrote, is if they would have the assurance that there would be aid from the federal government for as long as economic conditions warranted it, they wouldn't have to sort of forecast and say, oh my God, it might be lasting two years and I won't have any money, and so I'm going to lay off people now or I'm going to be very, very stingy now. The other benefit of doing that is that you would also right-size the aid. Right? So, if it turned out as it did this time, that economic conditions improved more than people had expected, you would end up giving them less money.

WESSEL: So, you mean it should be some sort of formula? Automatic?

SHEINER: Some sort of formula that's automatic that's tied to economic conditions. Another thing that I talk about is there's some evidence that when you give money directly to local governments, you're going to get a faster response in terms of hiring and spending, which makes sense. It takes time if you're going to give money to a governor for it to trickle down to the local governments, and in the ARP ...

WESSEL: … the American Rescue Plan …

SHEINER: … the American Rescue Plan, the 2021, the Biden administration's first big, major legislative achievement, they changed the way they gave aid to governments to do much more direct to local governments. So, I think everything that can get money to state and local governments quickly and to have them know that it's coming will help prevent layoffs.

WESSEL: One more thing. This time around, the Federal Reserve played a role. It helped the municipal bond market. Was that a good idea? Did it work? Should it be repeated?

SHEINER: So at the beginning of the pandemic there was a lot of trouble in the municipal bond market, and it was basically a nonfunctioning market. And so the federal government stepped in for the first time to actually directly lend to state and local governments. It actually didn't end up making very many loans, I think, just two loans. And yet it's widely viewed as having been successful. It was kind of knowing that the federal government facility existed. Lenders didn't have to worry that state and local governments wouldn't be able to pay them back because they know they can always go and borrow from the federal government and be able to pay them back. So it really normalized the market very quickly and I think is widely viewed as quite successful.

WESSEL: Great. Thanks. So Louise, thanks for your work on this. And for our listeners, you can read Louise's chapter and the entire *Recession Remedies* book at Brookings dot edu slash Recession Remedies.

I'm David Wessel, director of the Hutchins Center at Brookings. Recession Remedies is a joint project of the Hutchins Center and The Hamilton Project at Brookings and is a production of the Brookings Podcast Network. Learn more about our other podcasts at Brookings dot edu slash Podcasts and follow us on Twitter at Policy Podcasts. You can send feedback to us at Podcasts at Brookings dot edu.

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