Written Testimony of

Mark Zandi

Chief Economist, Moody's Analytics

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The finances of state and local governments across the country have been hit hard by the COVID-19 crisis. Moody's Analytics estimates that state and local governments will suffer budget shortfalls of $450 billion to $650 billion due to the pandemic. Without additional financial support from the federal government, state and local governments will have no choice but to further cut payrolls, essential government services, and critical programs. This will severely impact Americans in nearly every community and exacerbate the nation's serious economic problems. Since it increasingly appears that Congress and the Trump administration will not come to terms on additional direct aid to state and local governments any time soon, the Federal Reserve's 13(3) Municipal Liquidity Facility, established early on in the pandemic, should be made more generous to facilitate its use by hard-pressed state and local governments.

Budget shortfall

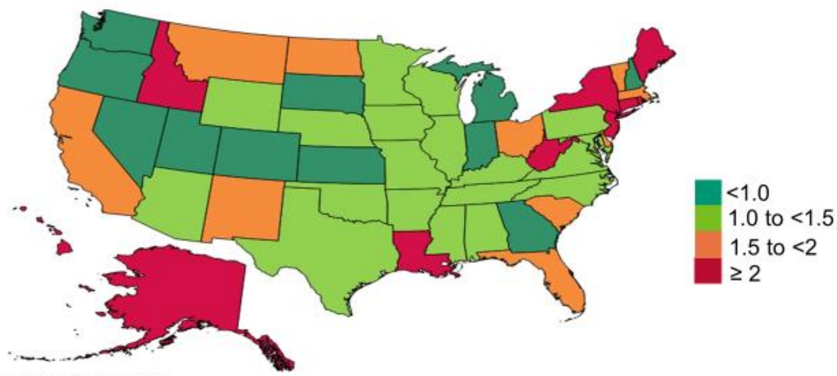
The COVID-19 crisis has choked off tax revenues that state and local governments rely on to fund services and jobs. More than one-fifth of American workers are either unemployed, working reduced hours, or suffering a pay cut because of the pandemic. Their massive loss of wages means a huge decline in personal income taxes. Meanwhile, nearly all businesses are disrupted in some way. Their profits and thus corporate tax revenues have been hammered. And with few people traveling, going to movies, or purchasing cars, sales tax revenues have fallen sharply as well. Property tax revenues are next to suffer, since commercial real estate values and even house prices in many places will likely eventually slump.

The COVID-19 crisis has also caused demand to surge for state and local government services and support programs. Public hospitals have been filled with COVID-19 patients, and the millions who have lost their jobs need unemployment insurance, Medicaid, and help with housing and other living costs. Just when Americans need their government most, cash-strapped cities, counties and states across the country have no option but to slash the help they provide.

States dependent on their oil and natural gas industries, including Alaska, Louisiana, North Dakota and West Virginia, will suffer among the most serious budget shortfalls (see Chart 1). Energy industries have been rocked by the fallout from the virus and the collapse in global energy prices. States hit hard by the virus, such as Connecticut, New York and New Jersey, and those with large tourist industries, such as Florida and Hawaii, will also suffer outsize budget shortfalls.

Chart 1: Pandemic Hits Some State Budgets Harder

Budget shortfall through fiscal 2022, % of gross state product



Source: Moody's Analytics

But no state will escape the financial hit caused by the crisis. Nationwide, we estimate that state and local governments will have COVID-19 budget shortfalls totaling at least $450 billion through fiscal 2022, and as much as $650 billion if there is a serious second wave of the virus. This is stunning—equal to approximately one-fifth of precrisis annual state and local government revenues—and does not include the direct healthcare costs states are bearing to battle the virus. The federal government should pick up these healthcare costs, and so far it has.

These budget shortfall estimates are based on an update to an analysis Moody's Analytics did, first in April 2020 and again in June 2020. They represent the difference versus a flat-budget baseline, or what states would need just to keep the lights on and avoid layoffs. The estimates do not include any real discretionary budget increases or address any long-term structural problems such as pensions or other post-employment benefits.

There are misplaced concerns that state and local governments were profligate spenders prior to the pandemic and should not be bailed out. As a share of GDP, their pre-pandemic spending was consistent with their spending during the past 30 years (see Chart 2). Most also did an admirable job saving for a rainy day during the record-long economic expansion. Rainy day funds were ample before the crisis hit—close to 10% of state government revenues. Only Illinois, Kansas and Pennsylvania did not sock something away.

States are in such a tough bind because they have balanced-budget laws. Unlike the federal government, they cannot run budget deficits for very long. Most times, this is considered a feature and not a bug. It ensures that states remain fiscally disciplined. But in tough times, like now, if the states do not get help from the federal government, they have no choice but to quickly cut jobs and programs, worsening conditions.

State and local governments do have debts. A handful of states have seriously underfunded their pension systems and racked up billions in unfunded liabilities. But those liabilities have no bearing on COVID-19 budget shortfalls. States with some of the best-funded pensions in the country are still taking huge budget hits from the pandemic. Other state debts finance infrastructure projects for roads, airports, healthcare centers and schools.

Large bang for the buck

The federal government typically comes to the aid of state and local governments in economic downturns. It did so in a big way during the financial crisis just over a decade ago and to great effect. Although that aid did not forestall budget and job cuts, it significantly mitigated them and allowed localities to delay needed austerity measures until the economy was back on track. According to a particularly well-done academic study of the $260 billion in state and local government aid in the American Recovery and Reinvestment Act stimulus, passed at the height of the financial crisis in early 2009, the support resulted a year later in 2.1 million to 2.8 million additional jobs. This implies that if federal lawmakers today provided enough funds to simply fill state and local governments' budget hole for fiscal 2021, it would result in well over 2 million additional jobs by this time next year.

Helping state and local governments is one of the most effective ways to support the economy in a downturn. For each dollar spent by state and local governments, Moody's Analytics estimates that the economy sees an estimated benefit of $1.34 approximately one year later. In other words, the economy sees an immediate 34% return on the dollar.

The economic multipliers, or bang for the buck, for state and local government aid are among the highest of any policy step lawmakers can take (see Table 1). For context, at the top is food assistance at over 1.6, while the lowest are corporate tax breaks such as a lower marginal tax rate and loss carryback at close to 0.3. Every dollar to a state or local government quickly goes to paying salaries, providing essential government services, or administering programs that largely benefit lower- and middle-income households. All of the funds get into the economy quickly.

Table 1: Fiscal Stimulus Multipliers

As of 2020Q2

	Bang for the buck
Tax cuts	
Refundable lump-sum tax rebate	1.21
Nonrefundable lump-sum tax rebate	1.00
Temporary tax cuts	
Child Tax Credit, ARRA parameters	1.35
Earned Income Tax Credit, ARRA parameters	1.23
Job Tax Credit	1.18
Making Work Pay	1.16
Payroll tax holiday for employees	1.14
Payroll tax holiday for employers	1.03
Across-the-board tax cut	0.98
Housing Tax Credit	0.79
Accelerated depreciation	0.52
Loss carryback	0.27
Permanent tax cuts	
Extend alternative minimum tax patch	0.52
Make dividend and capital gains tax cuts permanent	0.38
Cut in corporate tax rate	0.32
Spending increases	
Temporary increase in food stamps	1.67
Temporary federal financing of work-share programs	1.60
Extending unemployment insurance benefits	1.49
Increase infrastructure spending	1.43
Increase defense spending	1.39
General aid to state governments	1.34
Low Income Home Energy Assistance Program (LIHEAP)	1.11

Note: The bang for the buck is estimated by the one-year $ change in GDP for a given $ reduction in federal tax revenue or increase in spending.

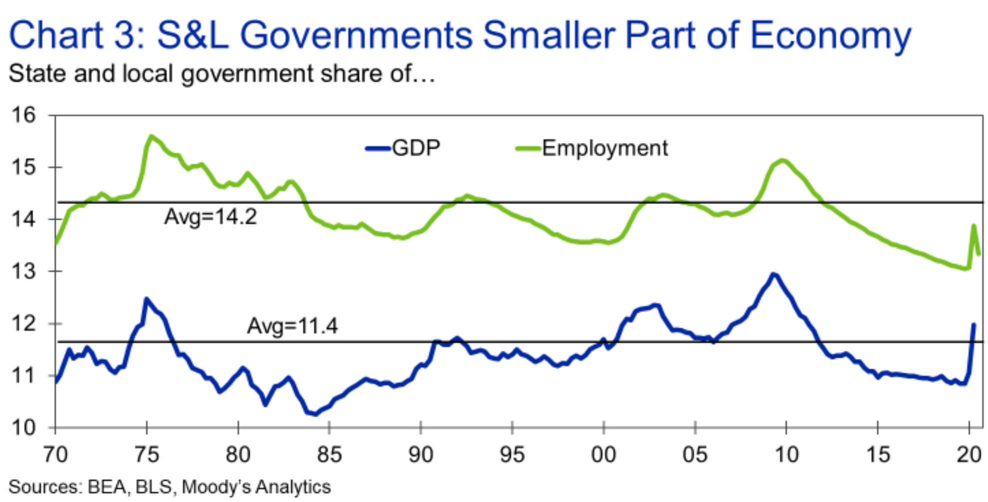
Source: Moody's Analytics

The economic bang for the buck from federal aid to state and local governments would be especially large in the pandemic given how low interest rates are and how likely they are to remain very low. The Fed recently changed its framework for conducting monetary policy and made clear that it will not begin to normalize rates until the economy is at full employment and inflation has been consistently above the Fed's 2% target for a considerable period. The Fed is thus likely to keep short-term rates close to zero for the next several years.

Economic fallout

If the federal government does the right thing and quickly helps state and local governments with additional aid, it will go a long way toward helping the broader economy through the remainder of the pandemic and quickly restoring the economy to full employment after the pandemic. If lawmakers fall short, the entire economy threatens to backslide into recession. Moody's Analytics estimates that a failure by lawmakers to provide additional direct aid to state and local governments will cut as much as 3 full percentage points from real GDP and erase almost 3 million jobs over the next two years.

This will be on top of the 1.1 million jobs state and local governments have cut in the past six months in response to the COVID-19 crisis, equal to almost 6% of all such jobs. These jobs include police officers and firefighters, healthcare workers, emergency responders, social service providers, and teachers—critical jobs at any time but particularly in a pandemic. And it is not as if state and local governments are cutting bloated payrolls. Prior to the pandemic, state and local governments had the same number of employees on their payrolls as they did about 15 years before the financial crisis. As a share of total employment, state and local government payrolls prior to the pandemic were as low as they have been since the 1960s (see Chart 3).



Many state and local government programs will also be cut significantly. The burden of these cuts will fall largely on lower- and middle-income Americans, many of whom rely on food, housing and educational assistance, medical care, unemployment insurance, and other social services. These are the same generally lower-income households that have suffered the brunt of the job and income losses during the pandemic.

The cuts to jobs, services and programs will likely occur quickly if it becomes clear that lawmakers will not be able to come to terms on more state and local government aid in the next few weeks. If lawmakers are unable to agree to provide this support and include it in or along with a continuing resolution to fund the federal government at the start of the next fiscal year in October, then it is highly unlikely that state and local governments will receive any help until after the next president is inaugurated in late January. State and local government officials have been holding off on major budget decisions until they have clarity on the financial resources they will have to work with. Once clear, given the extraordinary budgetary pressures they face, they will have no choice but to scale back quickly.

Municipal Liquidity Facility

Although it would be a far more preferable outcome for state and local governments and the economy if Congress and the Trump administration agreed to more direct aid to state and local governments, if such support is not forthcoming or is not sufficient, then the Fed's Municipal Liquidity Facility should be made much more generous. To be sure, although only the state of Illinois and New York City's Metropolitan Transportation Authority have used the facility to date, the backstop to the municipal bond market provided by the facility has eased investor concerns, allowing borrowing costs to remain low and the municipal bond market to function well. Municipal bond yield spreads have narrowed since the early days of the pandemic, particularly for more highly rated municipal issuers, and municipal bond issuance has remained ample. Nonetheless, the facility should play a more supportive role in shoring up the shaky finances of state and local governments. At minimum, the Fed should treat state and local governments as well as it does corporate borrowers that enjoy better interest rates and longer terms.

To this end, policymakers should consider the following changes to the Municipal Liquidity Facility:

(1) Lower borrowing rates, including as low as the federal funds rate;
(2) Lengthen the term to closer to 10 years;
(3) Extend the facility's expiration date, which is currently the end of this year;
(4) Allow for a deferred payment structure such as that provided in the Main Street Lending Facility; and
(5) Permit MLF funds to be used for broader purposes like capital infrastructure that can stimulate the economy (they are currently restricted to short-term cash flow).

Policymakers, including the Federal Reserve, Congress and the Trump administration, deserve a shout-out for responding aggressively to the pandemic. They have used the federal government's financial resources to help bridge American households and businesses to the other side of the pandemic. But the federal government's financial support has run out while the pandemic rages on. The bridge is unfinished. Unless lawmakers act quickly to extend it, many lower-income households and small businesses in particular face financial devastation. Congress and the Trump administration should agree to another significant fiscal rescue package that includes substantial direct aid to state and local governments, and the Federal Reserve should become more expansive in its implementation of the Municipal Liquidity Facility.