JOINT ECONOMIC COMMITTEE
CONGRESSMAN DON BEYER, VICE CHAIR

Massive Aid to State and Local Governments Needed to Slow Economic Damage

The coronavirus pandemic not only threatens the lives of millions of Americans, but it could unfold into a second Great Depression. In just two weeks, 10 million Americans filed for unemployment insurance benefits.[1] The St. Louis Federal Reserve estimates that the unemployment rate could hit 30 percent and second quarter GDP could fall 50 percent on an annual basis.[2]

Congress has acted decisively to prevent this enormous economic shock from developing into a full-blown depression. In recent weeks, it has dramatically increased unemployment insurance benefits, provided forgivable loans to small businesses, enacted direct cash payments to low- and middle-income Americans, and much more. However, the aid it has provided to state and local governments so far is relatively small given the challenges they face.

Prominent economists and former officials from both Democratic and Republican administrations argue in a recent open letter that the nation's *number one economic priority* should be containing the coronavirus outbreak, stating that "we will hasten the return to robust economic activity by taking steps to stem the spread of the virus and save lives."[3] However, the Administration has been extremely slow to respond to the crisis, forcing states and local governments to fill the void.

While the White House now predicts that the coronavirus could cause up to 240,000 American deaths, state governments are desperate for resources to fight the pandemic.[4] They face an impending fiscal catastrophe because while they attempt to fight an unprecedented public health crisis, most are required by law to balance their budgets. Meanwhile, their tax revenues are collapsing while their Medicaid costs are exploding. Some will slash other spending, pushing more of the shortfall onto municipal governments since many rely on state government funding while facing the same collapse in revenue.

Failing to provide adequate aid to state and local governments would represent a failure to learn the lessons of the Great Recession, the recovery from which was significantly slowed by budget cuts at the state and local level. It took more than 10 years for state and local government employment to reach its pre-recession level, making the hole for the private sector to dig out of that much deeper.

The lives of millions Americans and the strength of the U.S. economy are gravely threatened by the coronavirus outbreak—and in part are dependent on the ability of state and local governments to fight it. They must play a leading role in "flattening the curve" of outbreak and eventually containing it so Americans can feel safe to go back into their communities and back to work. No state is safe until every state successfully contains the coronavirus. The federal government must provide additional, large-scale assistance to state and local governments to make this possible.

States and cities forced to spend billions treating victims of the virus and slowing its spread

State and local governments across the country will face a severe budget squeeze from the response to the coronavirus outbreak. The immediate impact on state and local budgets is an enormous increase in spending as they lead the nation's public health response. One study estimates that the immediate public health response to the virus will cost local governments $20 billion.[5]

Medical needs alone are overwhelming. For example, admissions of patients with COVID-19 at New York Presbyterian Hospital have increased by as much as 10 percent each day, with 20 percent of these patients in intensive care units (ICUs) and 80 percent of these ICU patients needing ventilators.[6] In New Orleans, one thousand extra beds are being set up inside a convention center to help hospitals with the growing number of COVID-19 cases.[7] The needs will explode as the number of coronavirus cases requiring medical care grows exponentially in the coming weeks.

Governments are only beginning to reckon with the extraordinary cost of this response. The health department of King County, WA is already spending over $200,000 a week in diverted staff and overtime, which is the equivalent of five percent its budget. It plans to hire a temporary team of workers for eight months at an estimated cost of at least $1.25 million.[8] If there are many cases, the cost could be two or three times as high.

State and local governments are also buying ventilators and protective gear for health care workers at elevated prices during a mass shortage. The federal government until recently has refused to use the Defense Production Act to ensure the affordable production of this equipment. There also have been reports of the federal government bidding against state governments for these resources and thus driving up the price.[9]

States likely to face a historic increase in Medicaid costs

The coronavirus outbreak will further strain state governments' budgets as they play a significant role in funding Medicaid. Medicaid costs are likely to increase significantly as Medicaid enrollees receive treatment for the coronavirus. Medicaid enrollment will jump as millions of workers lose not only their jobs but also their employer-sponsored health coverage. States cover, on average, about 40 percent of the cost of Medicaid spending with the federal government paying the rest[10] and it is the largest destination for states' revenue after education.[11]

In previous recessions, the increase in Medicaid costs was so severe that states reduced Medicaid eligibility, which would be a tragic error during a pandemic.[12] Local governments may also feel the squeeze of the increase in Medicaid costs as a significant portion of their budgets come from state government grants, which states could reduce as Medicaid costs rise.[13]

State and local revenues shrink as the economy weakens

The historically deep and rapid drop in economic activity resulting from the pandemic will further squeeze state and local budgets by reducing tax revenue. Sales tax revenue is already facing an immediate drop as households cut back on spending. This has been exacerbated by the steep drop in tourism as states and localities typically charge extra taxes on hotel stays and Americans' sudden shift their dining from (typically taxed) restaurant meals to (typically untaxed or more lightly taxed) groceries. The hit to income taxes comes later as millions of workers lose their jobs and stop paying taxes, while the steep decline in the stock market will reduce state capital gain and dividend tax revenue.

Analysts project that the toll on state and local budgets will be astronomically high. New York state revenue may fall by as much as $15 billion.[14] California budget analysts believe that the state could go through its cash reserves—which were projected to reach $21 billion next summer—in just months. [15] Virginia expects revenue to drop by $1 billion in 2020 and 2021 compared to previous projections.[16] Initial modeling by the Michigan Treasury and Budget Office suggests the state could lose $1 billion to $3 billion in anticipated revenue this year and $1 billion to $4 billion in fiscal year 2021.[17] Arkansas is projecting a $353 million drop in state revenue—equivalent to six percent of its budget—just through June.[18]

No overall estimate exists of how much state and local tax revenue will decline. If states across the nation experience a revenue decline similar to the one the New York Governor's office is projecting, it would suggest that state tax revenue alone could decline by as much as *$175 billion*. This does *not* include the drop in local tax revenue, the cost of the public health response to the virus, and the expected increase in Medicaid spending.

State balanced-budget rules will require drastic spending cuts

Higher spending and lower revenue will create a dilemma for most state governments, which not only face a public health threat from the virus but also are forced to balance their budgets. Many are likely to turn to drastic budget cuts.

Indeed, Ohio Governor Mike DeWine has already frozen hiring in Ohio while proposing an enormous 20 percent across-the-board cut in the Ohio state budget to account for falling revenue and growing Medicaid costs. [19] New York lawmakers reached a tentative agreement this week to cut operating spending by $10 billion, which could include Medicaid cuts.[20]

The federal government does not face currently face rules hampering its ability to borrow and it can currently borrow at interest rates so low that, after expected inflation, it can actually *make* money by borrowing.[21] For this reason, the federal government can borrow money to spend to on urgent needs or to take action that will provide a substantial long-term benefit.

The rules for state and local governments, however, are entirely different. Every state other than Vermont is required to balance its budget and cannot borrow funds to meet ongoing costs (they usually issue bonds to finance capital expenditures such as infrastructure).[22] State governments must meet the coming budget shortfall with some combination of spending cuts, revenue increases, and withdrawals from reserves such as rainy day funds. Local governments face many of the same constraints since state laws require almost all cities to run balanced budgets.[23]

Without significant federal fiscal support, states and localities are likely to rely on drastic budget cuts to make it through the current crisis. They can draw down the rainy day funds they have set aside for fiscal emergencies like the current one, and the median state's rainy day fund balance amounts to about 8 percent of general spending.[24] But half of all states have rainy day funds below that amount and states' budget shortfalls will likely be far larger than their rainy day funds. State budget rules that make it harder to raise taxes than cut spending in some states will exacerbate the size of the cuts.

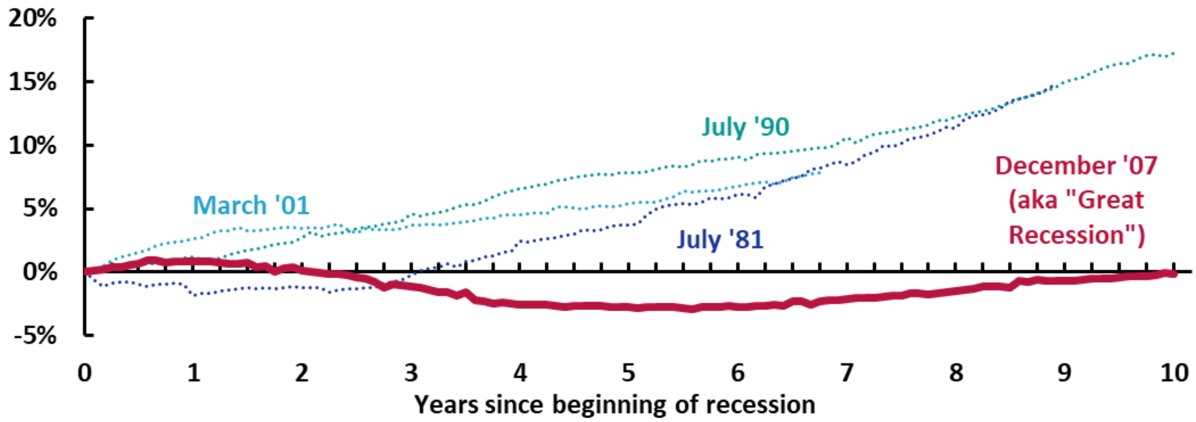
State and local budget cuts slowed the recovery from the Great Recession

Deep state and local budget cuts have the potential to deepen the recession caused by the coronavirus response and slow down the recovery. The combination of falling tax revenue with exploding Medicaid and public health budgets could squeeze other funding items. Even a relatively small decline in the 20 million state and local government jobs could result in a large increase in unemployment.

The best evidence for the dangers this poses was the aftermath of the Great Recession when squeezed state and local budgets caused a significant slowdown in the recovery. The American Recovery and Reinvestment Act included important benefits for state and local governments, but the amounts were both insufficient and did not last long enough.

State and Local Government Job Cuts Slowed Recovery from Great Recession

Cumulative percent change in state and local government employment from beginning of recession



Source: U.S. Bureau of Labor Statistics and National Bureau of Economic Research
Note: Data continues until the beginning of the next recession or until ten years from the beginning of the previous recession

This resulted in budget cuts that triggered a reduction in state and local government employment, whether through layoffs or not filling open positions. This significantly slowed the pace of the labor market recovery since private-sector hiring not only had to make up for its own substantial job losses but also had to cover public-sector job losses. Moreover, laid-off state and local governments workers cut back on their own spending, slowing private-sector hiring further.

The recovery of state and local jobs was slow. It took more than 10 years for state and local employment to reach its pre-recession level, even though the actual recession lasted less than two years. This was atypical compared to previous recessions where state and local employment grew or returned to its pre-recession level within a few years.

States and localities will also have trouble funding other priorities given the revenue shortfall they face, just as they did after the Great Recession. Without significant federal support, many will likely address the funding shortfall by cutting spending in areas like education. State and local government employees are generally being paid during this period of social distancing and are playing a significant role in preventing aggregate demand from collapsing entirely. Layoffs, furloughs, or even slower hiring among states and localities will further depress the economy at its low point or hinder the recovery depending on the timing.

States need help with the massive explosion of Medicaid costs

The biggest priority is helping states with the growing cost of Medicaid as current enrollees use Medicaid to pay for life-saving coronavirus treatment, while what is likely to be millions more Americans enroll in Medicaid as they lose their employer-sponsored coverage with their jobs. Failure to provide sufficient support to states with their Medicaid costs, given their coming fiscal squeeze could cause them to reduce Medicaid eligibility in the middle of a public health crisis.

The Families First Act, which was signed into law on March 19, included a 6.2 percentage point increase in the federal government's share of Medicaid funding (known as the Federal Medical Assistance Percentage or FMAP) and is an essential first step, costing about $40 billion on an annual basis.[25] But the increase in the FMAP is smaller than the average 10 percentage point increase that was part of the 2009 stimulus.[26] The FMAP increase should actually be *higher* than it was in 2009 both because health costs will rise as a result of the pandemic and because the economic contraction may be larger.

States and local government support is insufficient

The CARES Act that Congress passed last week already provides $175 billion in aid to state and local governments.[27] They may also receive some portion of the loans the CARES Act supports, but it is unclear how much will go to state and local governments since large businesses can also receive loans from the same pot of money.

This is widely seen as insufficient given the enormity of the potential fall in tax revenue.[28] New York Governor Andrew Cuomo, for example, has said that New York State would receive less than $4 billion despite a potential revenue shortfall of over $15 billion, which does not count the cost of responding to the outbreak or the increased Medicaid spending.[29] The total amount of state and local fiscal relief required will depend on how long the outbreak and the containment measures last. Congress should appropriate additional state fiscal relief in future spending packages that include triggers for additional aid into 2021 if economic conditions warrant.

Importantly, much of the CARES Act aid is also highly structured with specific funds for schools, mass transit and child care. These are all critical priorities, but state and local governments will see a decrease in general revenue and growing Medicaid costs could crowd out funding for other priorities. Future aid should be flexible, reflecting state and local governments' general funding challenges.

Local and state governments need help addressing borrowing costs

Finally, steps must be taken to prevent state and local governments' borrowing costs from exploding. Although they generally cannot finance operating costs with debt, state and local governments do borrow money for long-term projects such as building schools and highways as well as to manage uneven cash flow throughout the year. State and local governments' borrowing costs have fluctuated significantly in recent weeks as a result of market turmoil, which puts additional pressure on their already strained budgets.

The Federal Reserve has recently announced that it will begin accepting short-term state and local debt as collateral, which has alleviated some of the pressure.[30] It should also begin exercising its authority to directly buy short-term state and local debt.[31] The Fed currently lacks authority to buy longer-term debt, but lawmakers should pass legislation that would allow the Federal Reserve to purchase state and local debt of all maturities.

Further aid to the states will lessen the future burden on other states and the federal government

Failure to provide adequate aid to state and local governments will hamper our public health response, leave Americans less healthy, force states to divest from productivity-enhancing investments such as schools and infrastructure, and slow the recovery of the labor market. The federal government cannot afford to be shortsighted when it comes to aid to state and local governments.

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