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Pandemic's Impact on State Revenues Less Than Earlier Expected But Still Severe

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The pandemic's impact on state revenues this spring was smaller than the historical record predicted. Nevertheless, states, localities, tribal nations, and U.S. territories like Puerto Rico still face large shortfalls for this fiscal year and the next in funding schools, health care, and other basic public services. They desperately need more federal aid to avoid more layoffs and other cuts that would further weaken the economy, increase hardship, and worsen racial and class inequities.

State and local revenues have fallen as the pandemic has forced businesses to close or scale back, costing millions of jobs. Sales taxes, a major revenue source for states and, to a lesser extent, localities, have fallen especially sharply. Income taxes — states' other primary revenue source — are also down, as are revenues from gasoline taxes and other lesser sources.

As a result, states and localities have furloughed or laid off 1.2 million workers to date, far more than the 750,000 that lost their jobs during the Great Recession.[1] They've also imposed spending cuts that diminish the reach and quality of public services. Georgia, for example, cut K-12 funding by nearly $1 billion,[2] and California cut higher education by roughly the same amount.[3] Because many states are operating under budgets they know are unrealistic, more cuts — likely leading to more layoffs, tuition hikes, and reductions in public services — are coming unless the federal government steps up.[4]

[1] See Michael Leachman, "States, Localities Need Federal Aid to Restore Jobs, Avoid More Layoffs," Center on Budget and Policy Priorities, October 8, 2020, https://www.cbpp.org/blog/states-localities-need-federal-aid-to-restore-jobs-avoid-more-layoffs.

[2] Jill Nolan, "Ga. schools still bear brunt of adopted $2.2B spending cut," *Georgia Recorder,* June 27, 2020, https://georgiarecorder.com/2020/06/27/ga-schools-still-bear-brunt-of-adopted-2-2b-spending-cut/.

[3] California Budget & Policy Center, "First Look: State Budget Manages COVID-19 Challenges But Fails to Use All Options to Invest Now in Californians," July 2020, https://calbudgetcenter.org/resources/first-look-2020-21-state-budget-manages-covid-19-challenges-but-fails-to-use-all-options-to-invest-now-in-californians/.

[4] Elizabeth McNichol, "States Expect More Damaging Cuts Without More Federal Aid," Center on Budget and Policy Priorities, September 9, 2020, https://www.cbpp.org/blog/states-expect-more-damaging-cuts-without-more-federal-aid.

State, Local Shortfalls Likely to Exceed $500 Billion Over Next Two Years

Fortunately for states, revenues for fiscal year 2020 (which ended in June in most states) came in significantly better than they expected. Our analysis of Census data and state tax collections finds that revenues were about 2 percent below states' pre-pandemic projections, which translates into total shortfalls of about $22 billion. That's much lower than seemed likely earlier this year when unemployment rates were rising very rapidly and leading economic forecasters were projecting rates to hit Depression-era levels. It's also much less than the historical relationship between unemployment and state revenues, mainly because this recession has been concentrated among lower-income workers (who pay less in taxes) and because federal aid, like expanded unemployment benefits, boosted workers' income and purchasing power in the pandemic's early months.

Much of that federal aid, though, is now expired or spent, and states still face considerably lower revenues, with unemployment high and business activity still down. In the last couple of months, states have grown modestly more optimistic about the current fiscal year but remain pessimistic about next year. States' adjusted estimates suggest that, in the absence of further federal support, shortfalls will total about 11 percent of their budgets in fiscal year 2021 and 10 percent in 2022, which begins next July in most states.[5] Plus, states face increased costs due to higher enrollment in Medicaid and other programs. Including these higher costs, states' own estimates suggest shortfalls through fiscal year 2022 that total about $305 billion.

Those estimates could easily prove too optimistic. While the economic harm from this recession so far has been more concentrated among lower-income families than in past recessions, that may not remain as true in coming months. For example, if political turmoil and continued gridlock lead to a further decline in the stock market and more layoffs, including among more highly paid employees, the recession's impact on state shortfalls may come to look more like it did in past recessions, with the shortfalls increasing significantly. The historical relationship between unemployment rates and state revenues suggests that shortfalls could total $400 billion through 2022, based on the Congressional Budget Office's (CBO) most recent economic forecast.

In addition, CBO's most recent forecast doesn't assume a major new surge in COVID cases. Such a surge, however, may now be beginning. If COVID cases continue to rise rapidly, the economy could deteriorate and slip into a "double-dip" recession — a scenario that Mark Zandi of Moody's Analytics believes is likely in the next three months.[6] If that occurs, state shortfalls would grow still more. The failure of Congress and the White House to agree on a new relief package with additional fiscal aid for states and localities makes such an outcome more likely.

Local governments also face substantial shortfalls, though less than the states — largely because localities rely more on property taxes, which so far have been stable. No comprehensive data are available to project local shortfalls with precision, but researchers generally estimate that aggregate

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[5] We adjusted these aggregate state estimates upwards by a percentage point in 2021 and 2022 because some state forecasts assumed additional federal aid that has not yet materialized and because at least one state — South Carolina — deliberately underestimated its shortfalls to delay budget cuts.

[6] Mark Zandi, "Odds favor a double-dip recession, Moody's Mark Zandi says. Which presidential candidate has the best plan?" *Philadelphia Inquirer*, https://www.inquirer.com/business/election-economy-biden-trump-covid-stimulus-federal-reserve-interest-rates-inflation-infrustructure-20201023.html.

local revenue losses are roughly half of states' losses.[7] Using this rule of thumb, local revenue losses through fiscal year 2022 will reach about $135 billion if states' current revenue projections hold, or about $180 billion if the historical pattern reasserts itself.[8] Tribal nations and U.S. territories also face significant shortfalls; the House-passed Heroes Act includes $40 billion in aid to cover them, which would go a long way toward offsetting the fiscal damage.

In total, we estimate that shortfalls faced by states, localities, tribal nations, and U.S. territories will reach between about $480 billion and $620 billion through 2022, and could reach even higher in the event of a double-dip recession.

Similarly, Moody's Analytics estimates state and local shortfalls totaling $450 billion without a double-dip recession and $650 billion if a double-dip occurs.[9] Moody's estimates focus on states' General Fund taxes, while ours also include other state taxes such as gasoline taxes, and Moody's does not include shortfalls faced by tribal nations and U.S. territories.

Federal Aid Has Been Critical But Falls Far Short

Federal aid to states provided earlier this year will help in the months ahead, but it's far short of what's needed. The Families First Coronavirus Response Act raised the federal share of Medicaid costs for the duration of the official public health emergency, which CBO now projects will extend into the 2022 calendar year; this will reduce state shortfalls by roughly $100 billion. And the CARES Act provided about $30 billion to help states fund K-12 and higher education, raising the total aid provided to date to about $130 billion. (The federal government also provided $150 billion in aid to states, populous local governments, tribal nations, and territories, but *none* of it can cover revenue losses. States are using it primarily to cover COVID-fighting costs.)

Putting these figures together, states and other governments face total shortfalls — net of aid provided to date — of $350 billion to $490 billion. If states draw down all of their rainy day funds, which totaled about $75 billion heading into the pandemic, they and other governments will still need between about $275 billion and $415 billion.[10] Again, if COVID cases surge dramatically and the economy double-dips, state and local shortfalls could rise even further.

These estimates do not include states' added costs to continue fighting the virus over the coming year even if COVID's spread is relatively controlled. The primary form of aid that states and

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[7] The Upjohn Institute's Tim Bartik, for example, assumes local shortfalls equal half those of states. See "A proposal for timely, responsive federal aid to state and local governments during the pandemic recession," W.E. Upjohn Institute for Employment Research, April 20, 2020, https://www.upjohn.org/research-highlights/proposal-timely-responsive-federal-aid-state-and-local-governments-during-pandemic-recession. The American Enterprise Institute assumes local shortfalls equal about 40 percent of state shortfalls. See Jeffrey Clemens and Stan Veuger, "The COVID-19 Pandemic and the Revenues of State and Local Governments: An Update," American Enterprise Institute, September 2020, https://www.aei.org/wp-content/uploads/2020/09/The-COVID-19-Pandemic-and-the-Revenues-of-State-and-Local-Governments.pdf.

[8] These figures are half the revenue loss for states, rather than half the total state shortfall amounts.

[9] Dan White, Emily Mandel, and Colin Seitz, "U.S. State and Local Government Shortfall Update," Moody's Analytics, September 21, 2010, https://www.economy.com/economicview/analysis/381262/US-State-and-Local-Government-Shortfall-Update.

[10] Some 17 states have already tapped their rainy day funds to help close their 2020 gaps.

localities have received so far for this purpose, the Coronavirus Relief Fund, expires on December 30. But the virus very likely will remain a threat well into next year, forcing states to continue spending on protective equipment, testing, and other public health activities, especially if cases surge over the winter.

Nor do these estimates include shortfalls states may face in 2023 or beyond. Federal policymakers would do well to design fiscal aid with triggers to extend the aid, or turn it off, depending on the state of the economy. With the economic outlook so uncertain, this would enable states and localities to avoid further substantial layoffs and other spending cuts if the economy remains weak for several years.