The Devastating Impact of COVID-19 on State and Local Government Finances

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Highlights

- Business closures and stay-at-home orders mandated to stem the spread of COVID-19 are resulting in millions of dollars of lost tax revenue for state and local governments.
- Virus-related expenses, meanwhile, are skyrocketing for these governments at the forefront of response efforts. A growing number of states have started to tap into reserves accumulated over the past several years. But, even accounting for rainy-day funds, close to half of all states are likely to be faced with budget gaps.
- Most state and local governments cannot run deficits. In the absence of additional aid from the federal government, they will have to reduce spending severely to close these gaps. Already, a few states have ordered budget cuts, while others are contemplating future fiscal austerity.
- The response from federal policymakers has been encouraging thus far, but more assistance will be required to prevent devastating budget cuts that could stall the economic recovery even as the virus passes.

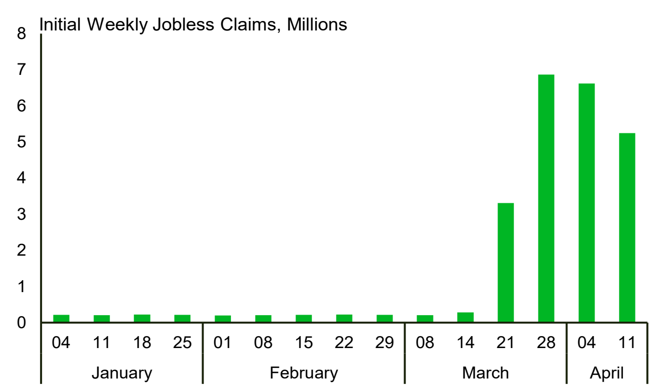
The United States has become the global epicenter of the COVID-19 pandemic, with over 600,000 confirmed cases as of writing. In order to stem the further spread of the disease, most states have issued stay-at-home orders and instructed non-essential businesses to shut down, leading to a sudden stop in economic activity, and millions of job losses.

With the economy entering a self-induced coma, state and local government finances have taken a massive hit. Revenue collected in the form of sales and income tax has all but disappeared. At the same time, expenses have risen significantly as authorities rush to respond to the growing pandemic.

As most state and local governments cannot run budget deficits, they will have to turn to rainy-day funds to provide some financial relief. However, for almost half of all states these are unlikely to be adequate in plugging large budgetary holes. Without sufficient federal aid, state and local governments will have to cut spending significantly, which could slow the pace of recovery once the virus is contained.

The U.S. Congress and the Federal Reserve have enacted measures to provide support for state and local governments, but more is needed. Over the next few weeks, we expect policymakers will put forward further supporting measures to cushion the impact of COVID-19 on state and local government finances.

Chart 1: Millions of Jobs were Lost in Recent Weeks



Source: Department of Labor, TD Economics. Last observation: April 11, 2020.

COVID-19 Has Made a Dent in State Revenues, While Expenses Rise

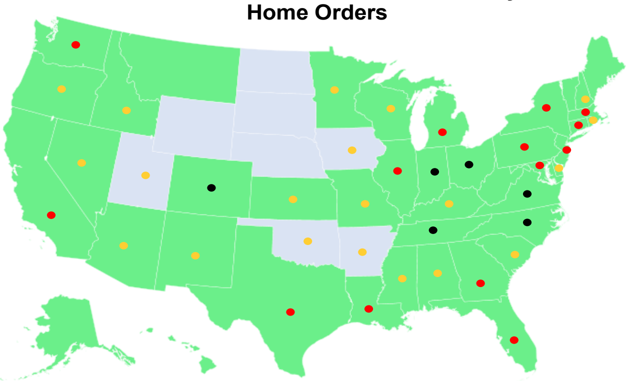
Business closures and stay-at-home orders have resulted in millions of dollars of lost tax revenue for state and local governments. Revenue that would have been collected through sales and income taxes have disappeared as millions of people have lost their jobs since mid-March (Chart 1). This has likely cut a hole of around $200 billion or 10% in total state and local government revenues. For comparison, during the 2008 recession, state and local tax revenues declined by 5% (from 2008 to 2010).

The impact of containment measures on revenues differs from state to state. States that have enacted more restrictive policies sooner are experiencing a larger drop in revenues. On the other hand, several states including Arkansas, Iowa, Oklahoma and Utah have yet to mandate statewide stay-at-home orders, despite current COVID-19 case counts in the thousands (Chart 2). The decline in tax revenues is likely not yet as striking in these states, but they face the risk of finding themselves in a more vulnerable position should the pandemic get out of hand.

As revenues decline, expenses are rising as states take COVID-19 head on. State and local governments have increased spending in areas most affected by the coronavirus. Support for health care, emergency treatment facilities, and unemployment insurance have all picked up significantly.

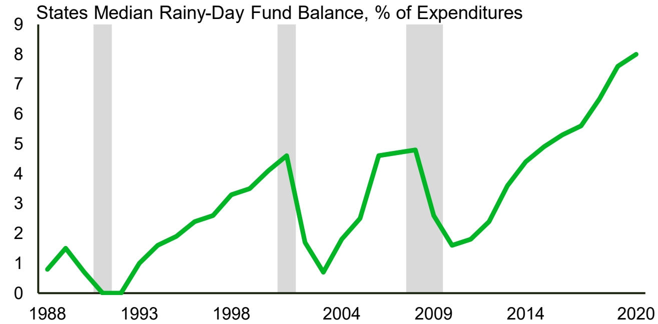
Adding to what is already a heavy burden, the turmoil in financial markets is having an adverse impact on state and local pension funds. These funds, which had increased the share of equities in their portfolios in recent years, are now struggling to generate income on their assets. At the end of the last year's third quarter, state and local pensions had 47.3% of their portfolio invested in U.S. stocks. In the first quarter of this year, financial markets recorded their worst performance since the financial crisis, with the S&P 500 and the Dow Jones Industrial Average falling by 20% and 23%, respectively.

Chart 2: Most States Have Mandated Stay-at-Home Orders



Source: State Govenrments, Johns Hopkins, TD Economics. Data as of April 15, 2020.

Chart 3: States Have Increased Their Reserves in Years Preceding COVID-19



Note: FY2019 figures are preliminary and exclude data for the state of Georgia; FY2020 figures are projected based on states' enacted budgets and exclude data for the states of Georgia, Michigan, North Carolina, Oklahoma and Wisconsin. Grey shaded areas represent recession years.
Source: National Association of State Budget Officers, TD Economics

Rainy-Day Funds Help Ease Budgetary Pressures, but Cuts Necessary to Balance Budgets

Since most state and local governments are required to balance their budgets, they will have to dip into their rainy-day funds to mitigate the pressure on both revenues and expenses.[1] Fortunately, states have been building up their rainy-day funds in years preceding the pandemic. The median state balance for such reserves now sits at a record 8.0% of expenditures, or about $70 billion, according to projected data based on states' enacted budgets for FY2020 (Chart 3).

Local governments also boosted their rainy-day reserves following the financial crisis. The median rainy-day fund balance for the largest 25 U.S. cities has grown from $387 million in 2007 to $582 million in 2018, representing a 50% increase.

Nearly Half of States Stand to Have Expenditures Exceed Revenues

Under the current circumstances, strong reserves are helpful, but are unlikely to be sufficient to close budget gaps. Indeed, for the majority of states, the spread of COVID-19 and measures to contain it will result in expenditures exceeding revenues, even when accounting for rainy-day funds. Without federal assistance, these states would have to cut spending.

In the absence of spending cuts, we estimate that 44 out of 50 states will see their budget balance move into operating deficits due to the impact of the pandemic. Even after factoring in all available rainy-day funds, we find almost 50% of states (24) will face budget gaps (Appendix, Table 1). [2,3]

In terms of pure revenue impact, the hit is largest for California and New York, whose revenues we estimate will decline by about $24 billion and $12 billion, respectively, relative to projections from their current fiscal-year enacted budgets. These are also two of the states most impacted by the coronavirus, New York being the epicenter of the pandemic with a case count in excess of 200,000 at the time of writing. Other populous states such as Texas, which has neither personal income nor corporate taxes, and Florida, which collects no personal income taxes, may feel a relatively lower, but still sizeable, impact on revenues due to the sudden stop in economic activity.

Before factoring in reserve balances, the revenue hit would create a budgetary shortfall of $21 billion and $5.8 billion, or 0.7% and 0.3% of GDP, respectively for California and New York, all else equal. Relative to the size of the economy, Connecticut is likely to see the largest budgetary shortfall of any state at 0.9% of GDP. Meanwhile, on the other end of the spectrum, New Mexico is likely to end with a substantial budgetary surplus equivalent to 1.4% of GDP, even after the revenue shock.

In order to plug budgetary holes, state governments can draw down rainy-day fund balances. Indeed, several states, including Arizona, Georgia, Maine, Maryland, Nebraska, Washington and California have already moved forward in using reserves in the battle against COVID-19. Rainy-day fund withdrawal conditions vary from state to state, but can generally be summarized under three main concepts: budget gaps, volatility and forecast errors.[4] Our analysis suggests that conditions will be met under the current circumstances to allow such withdrawals for all states.

Should state governments decide to use their entire rainy-day fund reserves to balance their budgets, roughly half of all states are still likely to end the current fiscal year with a non-negligible budgetary shortfall, assuming no other spending cuts. We outline the states with the biggest gaps relative to GDP in Table 1 in the appendix.

The current pandemic is the type of exceptional situation rainy-day funds are for, but totally exhausting such reserves to balance state budgets is not without costs. Indeed, during the recovery phase, state governments will likely need to boost spending to support a rapid and durable recovery. Empty rainy-day fund balances could push state governments toward future fiscal austerity, which in turn could further delay the recovery.

Policymakers Have Responded, But it is Not Enough

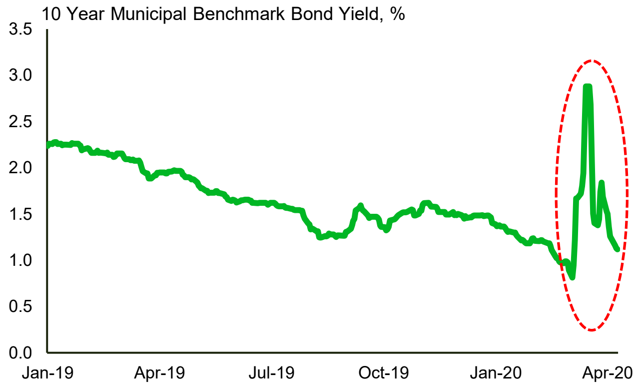
Without support from federal policymakers, state and local governments will have to enact severe budget cuts to balance the books. State and local government are an integral part of the American economy, accounting for about 13% of total employment. As the economy enters a period of contraction, this could turn into an additional headwind and would crush any hope of a "V-shaped" recovery.

We saw this play out in the aftermath of the Great Recession. In 2008, state and local governments drastically reduced spending in response to falling revenues. In the following years, spending was slow to recover as governments looked to build up their rainy-day funds. This lowered GDP growth by 1.2 percentage points between 2009 and 2012.[5]

We are now witnessing a near-term shock to economic activity far worse than 2008, but the reaction of policymakers could prolong the recovery just as it did then. For example, officials in Arkansas, Missouri, Idaho and Ohio have moved to order budget cuts, while a spending and hiring freeze has been implemented in Maryland. In states like Florida and New York, discussions around reigning future spending in have also started to surface. Fortunately, we have seen support come through Congress and the Federal Reserve in recent weeks, but more is needed.

On the monetary policy front, the Federal Reserve enacted measures to support state and local government finances. It announced that it will expand an emergency lending program to include purchases of short-term municipal bonds and variable-rate demand notes. Following these

Chart 4: Recent Fed Interventions Helped Provide Interest Relief for State and Local Issuers



Source: Bloomberg, TD Economics. Last observation: April 15, 2020.

announcements, yields on municipal bonds declined, providing some much-needed interest relief for state and local issuers (Chart 4). However, this does not address the budget shortfall issue as bond proceeds largely go toward funding capital projects and not operating expenses.

The Fed's moves last week, on the other hand, do ease pressures on the operating budget. It established the Municipal Liquidity Facility, which will offer up to $500 billion in lending to states and municipalities by purchasing tax anticipation notes, tax and revenue anticipation notes, bond anticipation notes, among other short-term assets. Some states will be able to use these revenues towards their operating expenses, relieving stress on state budget balances.

Congress, too, has been hard at work legislating several relief packages, many of which contained help for state and local governments. The Families First Coronavirus Response Act, which was signed into law on March 18, included $1 billion in emergency funding to state unemployment trust funds, while also temporarily increasing the federal share of Medicaid by 6.2 percentage points. Should the increase be maintained for the entire year, it could be worth around $35 billion in additional support. The Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted by Congress on March 27, 2020 included $150 billion in grants for state and local governments as part of a $2 trillion package.

While these developments are certainly most welcome, they are likely not enough. These measures will help cover the extra COVID-19 related expenses but will not cover the full decline in revenues. Notably, the CARES Act grants came with restrictions, as they are exclusively to be used to cover costs directly related to the coronavirus response that have yet to be budgeted by state and local governments.

There are early indications that Congress is working towards a "Phase 4" relief package to provide additional direct aid for state and local governments. According to our calculations, the next funding package for state and local governments should amount to at least $200 billion in order to cover budget shortfalls. If the virus impact intensifies, policymakers should consider a larger amount.

Bottom Line

The rapidly spreading coronavirus has caused sudden stops in large sections of the U.S. economy as authorities mandate restrictive measures to contain its spread. The immediate impact, which is starting to come through in various economic indicators, is tremendous and we forecast U.S. economic growth to contract by double-digits in the second quarter.

At the forefront of response efforts are state and local governments. The drop-off in economic activity is creating a large hole in their revenues at the same time as virus-related expenses skyrocket. Until recently, they also had to contend with an unprecedented rise in their borrowing costs as investors flocked to safer assets. Although the response from policymakers has been encouraging thus far, more assistance is likely required for these entities so that spending is not reined in when the virus finally passes.

Appendix

Table 1: TD Economics Estimates of COVID-19 Impact on State Government Finances					
	Revenue Impact, $ Billion	Budget Balance, $ Billion	Budget Balance, % of GDP	Rainy Day Funds, $ Billion	Budget Balance Incl. Rainy Day Funds, % of GDP
Arkansas	-1.1	-1.1	-0.8	0.2	-0.7
Kentucky	-1.6	-1.6	-0.7	0.3	-0.6
New Jersey	-5.2	-3.9	-0.6	0.4	-0.5
Pennsylvania	-5.0	-4.8	-0.6	0.3	-0.5
Illinois	-5.3	-4.7	-0.5	0.0	-0.5
Rhode Island	-0.5	-0.5	-0.8	0.2	-0.5
Maryland	-2.8	-2.7	-0.6	1.2	-0.4
Louisiana	-1.4	-1.4	-0.5	0.4	-0.4
Virginia	-3.3	-3.3	-0.6	1.4	-0.4
Wisconsin**	-2.7	-1.7	-0.5	0.6	-0.3
Maine	-0.6	-0.5	-0.7	0.3	-0.3
Kansas	-1.2	-0.5	-0.3	0.0	-0.3
Mississippi	-0.8	-0.7	-0.6	0.5	-0.2
Tennessee	-2.0	-1.9	-0.5	1.1	-0.2
Arizona	-1.8	-1.7	-0.5	1.0	-0.2
New York	-12.2	-5.8	-0.3	2.5	-0.2
Missouri	-1.6	-1.3	-0.4	0.7	-0.2
Florida	-4.8	-3.6	-0.3	1.6	-0.2
Utah	-1.2	-1.1	-0.6	0.8	-0.1
Idaho	-0.6	-0.5	-0.6	0.4	-0.1
North Carolina**	-3.6	-1.9	-0.3	1.3	-0.1
Iowa	-1.5	-1.0	-0.5	0.8	-0.1
California	-23.8	-21.0	-0.7	19.2	-0.1
Ohio	-3.6	-2.9	-0.4	2.7	0.0
Hawaii	-1.1	-0.4	-0.4	0.4	0.0
South Dakota	-0.2	-0.2	-0.4	0.2	0.0
Alabama	-1.2	-1.0	-0.4	0.9	0.0
Colorado	-2.1	-1.1	-0.3	1.0	0.0
Nebraska	-0.8	-0.5	-0.4	0.5	0.0
New Hampshire	-0.1	-0.1	-0.1	0.1	0.0
Michigan**	-1.6	-1.0	-0.2	1.1	0.0
Indiana	-2.6	-1.3	-0.3	1.4	0.0
Washington	-2.1	-1.5	-0.3	1.9	0.1
Connecticut	-2.6	-2.5	-0.9	3.0	0.2
Vermont	-0.2	-0.2	-0.5	0.2	0.2
Oklahoma**	-1.1	-0.4	-0.2	0.8	0.2
Texas	-5.7	-4.0	-0.2	7.8	0.2
Nevada	-0.4	0.0	0.0	0.4	0.2
South Carolina	-1.3	0.1	0.0	0.6	0.3
Montana	-0.3	0.0	0.0	0.1	0.3
Georgia*	-3.4	-0.5	-0.1	2.6	0.3
Minnesota	-3.3	-0.7	-0.2	2.5	0.5
Massachusetts	-4.4	-0.3	-0.1	3.3	0.5
Oregon	-1.5	0.1	0.0	1.5	0.6
West Virginia	-0.6	-0.2	-0.3	0.8	0.8
Delaware	-0.4	0.4	0.6	0.3	0.9
North Dakota	-0.2	-0.1	-0.1	0.7	1.2
New Mexico	-0.8	1.5	1.4	2.0	3.4
Alaska	0.0	-0.1	-0.2	2.3	3.9
Wyoming	-0.1	-0.1	-0.2	1.7	4.0

Note: Estimates are produced using projections based on enacted budgets for FY2020 and preliminary real GDP estimates for 2019. Budget balances are estimated by netting away the impact estimates from each states' total resources, and subtracting the projected expenditures and other adjustments. 24 states are at risk of seeing their budget balance move into a deficit due to impact of the pandemic. Due to rounding, Ohio's budget balance including rainy-day funds as a percentage of GDP does not show up as negative. *Due to data limitations, estimates for Georgia use the rainy-day fund balance from FY2018. **Due to data limitations, estimates are based on preliminary FY2019 data for Michigan, North Carolina, Oklahoma and Wisconsin. Source: Bureau of Economic Analysis, National Association of State Budget Officers, TD Economics.

Endnotes

1. For most states it is a constitutional or statutory requirement that budgets are balanced. According to the National Conference of State Legislatures (NCSL), all states but Vermont must balance their budgets. Other authorities include Wyoming, North Dakota, and Alaska as well. The requirement to balance budgets only refers to the general fund, also known as operating budget. Capital project financing through bond issuance is not considered to fall under this requirement.
2. To estimate the potential impact of the pandemic on state budgets, we assume COVID-19 results in business shutdowns and layoffs in all states, leading to a decline in state revenues collected through personal income and corporate taxes as well as gaming and lottery where applicable.
3. In terms of expenditures, we assume the grants received under the Coronavirus Aid, Relief, and Economic Security (CARES) Act prove sufficient to cover all non-budgeted cost increases related to the pandemic for each state. However, should coronavirus-related expenditures surge further, this could result in additional downward pressure on states budget balances.
4. http://www.pewtrusts.org/~/media/assets/2017/04/when-to-use-state-rainy-day-funds.pdf
5. This estimate was produced by the Hutchins Center Fiscal Impact Measure.