EconoFact Chats: State and Local Finances During the COVID-19 Crisis

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Michael Klein:

Hello everyone. Welcome to EconoFact Chats. I'm Michael Klein, founder, and executive editor of EconoFact. A nonpartisan web based publication of the Fletcher School at Tufts University. At EconoFact we bring key facts and incisive analysis to the national debate on economic and social policies, drawing on the contributions from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The economic fallout of the COVID-19 crisis has resulted in the highest unemployment rates since the Great Depression and the largest federal budget deficit and ratio of government debt to GDP since World War II. State and local governments have also taken a big hit. To discuss the effect of the economic crisis on state and local finances and what this means for the provision of vital services. I'm very pleased to be joined today by Michael Strain of the American Enterprise Institute. Michael is the director of economic policy studies at AEI, and he oversees the institutes work in a range of economic policy issues. I'm also pleased to say that Michael is on the board of advisors of EconoFact. Michael, welcome to a EconoFact Chats.

Michael Strain:

Thanks so much for having me. It's great to be here.

Michael Klein:

It's wonderful to have you on. Michael, let's start out by discussing the range of things that state and local governments finance.

Michael Strain:

Well, the state and local governments finance a broad range of things. A lot of the things that really touch people's lives on a daily or weekly basis. Local governments, finance, teachers, and schools, the police departments, fire departments, state governments, finance, a portion of Medicaid spending. They also help to finance localities. So a large number of things, parks and all sorts of things that people use and enjoy every day and benefit from every day come from state and local government.

Michael Klein:

So these are the things that really touch people's lives really very directly. And their absence would be tremendously felt, I imagine.

Michael Strain:

Yes, absolutely. Absolutely, right. I mean, if you're local school is laying off teachers, if you're a local government isn't doing maintenance and keeping up with public parks and things of that nature, those are going to be things you're really going to notice.

Michael Klein:

And an economic downturn puts pressures on government finances, state and local government finances, especially both by shrinking the tax base and also by raising the need for spending on social safety net services that the state and local governments provide. What today is particularly putting these strains on state and local finances?

Michael Strain:

Well, the big thing of course is that states are seeing a big reduction in tax revenue and that's due to the broader overall nationwide economic slowdown from the pandemic recession. So states just are having much less money come in the door, at the same time, the demands for state services have gone up again due to the pandemic and due to the pandemic recession. So Medicaid spending, spending on food stamps and other safety net programs, programs like this are seeing demand go up. So revenue is going down and demands are going up.

Michael Klein:

And as you mentioned, the state and local governments are responsible for education financing and with a focus on schools reopening, there's a fiscal side to that as well, where they have to prepare classrooms and so on. In order to be able to accommodate the students and the teachers safely at this time. You had an article about this recently in Bloomberg Opinion, right?

Michael Strain:

Yes, that's right. And you're exactly right about the demands. Schools need to do things to keep teachers safe and to keep students safe. Buy a bunch of hand sanitizer, buy a bunch of masks, install plastic shielding, these sorts of things, rearrange classrooms. Convert the gym into a few classrooms. Put up some tents on the football field in order to have class outside. I mean, these are all the sorts of things that schools should be doing if they're looking to reopen and that many school districts are, but that requires money.

Michael Klein:

And the football fields aren't going to be used for games, so I guess you can put the tents up there now.

Michael Strain:

Sure, sure. It would be a better use of that space. [crosstalk 00:05:29]

Michael Klein:

Well, it depends on how you feel about football, but you also wrote about when we closed schools, there's a real cost to that in terms of the education that's forgone by students. And there is a cost along a number of dimensions. You in particular spoke about the economic dimension foregoing schooling in that Bloomberg Opinion article.

Michael Strain:

Yeah, that's right. So something that I think is not getting enough attention is what are the longer term effects on the economic outcomes of students, if they have to miss a year of school or if shut downs continue into the spring, maybe even longer than that. And if you believe that an additional year of schooling is strongly correlated with higher wages, which is-

Michael Klein:

There's a lot of evidence of that, right?

Michael Strain:

Yes, that's right. I mean, there's a mountain of evidence in favor of that. I think a consensus estimate among labor economists, something like a nine percent increase in wages for every additional year of schooling. There's debate about the precise number obviously, and certainly debate about the mechanisms behind that correlation. But I think that's a reasonable consensus estimate. You're talking about tens of thousands of dollars per decade in lost earnings, if schools are closed again, this fall. Along with last summer, I'm sorry, last spring. And when you add that up, that's both bad for individual students, but also bad for economies as a whole.

Michael Klein:

And of course there's also a childcare aspect to that as the parent of two young children, I'm sure you're very intimately aware of that aspect, that it's not just the children, but also parents who can't find childcare because childcare centers are closed as well. And that impinges upon their ability to work also.

Michael Strain:

Yeah, it's going to be a major problem this fall, if schools are closed. A lot of parents are going to have to stay home to facilitate home virtual learning and just to keep an eye on their kids. And some parents can't work from home. And so that means that they're going to be in a really difficult situation. Even parents who can work from home, I think we learned from our experience this spring that a whole lot less work gets done, if you've got kids in the house who are trying to do virtual learning. And my suspicion is that employers are going to be a lot less forgiving at accommodating of that circumstance this fall than they were in the spring. So it's going take a big toll on parents' economic outcomes, if, the schools stay closed again.

Michael Klein:

It sounds like you're talking somewhat from personal experience there.

Michael Strain:

The deep psychological wounds will-[crosstalk 00:08:47]

Michael Klein:

Right, right. And I know you've spoken before about sort of these trade offs. So maybe we do have to make an effort through different ranges of things like you were talking about to open schools. It's not so clear that we should be making the same effort to open bars or tattoo parlors or things that impinge less upon GDP and people's wellbeing.

Michael Strain:

Yeah, I think that's right. I mean, if we open the schools in the fall, no matter how carefully we do that, and no matter how extensive our safety precautions are. That's going to increase the spread of the coronavirus. And so, we need to be looking at other less important parts of normal life, where we can scale back those activities to decrease the spread. And bars and tattoo parlors seem pretty high on the list, if our decision to allow bars and tattoo parlors to be open in May, June and July means that we can't open schools in the fall. That's a complete inversion of what our social priorities should be, in my view. Much better to close those activities down, if closing them down slows the spread, which means we'll have some public health space to reopen schools in the fall.

Michael Klein:

I'm returning now to the issue of state and local finances. There are differences in how hard different states have been hit by COVID-19 and the economic consequences for those states. So I guess that means that there are also differences in the hit that those states and local areas finances have taken as well.

Michael Strain:

Yeah, that's right. There's actually a really excellent EconoFact article on this subject. And the authors find that if you look at the upcoming fiscal year, fiscal year 2021. State budget shortfalls range from four percent in Arkansas to 30% in New Mexico. So a very wide range, but also widespread trouble, no matter what state you're looking at.

Michael Klein:

Just to identify the authors of that. It's Alicia Sasser Modestino, Michael Goodman, and Alan Clayton-Matthews. All of whom are based in Massachusetts and have focused a lot on state budget issues. Thanks for bringing that up. How does this compare to what we saw during the Great Recession, beginning in 2008, in terms of state and local finances?

Michael Strain:

Yeah, it's a little early to say, of course, because we don't quite know what's going to happen with the virus and we don't know what's going to happen with the fall. I think a lot of this ... The history of this period really is yet to be yet to be written. But if you look at the Great Recession, you saw during that period state revenues down by about 10%, but in this case the downturn, the initial phase of the downturn. It's just much more severe and sudden. I mean, sudden and severe really characterize the pandemic recession much more so than the Great Recession. If you look at the evolution of the unemployment rate, for example, which tells you how the economy is doing. It took about two years for the unemployment rate to double during the Great Recession from five percent in December 07 to 10% in October 09. The unemployment rate and the pandemic recession was less than four percent in February. And comfortably in the double digits just two months later. So the downturn is much more severe, and you've seen that reflected in state revenues as well.

Michael Klein:

And recently, Ben Bernanke had an opinion piece. Of course, he was the chairman of the Fed during the Great Recession. And he was advocating for the support of state and local governments and saying that was very important during the Great Recession, perhaps there wasn't enough of it back then, and we shouldn't be making the same mistake twice.

Michael Strain:

Yeah, I think that's right. I mean, when states see these significant revenue shortfalls, they lay off workers. And when they lay off workers that contributes to overall unemployment in the labor market. It suppresses consumer spending because those now unemployed state and local workers have significantly less income to spend. And it just slows down the overall recovery. And we've seen Congress, I think admirably during this period attempt to replace lost revenues for businesses, lost income for households. It's going to be very important in the next phase of congressional action that they also step up to replace lost revenue for state governments.

Michael Klein:

And so some of our listeners might be wondering, Michael, why don't states and local governments just run big deficits the way the federal government does. And the answer to that is?

Michael Strain:

Well, the answer to that is, roughly speaking, they can't.

Michael Klein:

Right, right.

Michael Strain:

They're bound by balanced budget mandates. Of course, they can do creative accounting and they have rainy day funds and things of this nature. But generally speaking, the requirement that states have to run balanced budgets is a binding constraint. So when they see their tax revenue plunge, they have to cut expenses. In line with the decrease in revenue and just like businesses and the federal government payroll costs are a huge part of their expenses. And so they really kind of have no choice, but to lay people off.

Michael Klein:

Or get perhaps some more support from the federal government that's forthcoming.

Michael Strain:

Exactly.

Michael Klein:

Yeah. Another issue, I know you've written about this as well. It's been an issue for a long time, but the pandemic has really brought it to the fore, is issues of the pensions that state and local governments owe. Can you talk a little bit about that?

Michael Strain:

Yeah. So state governments still have defined benefit pension plans rather than defined contribution plans.

Michael Klein:

Could you just describe very briefly what that distinction is?

Michael Strain:

Yeah. So a defined contribution plan is likely the retirement plan that people listening to this podcast have. It's the plan where you contribute during your working years, money into a retirement account, and maybe you have an employer match or something like that. Maybe the funds are tax preferred in some way, but really the basis for your retirement fund are contributions that you make during your working years. And then you draw down that fund in retirement. A defined benefit plan is very different. It's a plan that's based on your length of service. So you put in 20 or 30 years and for a state government entity or for a school district or something like that. And you receive an annuity in retirement in exchange for that service. And that annuity is funded by the state or local government. And not by contributions you made during your retirement, during your working years, excuse me.

Michael Klein:

That used to be more prevalent in the private sector too, right, generations ago. But pretty much it's only public sector employees who have defined benefit plans now. Isn't that correct?

Michael Strain:

Yeah, that's exactly right. It used to be a lot more common in the private sector, but now it's pretty much just governments that do this.

Michael Klein:

And so what's the source of this? Was it bad accounting? Was it bad investments, I couldn't pay back? Was it just different policies? What led to this problem even before the pandemic with public sector pensions?

Michael Strain:

Well, it's a combination of things. Of course, some factors are certainly beyond the control of state pension fund managers. Increased longevity, for example, if you guarantee somebody $50,000 a year for the rest of their life, and they ended up living 20 years longer than you think that they will, you're going to be on the hook for a lot more money. There are some technical assumptions about interest rates and rates of return on funds as well, that have led to state and local governments putting in too little money upfront. And then there not being enough money available to meet their obligations later on. And so, it's a bunch of factors, but look, of course, I mean, in several states, Illinois being one, Kentucky being another. Both a blue state and a red state. There have been just very poor management of these pension funds. And that's led to them being significantly underfunded and unable to meet their obligations.

Michael Klein:

And of course, all of this is exacerbated by the precipitous decline in the economy. And it's only making problems that were bad before much, much worse now.

Michael Strain:

Yeah, that's exactly right.

Michael Klein:

So Michael, it seems like there are basically three choices, cut spending, raise taxes, or get more money from the federal government, which unlike the state and local governments it can borrow. What are your thoughts about how the mix of these options should be used at this time?

Michael Strain:

Well, I think, it would be prudent to avoid tax increases because that would dampen consumer spending and weaken the recovery. If there are areas for state and local governments to cut spending prudently, I think that's something of course that should be looked at. But again, if cutting spending means laying off hundreds of thousands of workers, then that's going to be bad for the economy as well. And so really, I think the best thing right now is for the federal government to provide some broad based grants to state governments that can be used for a variety of things, not to be used to shore up mismanaged pension funds, but that can be used for many other purposes.

Michael Klein:

So state and local finances often seem to get less attention than the headline grabbing federal fiscal situation. But you've pointed out in very important ways, how it really touches people's lives and the consequences can be quite dire for so many people. So thanks very much for speaking with me today on EconoFact Chats, Michael. And shedding light on these very important issues.

Michael Strain:

Thanks so much for having me on and thanks for the great work that EconoFact is doing. It's a invaluable resource.

Michael Klein:

Thanks. Thanks for saying that. And thanks for serving on the board. Best wishes.