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State and Local Governments Find Funds Plentiful, but Labor Scarce

Economist(s)

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Summary

State and local (S&L) governments are in a much different place today compared to where they were in the years following the 2008-2009 financial crisis. On the fiscal front, aggregate state and local tax revenue *grew* 1.8% in 2020. Although this was the slowest pace of growth in more than a decade, it was still faster than the 0.9% growth seen in 2008 and the sizable 5.1% *decline* in tax receipts in 2009. As the economic recovery has gathered steam this year, S&L revenue growth has surged. Through the first nine months of 2021, S&L tax revenues are up 9.0% compared to the first nine months of 2020.

S&L governments' improved financial situations are not just a product of resilient tax collections. Federal government aid has poured into S&L coffers since the pandemic began. In total, S&L governments have received about $500 billion in grants from the federal government since the pandemic began, and we estimate there is at least another $100 billion still to be released. In addition, the recently enacted Infrastructure Investment & Jobs Act provides roughly $550 billion of new spending over the next decade for a variety of infrastructure areas, such as roads, bridges, public transit, water and broadband. Even S&L public pension funds have seen their fortunes improve amid robust asset price returns and increased contributions from governments and their employees. In the aggregate, S&L pension funding ratios are at the highest levels since the 2008-2009 financial crisis.

This relatively optimistic outlook does not mean that S&L governments are free of economic challenges. S&L government employment is still down nearly one million jobs compared to its pre-pandemic peak, and employment in this sector accounts for 22% of the shortfall in total nonfarm payrolls compared to pre-pandemic employment levels. Unlike the 2010s, the employment decline appears mostly attributable to labor scarcity and ongoing pandemic challenges rather than rigid austerity.

In addition, the aggregate state and local data mask divergences across different parts of the country. Our regional team has covered these various economic trends at length, but we will highlight just a few examples to illustrate the point. Public transit ridership remains well below pre-pandemic levels. Domestic tourism has largely rebounded, but international tourism and business travel are still depressed compared to 2019. We suspect it will be awhile before these sectors see pre-COVID levels of activity again. The "return to office" movement is ongoing, but progress has been gradual rather than sudden. This in turn has created challenges for office-centric regions, particularly the major gateway markets, such as San Francisco and New York City.

For now, robust federal aid, strong asset price returns and tax collections that have topped previous projections have combined to generate a rosy fiscal outlook for S&L governments nearly everywhere. As a result, we expect S&L government output and hiring over the next year or two to be much more resilient than it was in the few years following the 2008-2009 financial crisis. That said, regional disparities will likely persist, and the longer-run outlook remains clouded as the economy and society grapple with what "normal" will look like in a post-COVID world.

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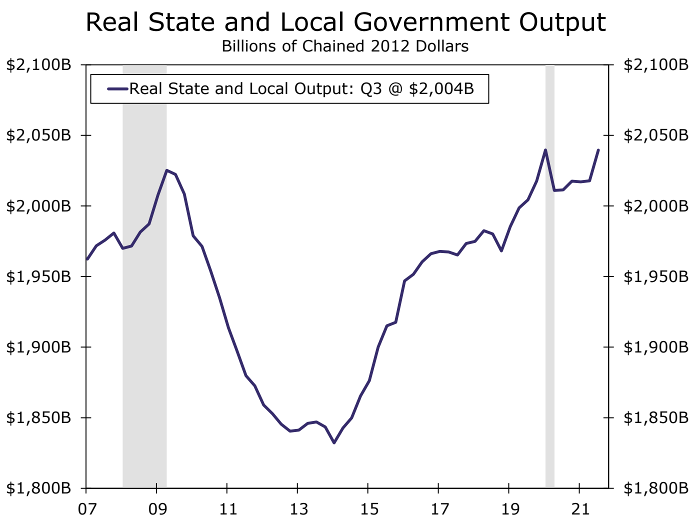
State and Local Government Tax Revenues, Output Recover

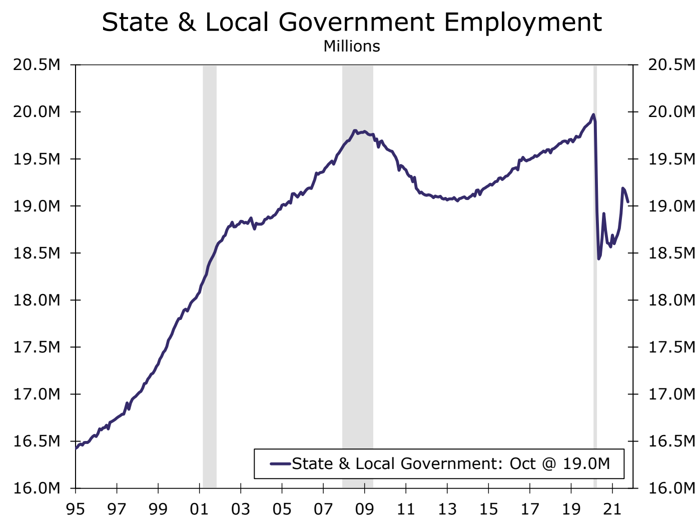
Like much of the U.S. economy, state and local (S&L) governments are facing a much different set of opportunities and challenges in this economic recovery compared to the 2010s' expansion. The 2008-2009 financial crisis was followed by a long and deep contraction in S&L government output as these institutions struggled with the fiscal fallout from the sluggish recovery. S&L output declined in every quarter from Q3-2009 to Q1-2013, eventually hitting a trough in Q1-2014 (Figure 1). The reduction in S&L output reduced real GDP growth by 0.35 percentage points in 2010, 0.44ppt in 2011 and 0.26ppt in 2012. On the employment side, the peak-to-trough decline in S&L employment was 747,000 jobs and took place over a period of more than four years (Figure 2).

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Securities

Figure 2



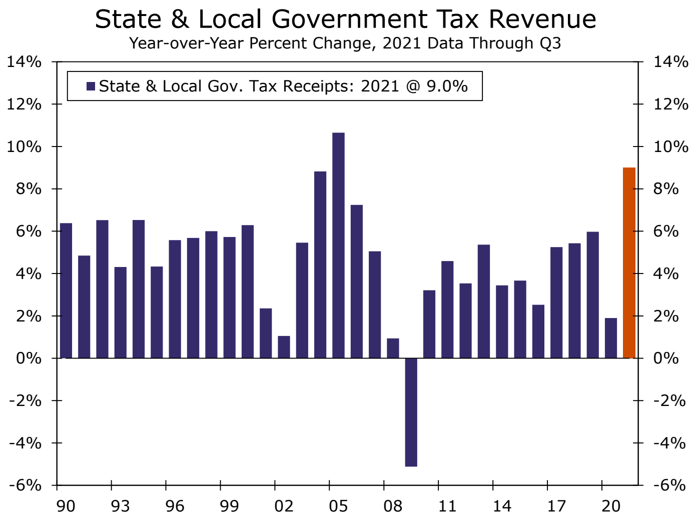
Source: U.S. Department of Labor and Wells Fargo Securities

Through the first nine months of 2021, S&L tax revenues are up 9.0% compared to the first nine months of 2020.

Today, S&L governments are in a much different place compared to where they were in the years following the 2008-2009 financial crisis. On the fiscal front, aggregate state and local tax revenue *grew* 1.8% in 2020 (Figure 3). Athough this was the slowest pace of growth in more than a decade, it was still faster than the 0.9% growth seen in 2008 and the sizable 5.1% *decline* in tax receipts in 2009. As the economic recovery has gathered steam this year, S&L revenue growth has surged. Through the first nine months of 2021, S&L tax revenues are up 9.0% compared to the first nine months of 2020. The drivers of this much rosier fiscal outlook are varied. The economy has come roaring back from its deep initial hole, and job growth, wage growth and business profits have rebounded strongly. Goods consumption has been remarkably resilient and provided a boon to sales tax receipts. Residential real estate prices have been on a tear over the past year, and commercial real estate valuations generally have held up better than anticipated compared to projections made earlier in the pandemic. Accordingly, property tax revenues are up 3.3% through the first nine months of 2021 following a 2.7% increase in 2020. The rapid recovery in other asset prices, such as equities, have also supported S&L income tax receipt growth.

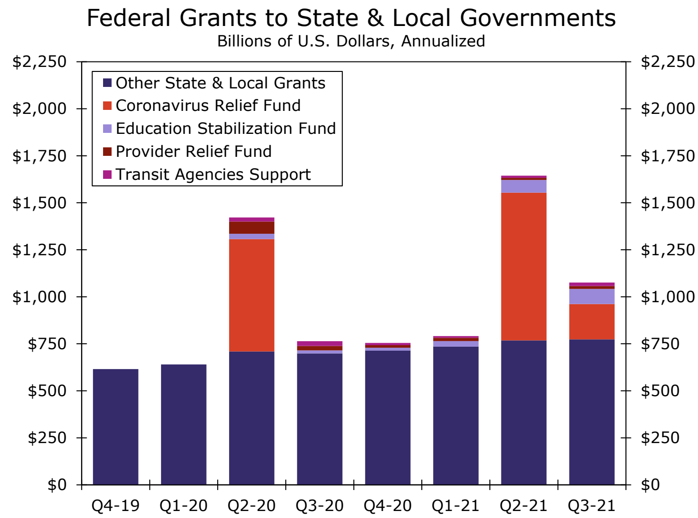
S&L governments' improved financial situations are not just a product of resilient tax collections. Federal government aid has poured into S&L coffers since the pandemic began. The funds have come from a few different bills and have come with various strings attached. Some money has been specifically for dealing with the public health needs of the pandemic, some funds have been targeted at specific S&L government activities such as public transit or education, while other grants have been more open-ended. In total, S&L governments have received about $500 billion in grants from the federal government since the pandemic began (Figure 4). This amounts to about one-quarter of annual S&L government tax revenue across all sources. The bulk of COVID relief funds to S&L governments have already been disbursed, but we estimate there is at least another $100 billion still to be released. In addition, the recently enacted Infrastructure Investment & Jobs Act provides roughly $550 billion of new spending over the next decade for a variety of infrastructure areas such as roads, bridges, public transit, water and broadband. Not all of this money will go directly to S&L governments, but much of it will go toward projects in which S&L governments typically share at least some of the financing costs.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Securities

Figure 4

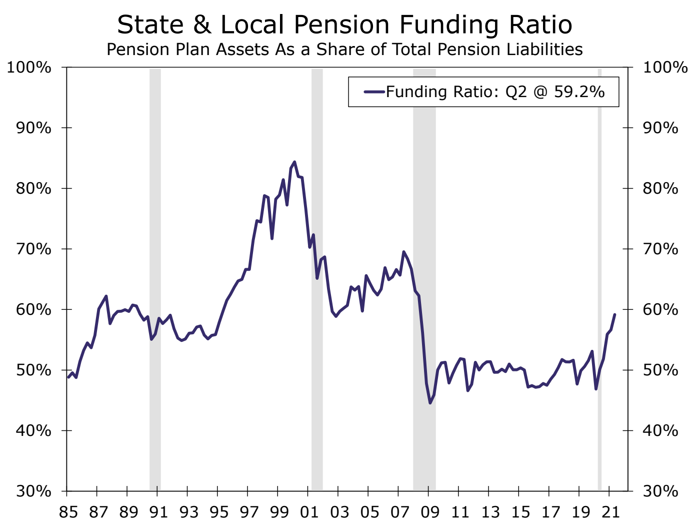


Source: U.S. Department of Commerce and Wells Fargo Securities

In the aggregate, S&L pension funding ratios are at the highest levels since the 2008-2009 financial crisis.

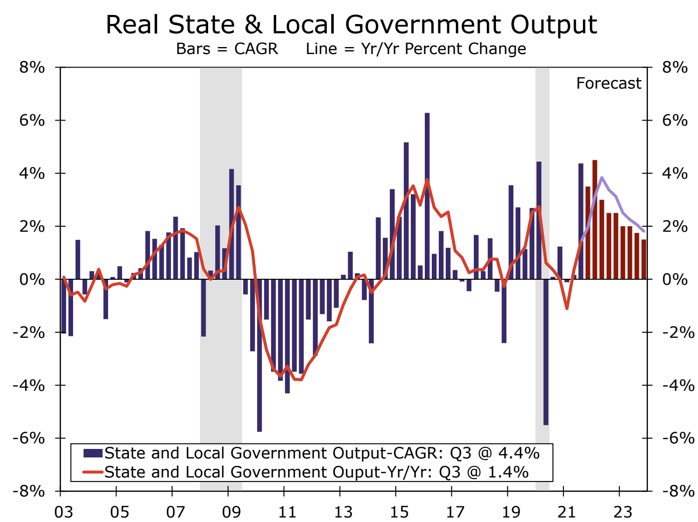
Even S&L public pension funds have seen their fortunes improve amid robust asset price returns and increased contributions from governments and their employees. In the aggregate, S&L pension funding ratios are at the highest levels since the 2008-2009 financial crisis (Figure 5), and a recent analysis by the Pew Charitable Trusts found that the nation's state retirement systems have improved significantly across a wide variety of metrics.[1] As we look to 2022 and beyond, we believe S&L governments are positioned for much stronger output growth in this expansion compared to the 2010s. S&L output increased at a solid 4.4% annualized rate in Q3-2021, and we look for a similar pace of growth over the next few quarters as the education sector continues to normalize and S&L governments put their windfalls to work (Figure 6).

Figure 5



Source: Federal Reserve Board and Wells Fargo Securities

Figure 6



Source: U.S. Department of Commerce and Wells Fargo Securities

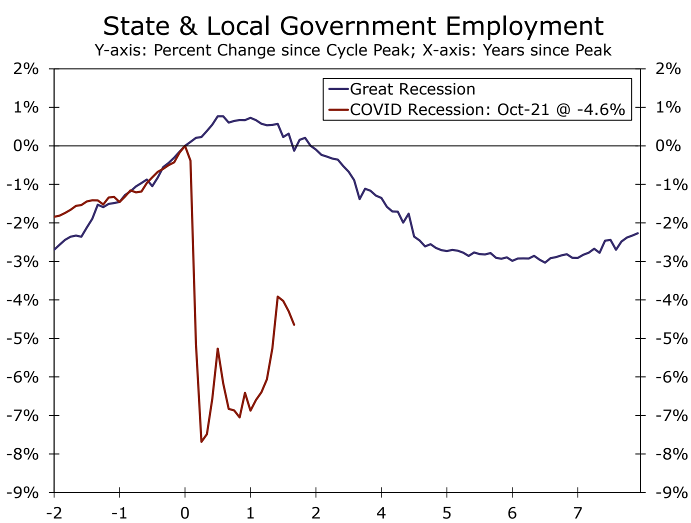
Labor Scarcity, Regional Disparities Among the Biggest Challenges

S&L employment accounts for 22% of the shortfall in total nonfarm payrolls compared to pre-pandemic employment levels.

This relatively optimistic outlook does not mean that S&L governments are free of economic challenges. S&L government employment is still down nearly one million jobs compared to its pre-pandemic peak. Unlike S&L tax revenues and output, which have been more resilient in this expansion compared to the early 2010s recovery, S&L employment has contracted at a much faster pace than it did in the 2010s (Figure 7). Remarkably, S&L employment accounts for 22% of the shortfall in total nonfarm payrolls compared to pre-pandemic employment levels. Roughly 62% of the decline in S&L employment has been in the education sector. Like many parts of the U.S. economy, education is still finding a new equilibrium. This has likely weighed on education-related employment that is predicated on in-person instruction, such as cafeteria workers, custodial staff and school bus drivers.

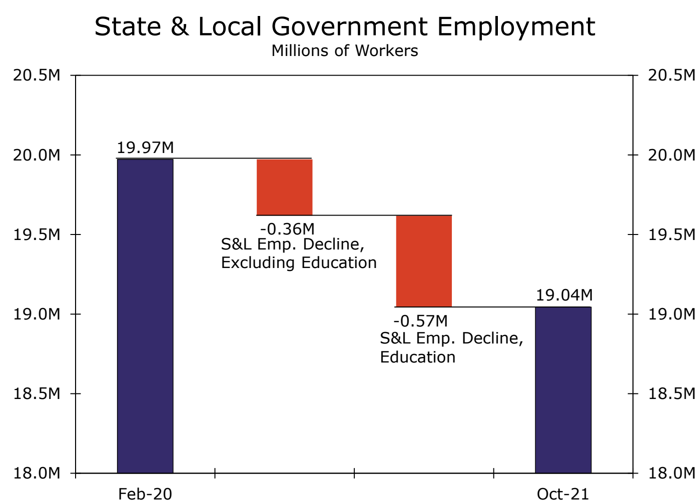
But even excluding education, S&L employment is down more than 350,000 jobs compared to February 2020 (Figure 8). Local government employment excluding education is down 4.3% compared to pre-pandemic levels, a bit more than the 2.5% decline for state employment excluding education. Interestingly, employment at public hospitals does not appear to be the main culprit. S&L hospital employment is actually up slightly from February 2020 levels even as total hospital employment is down 1.7% over the same period. Instead, the job losses appear most heavily concentrated in areas where public services have been reduced, such as public transit, museums and other recreational sites, and libraries. Even accounting for these sectors hit hard by the pandemic, however, S&L employment appears weaker than one would think, given the macro forces at work.

Figure 7



Source: U.S Department of Labor and Wells Fargo Securities

Figure 8



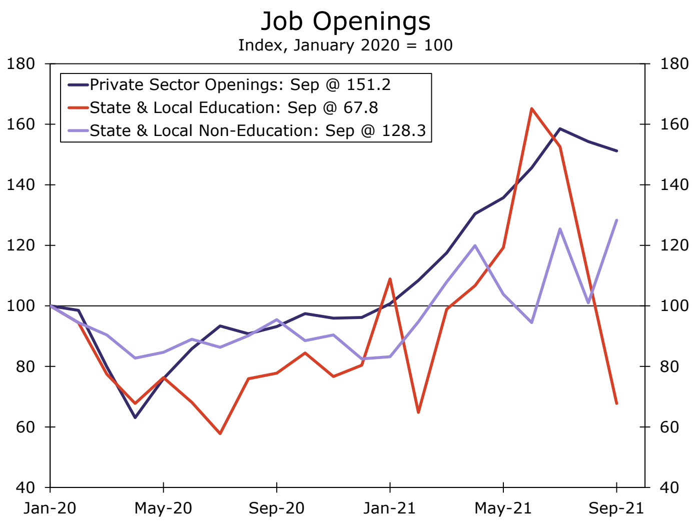
Source: U.S. Department of Labor and Wells Fargo Securities

A potential reason state and local government employment remains depressed could be an inability to fill job openings.

Of course, another potential reason S&L government employment remains depressed could be an inability to fill job openings. Labor scarcity across the United States has been well-documented, with total job openings in the United States at record highs. The S&L job opening data have been somewhat volatile, likely attributable to the way the seasonal adjustment process and education sector are interacting in these unusual times. Excluding education, S&L government job openings are above their pre-pandemic level, although they have not risen as much as job openings have in the private sector (Figure 9). We expect the number of S&L job openings and hirings to rise in the next few months as the education sector continues to gradually normalize, the seasonal adjustment factor turns to a tailwind and as S&L governments steadily shift away from austerity mode.

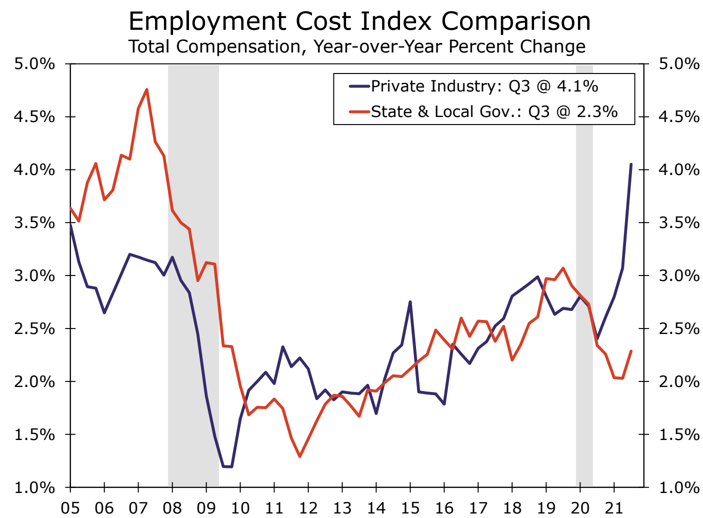
That said, luring workers to these jobs may prove a challenge in such a tight labor market. Employee compensation has surged in the private sector over the past few quarters as employers fight to keep and attract talent. Total compensation growth, which includes benefits that are a key part of S&L government compensation, is rising much faster in the private sector compared to the S&L sector, and the gap between the two is currently one of the largest on record (Figure 10). We suspect this gap may narrow some over time as public sector union contracts expire and are re-worked to reflect today's faster wage growth/inflation regime. However, the private sector may still maintain an edge given its more nimble ability to adapt in today's rapidly evolving labor market.

Figure 9



Source: U.S. Department of Labor and Wells Fargo Securities

Figure 10



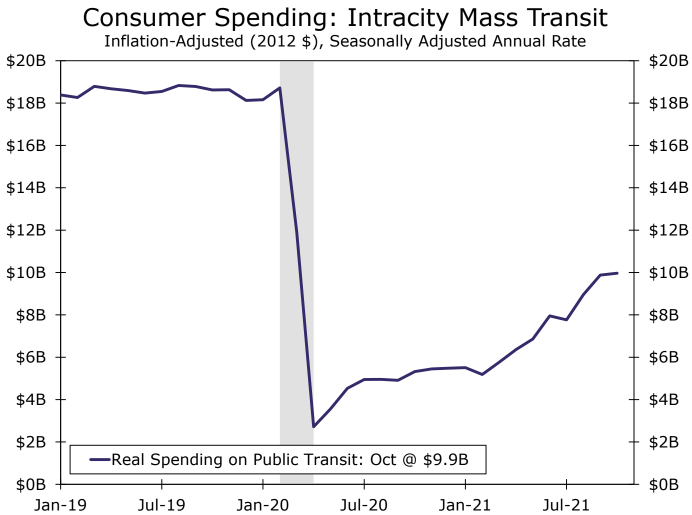
Source: U.S. Department of Labor and Wells Fargo Securities

Beyond the labor scarcity challenges, the aggregate state and local data mask divergences across different parts of the country. Our regional team has covered these various economic trends at length, but we will highlight just a few examples to illustrate the point. Public transit ridership remains well below pre-COVID levels, and the decline in consumer spending on intracity mass transit creates challenges for public finances (Figure 11). As an example, ridership on the New York City subway system was 38% below 2019 levels through the seven-day period ended Nov. 29, with similar ridership levels for commuter lines into and out of the city. In the near term, these fiscal challenges can mostly be met by the tremendous amount of federal aid provided in previously enacted COVID relief bills. However, once that money is exhausted in a few years, the fiscal health of numerous public transit systems will depend on how COVID has structurally changed the way we commute and travel.

Public transit ridership remains well below pre-COVID levels, and the decline in consumer spending on intracity mass transit creates challenges for public finances.

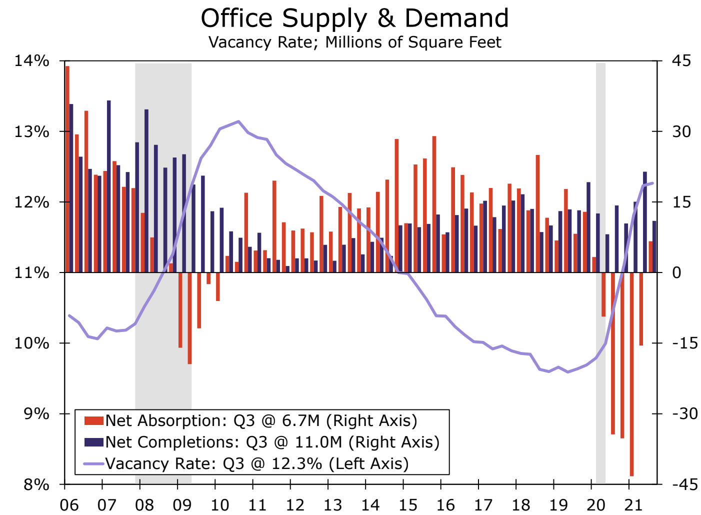
Similarly, office occupancy remains below pre-COVID levels as employers and employees alike strive to find the right balance between working in-person at the office and working from home. Nationwide, the office vacancy rate remains well-above pre-pandemic levels (Figure 12). There are some signs of green shoots; net absorption of office space turned modestly positive in the third quarter for the first time since the pandemic began. That said, a rapid return to pre-COVID office vacancy rates appears unlikely anytime soon. At the regional level, some large markets such Austin, Palm Beach, San Antonio, Boise and Miami, are seeing positive net absorption and rent growth. Meanwhile, operating fundamentals remain weak in New York City, Washington, D.C., Chicago, Los Angeles, San Francisco and Boston. We covered the outlook for office space and "return to office" in a recent special report. In short, we believe there is still a long road ahead for the office market, particularly in downtown areas and in the traditional gateway markets. such as New York City and San Francisco. This slow recovery for the office sector in turn could weigh on these areas' fiscal outlooks going forward.

Figure 11



Source: U.S. Department of Commerce and Wells Fargo Securities

Figure 12



Source: CoStar Inc. and Wells Fargo Securities

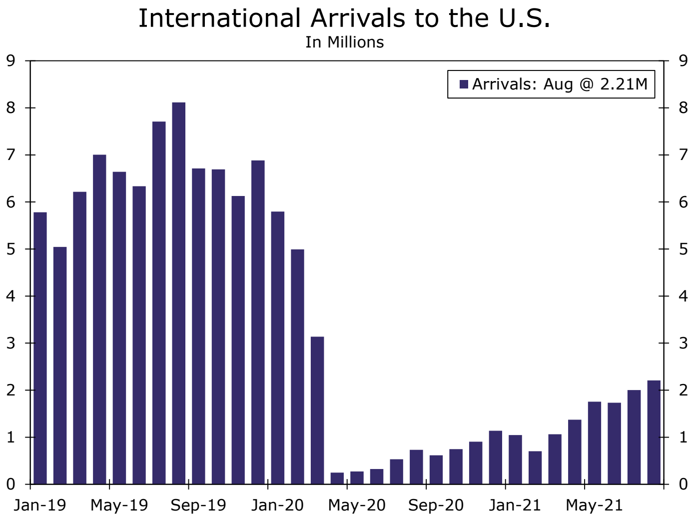
We expect S&L government output and hiring over the next year or two to be much more resilient than it was in the few years following the 2008-2009 financial crisis.

Regions with heavy exposure to travel and tourism have also had to cope with the ever-evolving COVID landscape. Domestic tourism rebounded solidly this year as the vaccine rollout prompted more people to finally take that delayed vacation. However, the recovery in business travel has been slow and gradual, and for most of the year the number of visitors to the United States from abroad has been well-below pre-COVID levels (Figure 13). Perhaps unsurprising, hotel occupancy in November 2021 was down the most compared to 2019 in tourist hotspots, such as Oahu Island, Hawaii and Orlando, and major business travel destinations, such as San Francisco, New York and Washington, D.C. (Figure 14).

There are some encouraging signs of continued improvement. On Nov. 8, the U.S. State Department began opening the U.S. borders to vaccinated international visitors, and Transportation Security Administration data suggest there was a bump in total flyers shortly thereafter. For the seven-day period ended Nov. 29, the total number of people passing through U.S. airport security was "only" down 8.6% compared to the same period in 2019. In addition, we still expect business travel to ramp up once the return to the office gains more momentum. That said, while continued directional improvement is encouraging, we suspect it will be quite some time before international and business travel is fully restored to pre-COVID levels.

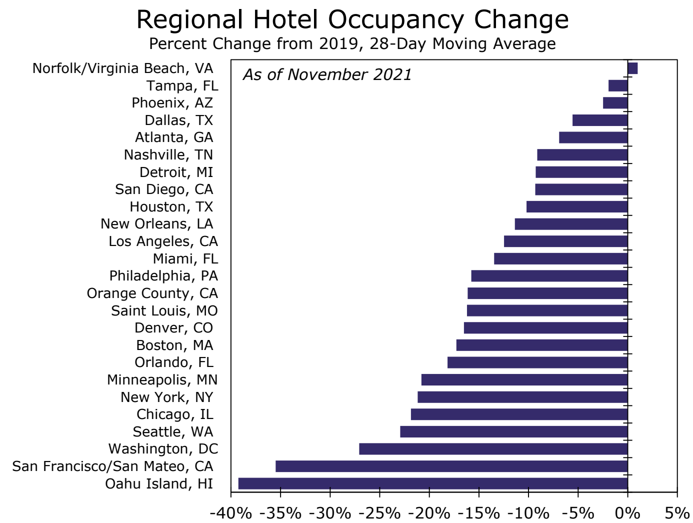
For now, robust federal aid, strong asset price returns and tax collections that have topped previous projections have combined to generate a rosy fiscal outlook for S&L governments nearly everywhere. As a result, we expect S&L government output and hiring over the next year or two to be much more resilient than it was in the few years following the 2008-2009 financial crisis. That said, regional disparities will likely persist, and the longer-run outlook remains clouded as the economy and society grapple with what "normal" will look like in a post-COVID world.

Figure 13



Source: National Travel and Tourism Office and Wells Fargo Securities

Figure 14



Source: STR and Wells Fargo Securities

Endnotes

[1] https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2021/09/the-state-pension-funding-gap-plans-have-stabilized-in-wake-of-pandemic (Return)

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