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Policy Note

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STABILIZING STATE AND LOCAL BUDGETS THROUGH THE PANDEMIC AND BEYOND

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COVID-19 has already upended the American economy, and state and local governments are scrambling to keep up in the face of an inadequate federal response. The St. Louis Federal Reserve recently estimated that in the absence of a credible and coordinated response, unemployment rates may reach as high as 32 percent in the coming months (Faria-e-Castro 2020). Social distancing measures have necessitated the closure of entire sectors of the economy across the country, and shelter-in-place orders in many cities have drastically curtailed consumer spending. We are already in recession. New unemployment claims have reached 6.6 million in a single week—doubling the record set only the week prior, and nearly ten times greater than the pre-pandemic high (set in October 1982). The federal government has declined to mount a public health response to the pandemic, and state and local governments have been forced to pick up the slack. All of this has been added to already-fragile state and local finances, stretched thin by decades of underinvestment as well as the fallout from the Great Recession.

The depression induced by necessary public health measures will devastate state and local government finances and prevent them from mounting a sufficient response to the crisis, in economic as well as public health terms (Rampell 2020). The $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act emergency relief package offers a small measure of support, but is clearly inadequate against the coming dislocation. One month into the crisis, numerous states have already instituted hiring freezes, and more are suggesting that budget cuts of up to 20 percent are coming (Nichols 2020). Intragovernmental automatic stabilizers offer a way of understanding the response that will be necessary to support state and local governments through this unprecedented crisis.

The correct public health response to COVID-19 requires taking huge portions of the economy's service sector offline without damaging capacity in that sector, such that it can be quickly brought back online when the pandemic has passed. At the same time, production and distribution of necessary food and supplies has to continue, potentially under direct administration by

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state and local governments. However, these responses require financial time to be effectively stopped, or dramatically slowed, such that workers, firms, and governments can respond to the crisis without worrying about where liquidity in the system will be coming from. On the firm and worker side, this can be done in one of two ways. Either all payments—rent, mortgage, loans, wages—are suspended, or money is helicoptered in (direct cash transfers to households) such that required payments can be made without actual goods changing hands. The CARES Act represents a small step in the direction of the latter.

However, the state and local governments mounting the response to COVID-19 face these problems as well. States have an extremely limited capacity to issue debt. A majority have constitutional requirements that general operations budgets—all spending excluding capital expenditure—must balance every year. Of those without a constitutional prohibition, all but two have statutory budget requirements to the same effect. While states have circumvented these requirements for years through securitization of future revenues and the creation of off-budget enterprises such as water and sewage districts, such complex financial engineering cannot be accomplished against the backdrop of the extreme market volatility we have seen recently. Though these governments are able to close all businesses and enforce social distancing measures through shelter-in-place orders, they do not have the budgetary ability to absorb the economic impact of doing so. At the same time, the public health response, in terms of field hospitals, ventilators, and personal protective equipment in each state, must be paid for out of grants or own revenues. Without grants from the federal government to replace lost own revenues, states and local governments find themselves in this past month's impossible situation of choosing between social distancing measures and revenue to fight the outbreak.

State governments draw the overwhelming majority of their funding from sales tax, income tax, and user fees on public infrastructure. COVID-19 and the required public health response disrupt all three of these sources. Sales tax revenue falls dramatically as the purchases within whole sectors must be paused for public health reasons. Income tax revenue is disrupted for the same reasons—many of the workers in these idled sectors have been laid off already, and many more will be. Paused wages are just the other side of paused sales. Lastly, public transportation, public works, and public services have been shut down or had their usage drastically reduced. This will hit state budgets in a variety of hard-to-anticipate places, as many of these user-fee-funded services are tied up with the elaborate financing structures of off-budget enterprises. Additionally, state budget allocations are subject to complex preexisting laws. Certain sources of funding are linked to certain expenditures; shortfalls in some departments trigger mandatory across-the-board cuts in others. This fact precludes many legislative responses to the crisis and so must be incorporated in a federal response to the state and local government budget squeeze.

The federal government appears to have abandoned the idea of a coordinated public health response, leaving the entirety to state and local governments. For this to be anything other than disastrous, state and local governments need a funding backstop from the federal government. First steps have been made in this direction by the Federal Reserve, which has exercised its authority under section 13(3) of the Federal Reserve Act to accept municipal bonds as collateral in repo operations (Lane 2020). This ensures orderliness in the municipal bond markets such that new issues can proceed at acceptable interest rates and is a first step toward a comprehensive backstop in the municipal bond market from the Federal Reserve (Amarnath and Feygin 2020). However, given the reluctance of states to use debt instruments on-budget, and the degree of legal gymnastics required to backstop state and local government funding using only Federal Reserve facilities, we need a Treasury appropriation in the near term.

My proposal for intragovernmental automatic stabilizers sheds some light on the form that this Treasury appropriation should take.[1] The mechanical procyclicality of state and local government spending can be overcome by the creation of an automatic stabilization program that replaces lost state and local tax revenues owing to a macroeconomic downturn. The proposed stabilization program provides a block grant to states whose unemployment rates exceed a given baseline. The proposal recommends block grant transfers on the order of 8 percent of the previous year's own-source tax receipts, multiplied by the number of percentage points unemployment exceeds the baseline rate. This captures heterogeneity in state tax structures and sectoral composition, and provides sensitivity to a quickly changing unemployment rate.

This automatic stabilizer program can be contrasted with the portions of the American Recovery and Reinvestment Act (ARRA) allocated to state fiscal relief. A matching program of the sort I have proposed would have run for far longer and spent nearly three times as much per year as did the ARRA (Williams, forthcoming). This increased spending would have prevented large-scale government layoffs and ensured that necessary investment could have been made by state and local governments in the face of the crisis. Additionally, while implementation of these sorts of automatic stabilizers would have dramatically increased federal fiscal transfers, the impact on total fiscal spending would have been smaller, as increased spending at the state and local level would have lessened federal welfare program uptake as well as unemployment.

This proposal can be easily adapted to the present situation, since we have much more information about the size and sectoral composition of the disruption than in an arbitrary recession. The ideal response at the federal level identifies the lost revenue to states—in sales tax, income tax, and user fees—and replaces it with block grants. This removes the incentive to keep the economy going at all costs, and simultaneously provides state and local governments with the funds required to mount a public health response while continuing normal governance operations. Issuing block grants also allows state governments greater flexibility in allocation, getting around thorny legal requirements attaching certain kinds of revenue to certain other kinds of expenditures that hamstring many state budgets.

Rather than 8 percent of the previous year's own-source total tax revenue per percentage point that unemployment exceeds the baseline rate, we can key stabilization payments to the size of each state's revenue from taxes and fees in affected sectors. To get a back-of-the-envelope sense of the general magnitude of stabilization spending needed, we assume that property taxes are constant, sales and gross receipts taxes get cut in half, 15 percent of workers stop working, net corporate income tax falls by 30 percent, and that total general charges fall by half due to sweeping closures of public infrastructure. Under this specification, I estimate the revenue loss using 2017 tax and fee data provided by the Urban Institute (2020). Even doing back-of-the-envelope calculations like this, we are looking at a $63 billion monthly shortfall in state and local budgets due to social distancing measures. Given that this is working from 2017 data, the 2020 number is likely to be closer to $70 billion. Again, this is just to keep services running at normal levels and stave off government layoffs. Any positive response to COVID-19 will require additional funding, as will the increased uptake in state-level welfare services. Given the extent of disinvestment at the state level since the 2008 crisis, the cost of spinning up fixed capital for the COVID-19 response will have to be rolled into the budget for staffing and administration as well.

The CARES Act provides $339.8 billion for state and local governments, per an analysis conducted by Audrey Carlsen (Snell 2020). Of this, $274 billion is allocated for the state- and local-level COVID-19 response. Only $150 billion of this is direct aid to states intended to stave off both revenue loss and increased use of state welfare services. Without making any assumptions about increased uptake of state services, these provisions of the CARES Act will delay significant budget crunch at the state and local level by just over two months. Once funds run out, experience tells us the budget cuts will be swift and brutal, exacerbating the existing depression. This same insufficiency hampered the response to the budget crises of the Great Recession, and policymakers must learn from past failures.

We do not know how long this current crisis will continue; however, it is unlikely that the economic impacts will be resolved in under three months. Even without a pandemic, recovering from 10 million new unemployment claims would take years. Rather than fighting over a series of patchwork bills, the Treasury should create an Office of Fiscal Harmonization dedicated to federalizing lost revenue at the state and local levels owing to the pandemic and its higher-order effects. This office would administer automatic stabilizers that maintain trend growth in tax receipts at the state and local level. The federal transfers would ensure states neither cut spending nor boost taxes into the teeth of a depression. The Office of Fiscal Harmonization could identify sectoral closures and those sectors' contributions to various taxes at the state level. Alternatively, to get funds out as quickly as possible, this office could use the original specification of 8 percent of total own-source revenue per percentage point that unemployment exceeds state baseline rates. Without this, states will be severely constrained in their ability to respond to COVID-19, and balanced budget requirements will force them to cut jobs and raise taxes during the deepest recession in living memory.

Note

1. For an extended treatment of this proposal and related matters, see Williams (forthcoming).

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