HOW TO SHORE UP STATE AND LOCAL BUDGETS DURING A CORONAVIRUS RECESSION

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As the potential economic impact of a global pandemic starts to crystalize, there has rightly been a lot of discussion about how individuals and businesses will fare—and what governments can do to support them. But what will happen to government finances? In particular, what happens to U.S. state and local governments, which are responsible for delivering much of the social safety net that individuals rely on to weather a crisis?

Therese McGuire is a professor of strategy at Kellogg who studies state and local finances. Kim Rueben is director of the State and Local Finance Initiative at the Urban-Brookings Tax Policy Center (which is publishing up-to-date articles on the coronavirus crisis here). The pair discuss how the crisis is likely to hit state and local budgets, and what we can learn from previous crises about how to keep states afloat, so they can continue to support their citizens.

This interview has been edited for length and clarity. Previously published in Kellogg Insight. Reprinted with permission of the Kellogg School of Management.

THERESE MCGUIRE: As we think about how state and local governments are likely to respond to this pandemic, we have this political experiment from about 10 years ago to learn from: the Great Recession.

We basically have about one recession a decade. Throughout all of them, state and local revenues fall. But the Great Recession was something we'd never lived through before. In one quarter, income taxes fell by 18 percent, compared to the year before. Just think about the revenues coming into your household falling by that amount from last year. Even more remarkable, sales tax revenues also fell off almost 10 percent—more dramatically than they ever had before.

In general, property taxes tend to be more stable than income and sales taxes. In the Great Recession, property taxes took longer to fall, and, in aggregate, they didn't drop as much as sales and income taxes. Still, in some states they, too, fell dramatically.

Because we are entering another, likely deep, recession, we can expect revenues to fall again.

KIM RUEBEN: The good news is, in general, states are starting this downturn in pretty good shape. There's a big "Illinois asterisk" that needs to be here. But according to the National Association of State Budget Officers, states ended the last fiscal year with $72 billion in rainy day funds, or 7.6 percent of their general funds, versus, before the Great Recession, $33 billion, or about 4.7 percent. So, overall, states are starting with more leeway than they were before.

Still, states are likely to see revenues in Fiscal Year 2020 decrease, especially income tax revenues, even though these revenues are based on last year's economic activity. That's because the federal government is postponing when income tax payments are due from April 15 to July 15, and a lot of states are following suit. This means that the big bump of tax payments expected in April, which generally represent about 13 to 15 percent of state income taxes, might come in July instead and thus won't count toward this fiscal year but the following one.

Income tax revenue is also going to be low in Fiscal 2021 because people are not going to have income tax liability if they're not earning income. The fact that the stock market has been on a roller-coaster ride means less money coming in based on capital gains. So, for states that are highly reliant on that kind of income—California, New York, Connecticut—that's going to be a big hit to their budgets in 2021.

As for sales tax, we've seen a splurge in certain types of spending, but mostly on things like food and toilet paper, which aren't taxed in a lot of states. And we know that states will lose some revenues because we're not seeing any tourism or any activities related to going out to eat, or getting on planes, or staying in hotels.

Corporate income taxes, which don't make up a lot of state budgets, will also be down, because corporate profits will be down. And unrelated to the pandemic, we've also seen oil prices go down. There are going to be a number of states that are highly dependent on natural resources that are going to end up seeing their revenues fall for that reason too.

All this means that we're likely going to see less revenue coming in for the remainder of this year and also into the next fiscal year. States may need to try and figure out how they're going to change their priorities.

Now, there's another thing that's going to look much worse on paper, because of the decline in the stock market values: the assets of public-pension systems. But this is not the time for states to worry about shoring up the ratio of public-pension assets to liabilities. Today's revenues are going to be needed to provide services to people directly or to help pay for things like healthcare and hospitals.

MCGUIRE: After the Great Recession, the federal government did a lot to shore up state budgets. I think it's worth discussing what worked and what didn't, and whether those efforts can inform our response to the current pandemic.

RUEBEN: Well, I'm not sure how good of a model the Great Recession really is—partly because what's about to cause this recession is fundamentally different. Economic slowdowns are typically caused by a collapse in consumer demand or a financial crisis or some other economic shock. And we have tools that we can use, and that we have used, to respond to that.

But this slowdown is being caused by a disease. Governments are closing off parts of the economy deliberately in an attempt to stop its spread. We're shutting down tourism, airlines, and public gatherings.

Right now, we wouldn't want the government to stimulate additional activities to shore up the economy, as any spending that would increase current economic activity would need to go into parts of the economy we aren't trying to curtail and thus industries that don't need it, or to encourage people to go out looking for new jobs when we are trying to keep people home. Instead, we want to help the people within the economy who have been hurt by losing their jobs or hours or by having their business activity cut down and ensure that we have the funds to start up the sectors we have shut down later, after we have addressed the pandemic and public-health crisis.

Ideally, we want to slow the public-health ramifications and flatten the public-health curve with what might be a sharp but temporary change in economic activity, versus taking actions that prematurely revive the economy before getting the pandemic under control.

MCGUIRE: Yes, I agree with this interpretation and that the exact policies that we will want to enact are likely different. But in the response to the Great Recession, we did learn a lot about how to get money from the federal government into state and local governments. Which is important, because states have balanced budget requirements, but the federal government does not. One thing that worked well then was that we used already existing infrastructure and formulas—we just shoved more money into those formulas.

RUEBEN: Right, the federal government helped support state and local governments through expanded Medicaid and education payments. This worked relatively well because those are the biggest spending items that state budgets face. To the extent that you want to move money fast between the federal government and state or local governments, being able to take advantage of existing programs becomes really important, because you don't have to figure out how you get all of the infrastructure in place.

There was also an ability for states to borrow from the federal government to help shore up unemployment payments. With unemployment generally, you get money if you're unemployed, but you're supposed to be looking for a job.

Today, we want to get that money out to people who have lost their jobs because the government has closed their businesses. But we don't really want them out looking for jobs!

MCGUIRE: And that's what the federal government has done. They've taken off the restrictions on those who are unemployed, so they now no longer need to demonstrate that they are seeking work in order to receive unemployment benefits. They have also provided a billion dollars to states to help them ramp up delivery of the unemployment insurance program and offered them interest-free loans to pay for unemployment-insurance benefits through December. And in the latest deal, expected to be signed today, they are going to give unemployed workers an extra $600 a week on top of their state benefits for four months. They have also expanded unemployment insurance to other categories of workers, such as gig workers and freelancers.

RUEBEN: But I would love for them to go even further and use federal funds to pay for the entire program by issuing grants rather than loans to the states.

It's important for the responsibility for those payments to be borne by the federal government, because it's much easier for the federal government to run deficits and also borrow money than it is for states and local governments.

When you're going into a recession, state revenues fall off while state expenditures tend to go up, because the states are responsible for the social safety net. If the federal government can give money to the states to spend on the social safety net, that's going to help state governments stay solvent, and it's going to help people, too.

Plus, when states have less revenue and more spending responsibilities and a balanced budget requirement, they have to cut programs, and that means cutting jobs. The last thing you want is for states to start laying off people, too. One of the most positive things that emerged from the last stimulus package was the money that was directed at K-12 education, which helped school districts retain teachers. Without it, they would have had to fire (even more) teachers.

One big difference this time around on the spending side, however, is going to be physically responding to the pandemic. So, before we start making sure that state budgets and economies are okay, Job #1 needs to be taking actions to help address the public-health challenge. To the extent that federal money could be aimed at getting medical supplies to states and hospitals, that's going to be really important. And I would love to see the federal government and states try to build some of the things we think we're going to need in terms of healthcare infrastructure, including new facilities with more hospital beds, and equipment needed to treat victims, which means ICU beds with ventilators.

MCGUIRE: What do you think about having 50 different state-directed responses to the crisis? Let's call it 51 to include the federal government. Should there have been a coordinated response, or do we just not know because this is so new, and we're in uncharted territories?

RUEBEN: I think it's new. Everything's moving really fast. In general, I would have preferred if there had been a more coordinated response from the start, but that would have required the federal government leading the charge. And some states, like the state of Washington, couldn't wait for the federal government to make policy.

One thing that I like about what we have seen across different states is that some places have tried to move faster and be innovative, like Colorado adopting drive-through testing. I'm hoping that those initiatives can then be copied in other places.

MCGUIRE: With the U.S. system of fiscal federalism, you have 50 states each with a lot of autonomy to set their own policies and innovate. You could have a state like Massachusetts enact a healthcare plan that ultimately became Obama's healthcare plan for the nation.

Another reason why we might want states to respond differently is that maybe the policies in, say, Florida—which has a very heavily tourist-industry economy and also an aged population—are different than the ones you might want in a state like Utah, with a very young population.

RUEBEN: Maybe you want some variation, but in many instances coordinated action could be much more effective. For example, a coordinated approach might help avoid a bidding war among states for scarce medical equipment and supplies.

MCGUIRE: Right now, I'm looking at a map that shows, from FY 2018, the days each state could run based on the amount of money they have in their rainy day fund that year. California was at 48, which is a big number. But there are like four or five states that are at zero. One of which is Illinois.

What does it mean for a state like Illinois to go through this crisis?

RUEBEN: It's going to be much tougher. Illinois already was in a place where it really needs to increase taxes somehow. But it's much tougher to raise taxes when people are struggling and to figure out how you're going to move forward when you have less nimbleness. And big cities that are relying on tourism, wealthy people from overseas coming and shopping, are going to be especially hard-hit.

For Illinois—but really across the country—even as we remain physically separated, we will need to come together to find solutions.

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