Risks Rise for State and Local Budgets: COVID Stress Test Update

BY DAN WHITE, EMILY MANDEL, COLIN SEITZ — JUNE 24, 2020
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- States and local governments will need approximately $500 billion in additional aid over the next two fiscal years to avoid major damage to the economy.
- Timing is of the essence, as state and local policymakers face several important budget deadlines in the weeks and months ahead.
- If action is not taken quickly enough, the spending cuts and tax increases that would need to be undertaken could cost several million additional jobs and further delay the recovery.
- The specter of a second wave of widespread infections is broadening the distribution of potential downside scenarios.

Almost three full months into the COVID-19 pandemic state and local government budget risks are at an all-time high as revenue uncertainty abounds and questions continue about how much, if any, aid will be coming from the federal government. Complicating issues more, budget deadlines have become much tighter and the specter of a second wave of widespread infections has amplified the potential revenue losses in our more severe scenarios.

The biggest question remains how much, if any, help is on the way.

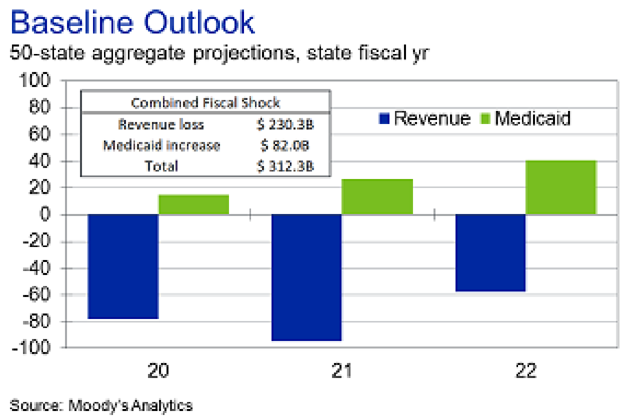
Under baseline economic assumptions, we project that Congress and the White House will need to enact approximately $500 billion in additional flexible aid to states and local governments over the next two fiscal years to avoid major damage to the economy.

This is based on a refresh of our April state budget stress tests to include the most up-to-date economic scenarios and data, as well as a rough estimate of local government revenue shortfalls relative to those state results. Local government shocks are estimated at approximately 48% of state government shocks based on work done by the Upjohn Institute for Employment Research and Brookings Institution.

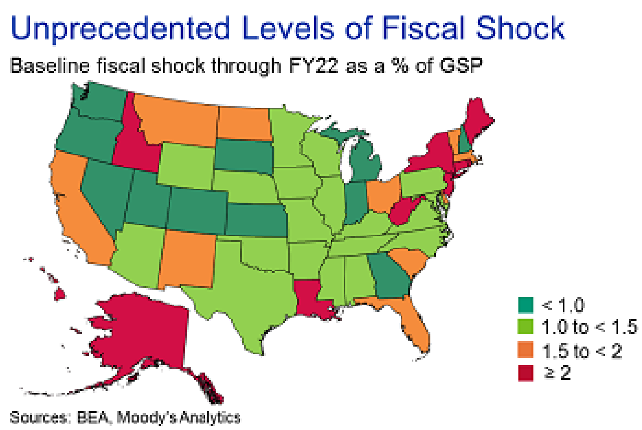
The stress-test results are based on our proprietary state revenue and Medicaid models versus a flat-budget baseline, or what states would need just to keep the lights on and avoid layoffs. The estimates do not include any real discretionary budget increases or address any long-term structural problems such as pensions or other post-employment benefits.

Baseline

Through the end of fiscal 2022 the fiscal shock to state budgets under baseline economic assumptions is projected to be $312 billion. This roughly matches what was our more severe scenario projection during the April stress-testing exercise. Both revenues and Medicaid spending are significantly impacted, with much of the stress concentrated in fiscal 2021, which begins this July for most states.



When potential shortfalls at the local government level are added, total fiscal drag on the economy over the next 2½ years comes out to be almost $500 billion. Relying on economic multipliers from some of our previous research, we estimate that such a severe drag could shave as much as 3 full percentage points from real GDP and erase about 4 million jobs.

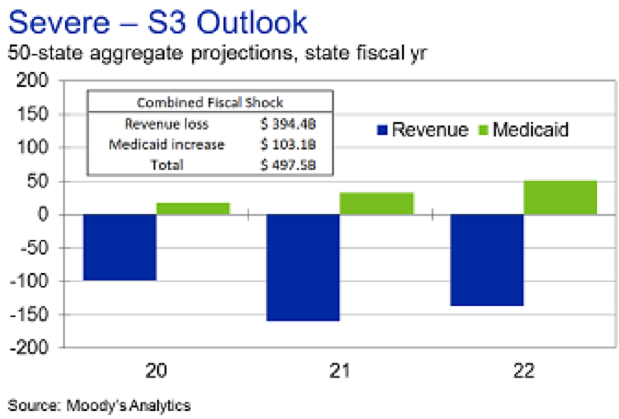


The baseline forecast assumes, from an economic perspective at least, that the worst of the pandemic is passed, followed by a continuing sluggishness until a vaccine can be established late next year.

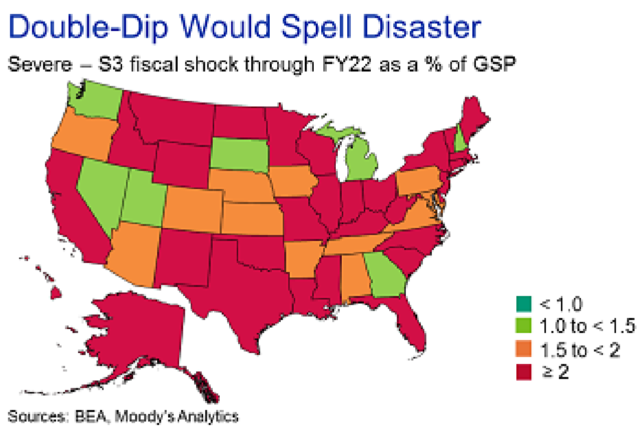
Second wave

However, the risk of a potential second wave of infections resulting in another COVID-19-induced recession toward the end of this year has increased. Our more severe S3 scenario captures this possibility, with the economy taking much longer to recover relative to the baseline. In a true double-dip recession, real GDP may not fully recover until early 2023, and total employment would remain below 2019 levels until at least 2025.

The fiscal impacts of such a scenario would generate a level of budget stress not seen since the Great Depression. Through fiscal 2022, our modeling suggests that state budgets would be shocked by $498 billion.



Coupled with corresponding shortfalls at the local level, the total amount of fiscal drag from a double-dip recession could reach almost $750 billion. Using past data on economic multipliers, we estimate that such a drag could shave almost 5 full percentage points from real GDP and erase more than 6 million jobs.



The magnitude of the fiscal shocks estimated in this exercise is more than even the most well-run state or local government can handle without having to make substantive spending cuts or tax increases. These fiscal actions will have economic consequences, amplifying the business cycle and damaging the recovery. Because states and local governments are for all practical purposes unable to borrow to finance current operations, only the federal government is in a position to cushion the blow to the economy.

Time is short

The scope of aid being requested is certainly unprecedented in size and warrants significant scrutiny. For example, the $1 trillion in aid recently approved as part of the house's HEROES Act would be enough to raise the eyebrows of even the most aggressive advocates of fiscal stimulus. Though the magnitude of such an aid package is certainly up for debate, the timing should not be.

Many state officials are still grappling with how to close out fiscal 2020, which ends for most states in less than a week. After that they will likely begin to convene special legislative sessions in late summer and early fall to address shortfalls for fiscal 2021, and shortly thereafter states and local governments will begin work in earnest on spending plans for fiscal 2022.

Given the uncertainty around the potential for a second widespread outbreak and the unprecedentedly massive size of the aid being requested, the wisest course of action would be to approve $500 billion in additional aid over the next two fiscal years as quickly as possible.

That will provide state and local government policymakers sufficient breathing room to avoid having to make economically disastrous fiscal decisions, and should a second virus outbreak actually occur, federal policymakers will have plenty of time to consider the prospect of additional aid over future fiscal years if necessary.

If the federal government fails to act quickly enough, state and local policymakers will have to go into impending budget negotiations with no knowledge of how much, if any, aid is headed their way. This will require them to be even more cautious than usual to the detriment of the economy. More than 1.5 million government workers have already been laid off since the pandemic began. Without quick action, millions more could be next.

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CONTACT US

For further information contact us at a location below:

U.S./CANADA
+1.866.275.3266

EMEA
+44.20.7772.5454

ASIA/PACIFIC
+852.3551.3077

OTHER LOCATIONS
+1.610.235.5299

Email us: help@economy.com
Or visit us: www.economy.com

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