U.S. State and Local Government Shortfall Update

BY DAN WHITE — SEPTEMBER 21, 2020
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- A stronger than expected summer labor market has helped the baseline forecast.
- The CBO increased its estimate for the amount of money that the federal government would need to spend on Medicaid.
- The biggest risks that could cause us to slide into the more severe scenario are a resurgence in COVID-19 infections nationwide, or a failure to pass another round of fiscal stimulus.

We have updated our estimates of state and local government shortfalls owing to the economic impacts of the pandemic. Two important developments have reduced the amount of money we estimate state and local governments will need in additional federal assistance since our June update, though the urgency and economic consequences of that assistance remain as crucial as ever.

First and foremost, the economic outlook has marginally improved since June. This has resulted in a slightly less downbeat baseline economic outlook, and in turn lower revenue shortfalls and Medicaid increases. Second, we have a better understanding of how much federal money has been made available to states and local governments thus far, as well as how that money has been used.

**Baseline forecast buoyed**

The baseline economic forecast has been buoyed by a stronger than expected summer labor market. The forecast still calls for exceptionally sluggish growth through at least 2021 but assumes that the worst of the pandemic is over from an economic perspective. Under such a scenario the unemployment rate would remain over 8% through at least the end of next year, with the labor market not recovering all of the jobs lost during the recession until 2023.

The fiscal consequences of such a scenario for states and local governments would be the worst since the Great Depression. Our models estimate that state governments alone would see revenue shortfalls of almost $200 billion over fiscal 2020 through fiscal 2022. This is compared with a flat baseline, growing 2019 revenues out solely by the rate of inflation.

![Baseline Outlook](source: Moody's Analytics)

In terms of spending, states would see Medicaid needs increase by more than $80 billion versus a pre-pandemic baseline as millions of Americans remain unemployed. Medicaid rolls have been slow to react to the pandemic so far, but as the recovery progresses and more individuals who had thought they were unemployed temporarily remain jobless, spending on Medicaid benefits will increase considerably.
The Congressional Budget Office notably increased its estimate for the amount of money that the federal government would need to spend on Medicaid since our last update. That change is accounted for in our estimates of available federal aid to states and local governments below.

Though the fiscal consequences nationally are unprecedented in many respects, the state-by-state impacts remain extremely nuanced. In general states that have had the largest exposure to the virus, as well as those whose economies have been most affected by business restrictions and other types of shutdowns, will suffer the most fiscally.

Additionally, states that rely heavily on volatile tax structures such as energy taxes or very progressive personal income taxes will also experience larger than average amounts of fiscal shock. This shock can be especially important in states whose economies have an outsize reliance on state government spending. The average gross state shortfall represents about 1.3% of its overall economy, but several states see that percentage rise to well over 2%.

When these state projections are combined with local government shortfalls, we estimate that the combined amount of fiscal shock to be dealt with may be as high as $450 billion, or about 2.2% of the economy not accounting for multiplier effects.

**Severe scenario mellowed slightly**

As with the baseline outlook, our more severe economic scenario has mellowed slightly over the summer. The biggest risk factors that could cause us to slide into the more severe scenario from the baseline are a resurgence in COVID-19 infections nationwide, or a failure in Congress to pass another round of fiscal stimulus.

The baseline outlook assumes that approximately $1.5 trillion in additional stimulus—made up of enhanced unemployment insurance, direct payments to taxpayers, and aid to state and local governments—is enacted before the November election. This means that lawmakers have only a few more weeks to agree on a package before the October recess.

In a scenario in which either of these risk factors comes to fruition, it is incredibly likely that the economy falls into a double-dip recession toward the end of 2020. This would result in a much more difficult recovery in which the labor market doesn’t fully heal for several years. Under such a scenario, the unemployment rate would still be over 11% at the end of 2021, with the labor market not recovering all of the jobs it lost during the recession until at least 2027.
This darker scenario is in turn accompanied by much more destructive fiscal impacts for states and local governments. The double-dip recession would increase unemployment considerably over the baseline, pushing Medicaid rolls higher, and smaller incomes would greatly limit sales and income tax collections. Our models project that such a severe scenario would see state revenue shortfalls of approximately $330 billion and Medicaid spending increases of more than $100 billion through fiscal 2022.

When combined with local government shortfalls we estimate that the combined amount of fiscal shock to be dealt with under a double-dip recession scenario could be as high as $650 billion, or about 3.1% of the economy not accounting for multiplier effects.

**Available resources**

Since our June update, more clarity has been established around how much of the existing federal fiscal aid to states and local governments is available to help close the budget shortfalls. Earlier this year through the Families First Coronavirus Response Act, or FFCRA, and the Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, the federal government provided an estimated $360 billion in aid to states and local governments to fight the virus.

However, those moneys were specifically earmarked for various COVID-19-related purposes and were not necessarily available to offset the budget shortfalls brought on by the economic impacts of the pandemic.

Nonetheless, some of those moneys, particularly the enhanced Medicaid provisions of the FFCRA and the education grants included in the CARES Act, are helping to offset those shortfalls. These combined federal aid initiatives are estimated to help states and local governments offset approximately $182 billion of their shortfalls through fiscal 2022. This is considerably larger than what was estimated just a few months ago because the CBO has greatly increased its
enhanced Medicaid estimates.

It still leaves, however, state and local government shortfalls of as much as $268 billion under the baseline scenario and $468 billion under the more severe scenario.

Even if we make the generous assumption that state governments would be willing and able to pour 100% of their available reserves into the breach, policymakers will still need to deal with shortfalls of at least $200 billion through the end of next fiscal year. If they are required to do so through spending cuts and revenue increases alone, it will come at great cost to the economy.

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<th>Shortfalls Net of Federal Support and Reserves</th>
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<tr>
<td>FY2020 to FY2022, bil</td>
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<td>Gross combined shortfall: 450.00</td>
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<td>Enhanced FMAP (FFCRA): 165.00</td>
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<td>Education grants (CARES): 17.00</td>
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<td>Shortfall net of existing federal help: 268.00</td>
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<td>State reserve funds ending FY2019: 72.00</td>
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<td><strong>Total net shortfall:</strong> 196.00</td>
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Sources: CRFB, NASBO, Moody’s Analytics

Using multipliers gleaned from our experiences around the Great Recession, the impact of $200 billion in cuts to state and local government spending will shave as much as 1.3% off the economy at a cost of more than 2 million jobs. Under the more severe set of economic assumptions, those impacts balloon to 2.7% of the economy and nearly 4.5 million jobs.

The good news is that the combination of an improved economic outlook and updated federal aid estimates reveal a smaller need than many had originally estimated. At $200 billion to $400 billion, the onetime ask to federal policymakers of supporting the economy via states and local governments is much more practicable than the approximately $1 trillion proposal originally included in the House’s Health and Economic Recovery Omnibus Emergency Solutions Act, or HEROES Act.

What’s more, if Congress were to loosen restrictions on other pieces of aid already enacted as part of the CARES Act, the amount of new dollars to be appropriated could be reduced even further. As an investment to be financed by federal debt at record low interest rates, this measure of additional fiscal stimulus promises to pay dividends for the economy and taxpayers well into the future.
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