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FEDERAL FISCAL STABILIZATION PROGRAM NEEDED TO PREVENT SEVERE STATE AND LOCAL BUDGET SHORTFALLS FROM DEEPENING COVID-19 RECESSION, NEW LEVY ECONOMICS INSTITUTE STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.— With social distancing measures requiring the closure of entire sectors of the U.S. economy, shelter-in-place orders drastically curtailing consumer spending, and unemployment claims reaching record levels, the COVID-19 pandemic has upended the American economy and will soon cripple state and local budgets. A new study from the Levy Economics Institute of Bard College, "Stabilizing State and Local Budgets through the Pandemic and Beyond," proposes an intragovernmental automatic stabilizer program that would provide a backstop for state and local finances, and argues that, without this program, states will be severely constrained in their ability to respond to COVID-19, and balanced budget requirements will force them to cut jobs and raise taxes further deepening the long term economic impact of the pandemic.

"The federal government has declined to mount a public health response to the pandemic, and state and local governments have been forced to pick up the slack," writes Alexander Williams '20, an M.S. candidate in the Levy Economics Institute Graduate Programs in Economic Theory and Policy. "All of this has been added to already-fragile state and local finances, stretched thin by decades of underinvestment as well as the fallout from the Great Recession. The $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act emergency relief package offers a small measure of support, but is clearly inadequate against the coming dislocation."

In his policy note, Williams writes that the CARES Act provides $339.8 billion for state and local governments, $274 billion of which is allocated for the state- and local-level COVID-19 response, leaving only $150 billion to stave off both revenue loss and increased use of state welfare services. "Without making any assumptions about increased uptake of state services, these provisions of the CARES Act will delay significant budget crunch at the state and local level by just over two months," he writes. "Once funds run out, experience tells us the budget cuts will be swift and brutal, exacerbating the existing depression."

To address state and local revenue shortfalls, Williams proposes the creation of intragovernmental automatic stabilizer program that provides a block grant to states whose unemployment rates exceed a given baseline, recommending transfers on the order of 8 percent of the previous year's own-source tax receipts, multiplied by the number of percentage points unemployment exceeds the baseline rate. "The ideal response at the federal level identifies the lost revenue to states—in sales tax, income tax, and user fees—and replaces it with block grants," Williams writes. "This removes the incentive to keep the economy going at all costs, and simultaneously provides state and local governments with the funds required to mount a public health response while continuing normal governance operations. Issuing block grants also allows state governments greater flexibility in allocation, getting around thorny legal requirements attaching certain kinds of revenue to certain other kinds of expenditures that hamstring many state budgets."

Williams concludes that it is unlikely that the economic impacts of the current crisis will be resolved in under three months, and that, even without a pandemic, recovering from 10 million new unemployment claims would take years. Rather than fighting over a series of patchwork bills, he calls for the U.S. Treasury Department to create an Office of Fiscal Harmonization dedicated to federalizing lost revenue at the state and local levels owing to the pandemic and its higher-order effects. "This office would administer automatic stabilizers that maintain trend growth in tax receipts at the state and local level," he writes. "The federal transfers would ensure states neither cut spending nor boost taxes into the teeth of a depression. Without this, states will be severely constrained in their ability to respond to COVID-19, and balanced budget requirements will force them to cut jobs and raise taxes during the deepest recession in living memory."

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Policy Note 2020/2: "Stabilizing State and Local Budgets through the Pandemic and Beyond"

To read the full text of this policy paper or to learn more about the Levy Economics Institute of Bard College, please visit levyinstitute.org.

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