State and Local Austerity Could Weigh on Recovery

Executive Summary
State and local (S&L) governments face significant fiscal headwinds as a result of the economic fallout from COVID-19. Unlike the federal government, most S&L governments have balanced budget requirements that prevent unlimited borrowing to meet general revenue shortfalls. This mandated austerity often comes right as the private sector is beginning to rebound from a recession and can hamper the pace of the subsequent recovery. S&L employment has already declined by nearly 8% since February, and while some of these jobs will probably return as lockdown measures are increasingly eased, more cuts will likely be on the way for budget reasons. With S&L governments potentially facing hundreds of billions of dollars in revenue shortfalls over the next couple years, and the outlook for additional federal government aid highly uncertain, the S&L sector of the economy could be a material drag on real GDP growth in the quarters ahead. But should sizable federal aid be forthcoming and/or the private sector recovery be more robust than we expect, then the S&L sector would be a source of upside risk in our macro forecast.

What Can the Great Recession Teach Us About the Outlook Today?
State and local (S&L) governments play an important role in shaping the economic outlook. At the end of 2019, S&L consumption and investment was 10.9% of U.S. GDP (Figure 1), and slightly more than one in eight American workers were employed by S&L governments (Figure 2). S&L government spending is more important to the economy than just the quarterly GDP prints; investment at the S&L level in areas like education and infrastructure are critical to the long-run potential growth rate of the U.S. economy.

S&L government budget woes can generate a sizable headwind on the U.S. economy, a dynamic that was illustrated after the Great Recession. Unlike the federal government, most S&L governments have balanced budget requirements that prevent unlimited borrowing to meet general

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Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

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revenue shortfalls. S&L tax receipt growth collapsed during the recession, falling nearly 10% from peak-to-trough (Figure 3). But, the economic impact from declining revenues was not felt right away. In fact, S&L output actually rose in late 2008 and the first half of 2009, especially after the American Recovery and Reinvestment Act was passed in February 2009 (Figure 4). Policy measures like additional spending on infrastructure and Build America Bonds provided the boost, but as this federally financed spending faded and a slow, sluggish recovery began, S&L output began to contract amid austerity. S&L production declined in every quarter from Q3-2009 to Q1-2013, eventually hitting a trough in Q1-2014. The reduction in S&L output reduced real GDP growth 0.35 percentage points in 2010, 0.44ppt in 2011, and 0.26ppt in 2012. On the employment side, the peak to trough decline in S&L employment was 747,000 jobs and took place over a period of more than four years.

**Figure 3**

[S&L tax receipts chart]

**Figure 4**

[Real state and local government expenditures chart]

Source: U.S. Department of Commerce and Wells Fargo Securities

**Economic Fallout from COVID-19 Puts Budgets in Dire Straits**

The recent economic fallout from the COVID-19 pandemic has generated significant concern about the fiscal health of S&L governments. The historic collapse in retail sales threatens sales tax revenue, which comprises about a quarter of S&L government tax receipts (Figure 5). Personal income tax receipts account for roughly another quarter of S&L tax revenues, and given the surge in personal income in April one might think that this portion of the tax base would hold up better. But the bulk of April's increase in personal income was due to the one-time economic impact payments made by the federal government, and these payments are taxable income. Excluding those payments, U.S. personal income fell 6.3% in April. Property tax receipts, which account for 31% of S&L revenues, will likely hold up better than sales or income tax collections. But here too there will likely be some weakness, particularly for commercial properties as some businesses struggle to keep up on fixed costs like property taxes amid challenging economic times.

The data have already begun to reflect the significant headwinds facing S&L governments. S&L employment has collapsed over the past three months, falling by 1.6 million since February (Figure 6). Some of these job losses have been more driven by the shutdowns than budget cuts. The establishment survey for nonfarm employment counts a worker as employed so long as their employer paid them for part or all of the pay period that occurred during the survey window.

**S&L production declined in every quarter from Q3-2009 to Q1-2013.**

**S&L employment has collapsed over the past three months.**
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Figure 5
State & Local Government Tax Receipts

Sales Taxes 23.1%
Personal Income Taxes 23.7%
Excise Taxes 11.1%
Property Taxes 31.5%
Other 7.7%
Corporate Income Taxes 3.4%

Q1-2020

Figure 6
State & Local Government Employment

In the near term, we expect S&L output to collapse.


Thus for some workers, such as many teachers who are still being paid, this would mean an outright cessation of instruction would not count as a job loss in the establishment survey. But for other education workers, such as school security guards, school bus drivers or substitute teachers, the school closures may not come with continued pay, though of course this will vary across different areas. In this scenario, these job losses would count as a decline in government education employment. Even excluding education, S&L employment has fallen by 545,000 jobs since February, nearly matching the total S&L jobs lost during the four years following the Great Recession.

Assuming the gradual lifting of statewide lockdowns continues in the months ahead, some of these jobs should come back. But as some jobs return, others will likely to be permanently lost due to budget cuts, and capital investment will be significantly curtailed. In the near term, we expect S&L output to collapse, largely due to declines in education output as some schools have stopped or cut back on instruction (Figure 7). If education output returns to normal later this year as we expect, this should lead to a bounce back in output. But through the lockdown-related noise, declines in capital investment and budget-related job cuts will almost certainly be occurring through the rest of 2020 and 2021. We expect S&L output to still be 3.7% lower in Q4-2021 than it was in Q4-2019. And although we do not formally forecast 2022, it is possible that S&L austerity could still be weighing on output, as it did in 2012 and 2013.

Figure 7
Real State & Local Government Purchases

Back = CAGR  Line = Y/Y Percent Change

State and Local Government Purchases-CAGR: Q1 @ 5.3%
State and Local Government Purchases-Y/Y: Q1 @ 1.4%

Source: U.S. Department of Commerce, U.S. Department of the Treasury and Wells Fargo Securities

Perhaps the biggest wild card in this outlook is the uncertain status of additional federal aid to S&L governments. S&L governments have gotten some fiscal aid in previous federal packages, including

Figure 8
Federal Budget: Record Deficits Coming

Source: U.S. Department of Commerce, U.S. Department of the Treasury and Wells Fargo Securities

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expanded federal cost-sharing for Medicaid and access to a $150 billion Coronavirus Relief Fund that covers expenses made specifically in response to the pandemic. But while these and some other measures have been passed, there has not yet been a large, open-ended infusion of federal cash to cover general revenue shortfalls. Is such a package forthcoming, and if so, will it be “enough”?

How much would be “enough” is a difficult question to answer as the size of future budget shortfalls will largely depend on the path forward for the economy over the next few years. Putting a number on it also requires choosing a time period to examine (e.g. the shortfall over this fiscal year? Next year? Several years combined?) as well as choosing a baseline against which to judge (e.g. a revenue shortfall as compared to actual FY 2019 revenues or pre-COVID projections for FY 2020 and beyond?).

On April 11, the National Governors Association (NGA) called for $500 billion in aid to state governments plus an unspecified amount for the separate but “much-needed fiscal stabilization for local governments.”¹ This was not far off the bear case scenario presented by our municipal analysts around the same time, which looked for a $487 billion revenue shortfall for states through FY 2022 (their “base case” scenario was a $330 billion decline).² Using a third approach that looks at the elasticities between changes in the unemployment rate and change in state tax revenue collections, we found a similar state revenue shortfall over the next two years of $300-$350 billion.³ Local tax revenues are often more stable given their greater reliance on property taxes, but even so it is easy to imagine the total revenue shortfall for S&L governments approaching $500 billion.

At present there is a bipartisan bill in the U.S. Senate to establish a $500 billion fund that would help S&L governments deal with their fiscal woes. This bill appears unlikely to become law as a standalone piece of legislation, however, and we believe the ultimate fate of any additional funding for S&L governments will be dealt with in a larger piece of legislation that will not begin to take shape until July at the earliest. For the past couple months, our forecast has assumed no additional S&L aid as its baseline. Ultimately we believe another fiscal package is more likely than not, but the timing, scope and size of such a package is highly uncertain, and this uncertainty extends to potential S&L aid. Thus, should there be a meaningful rescue package floated by the federal government to S&L governments, our baseline forecast for S&L output would have considerable upside.
