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State and Local Fiscal Outlook: Coming Full Circle

Twelve Months Later, State and Local Governments Find Their Fiscal Footing

Economist(s)

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Summary

- When the pandemic first struck, we wrote at the time that state and local government austerity could be a material drag on real GDP growth for several quarters, if not years. To some extent, this proved prescient as state and local government output contracted in all three of the quarters that followed Q1-2020.
- These contractions in output were smaller than we initially feared, however, and as time passed it became increasingly clear that state and local governments were experiencing better fiscal outlooks than originally expected.
- State and local tax revenue data are reflective of this improving backdrop. Remarkably, 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 better than the 0.9% growth in 2008 and the sizable 5.1% decline in 2009.
- Robust personal income and property tax collections were the main factors keeping total revenue growth positive. Personal income tax receipts rose 3.4% in 2020, while property tax receipts were up 3.9%.
- Sales tax receipts declined by 2.1% in 2020, but given the severe decline in economic activity early in the pandemic, it is almost hard to believe the decline was not more severe. In 2009, state and local sales tax receipts declined 7.2%, more than triple the 2020 decline.
- Of course, even though we expect the economy to rapidly improve in 2021, it is possible state and local tax collections could slow further in 2021, or perhaps even decline outright, since tax receipts are generally a lagging indicator. But even if tax collections are weaker than we expect, there is another factor that gives us reason to believe state and local output and hiring will accelerate in the months ahead: the tremendous amount of federal aid flowing to state and local governments.
- State and local governments have received hundreds of billions of dollars from the federal government for a variety of activities such as education, public transit and public health steps measures to fight the pandemic. On top of this money, the American Rescue Plan allocated another $360 billion for state and local governments to use for plugging revenue gaps, fighting the pandemic and investing in water, sewer and broadband infrastructure.
- The $360 billion in direct aid represents about 20% of annual state and local tax revenue. When combined with the hundreds of billions of dollars for other items, as well as modestly positive revenue growth, most state and local governments are well-equipped to ramp up hiring and investment. Our forecast for state and local output exhibits a much shallower decline and much faster rebound than what occurred in the 2010s.
- There are still disparities among individual states and municipalities. Tax revenues were higher in 2020 than 2019 in almost half of the 50 states, but several states saw double-digit declines. The hardest-hit states typically have outsized energy or tourism sectors, while rural and suburban areas generally have weathered the pandemic better than cities.

State and Local Government Tax Revenue Holding Up

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When the pandemic first struck, we wrote at the time that state and local government austerity could be a material drag on real GDP growth for several quarters, if not years. The Great Recession hit state and local finances especially hard, and early in the pandemic it appeared that this economic downturn could be even worse than 2008-2009. To some extent, this proved prescient as state and local government output contracted in all three of the quarters that followed Q1-2020.

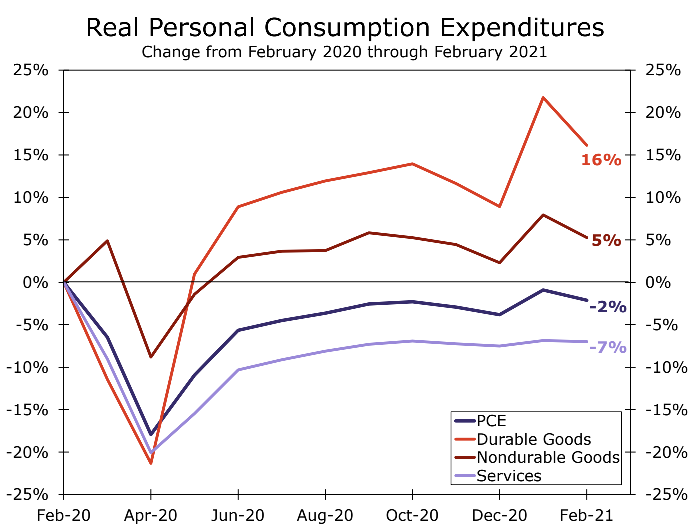
These contractions in output were smaller than we initially feared, however, and as time passed it became increasingly clear that state and local governments were experiencing better fiscal outlooks than originally expected. We laid out the reasons for this brighter outlook in a report last September. They included a stronger economic outlook, a shift in consumption towards goods and away from services (the former being more broadly covered by sales taxes), a robust residential housing market, resilient personal income and a rapid rebound in stock prices.

For the most part, these trends have been further reinforced since that report was published. The U.S. economic outlook has continued to strengthen. In our September 2020 forecast update, we projected that the U.S. unemployment rate would finish 2021 at 5.9%. Our most recent forecasts looks for the unemployment rate to finish this year at 4.6%. Aggregate personal income has also held up well relative to the drop in output, in part because of this better economic outlook, in part because of federal aid, like enhanced unemployment benefits, and in part because job losses have been more heavily concentrated among lower-wage workers. The upshot is that job gains in 2021 will likely be more heavily concentrated among lower-wage workers and thus may not provide as much "bang for the buck" in terms of tax revenue growth, but capital gains realizations should help make up for it. The S&P 500 index hit a pre-pandemic peak on February 19, 2020 and is currently up 22.3% from that level.

These contractions in output were smaller than we initially feared, however.

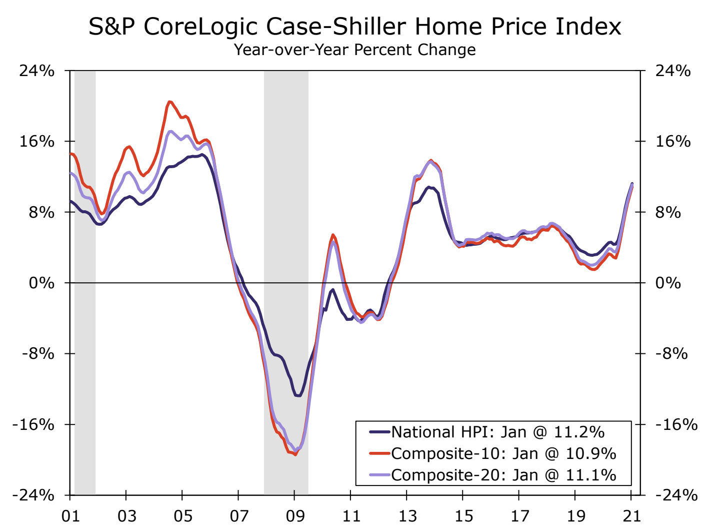
Durables goods consumption has remained robust and was up 16.1% year-over-year in February, while nondurable goods consumption was up a smaller but still solid 5.3% over the same period (Figure 1). The continued resiliency in goods consumption, paired with the ongoing recovery in services, has propped up sales tax revenue. Home prices as measured by the S&P/CoreLogic Home Price Index were up 11.2% year-over-year in January, the latest data available (Figure 2). This marked the most robust pace of year-ago home price appreciation since February 2006 and has helped sustain property tax receipts.

Figure 1



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

Figure 2



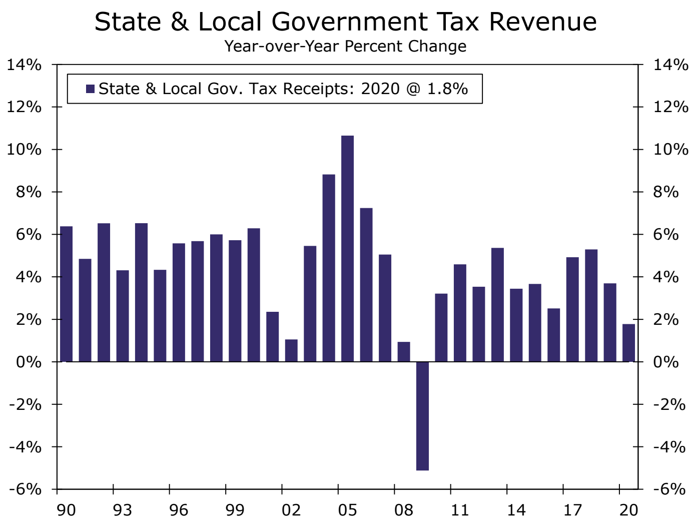
Source: S&P CoreLogic and Wells Fargo Securities

State and local tax revenue data are reflective of this improving backdrop. Remarkably, aggregate state and local tax revenue grew 1.8% in 2020 (Figure 3). Although this was the slowest pace of growth in more than a decade, it was still better than the 0.9% growth in 2008 and the sizable 5.1% decline in 2009. Robust personal income tax and property tax collections were the main factors keeping overall revenue growth in positive territory. Personal income tax receipts rose 3.4% in 2020 (Figure 4), while property tax receipts were up 3.9%. Sales tax receipts declined by 2.1% in 2020, but given the severe decline in economic activity early in the pandemic due to government restrictions and behavioral changes, it is almost hard to believe the decline was not more severe. In 2009, state and local sales tax receipts declined 7.2%, more than triple the 2020 decline.

Of course, even though we expect the economy to rapidly improve in 2021, it is possible state and local tax collections could slow further in 2021, or perhaps even outright decline modestly. Tax receipts are generally a lagging indicator. It will take time for lower assessments on beaten down commercial properties to flow through to property tax collections, for example, and personal income tax payments made ahead of the 2020 filing deadline were for pre-pandemic 2019 income. And early in a recession, state and local governments sometimes turn to tax increases in order to meet their balanced budget requirements. All that said, the unusually strong recovery we expect this year should keep aggregate tax collections in a much better place than 2009. This in turn should precipitate a recovery in state and local output and hiring far stronger than the one that occurred in the previous expansion. But even if tax collections are weaker than we expect, there is another factor that gives us reason to believe state and local output and hiring will accelerate in the months ahead: the tremendous amount of federal aid flowing to state and local governments.

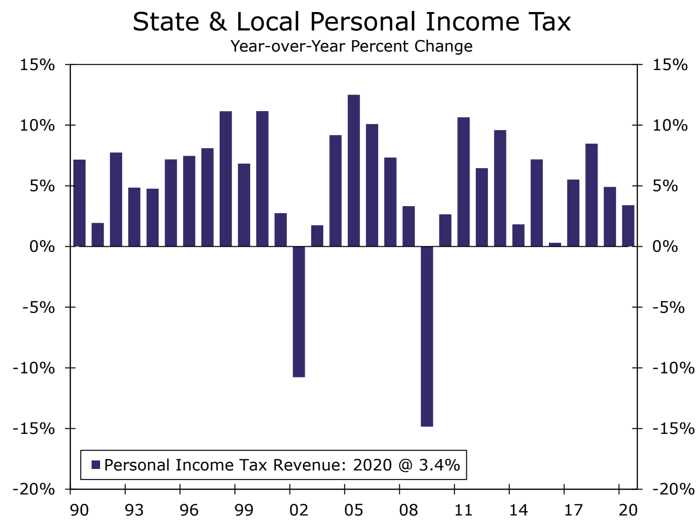
Even though we expect the economy to rapidly improve in 2021, it is possible state and local tax collections could slow further in 2021.

Figure 3



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

Figure 4



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

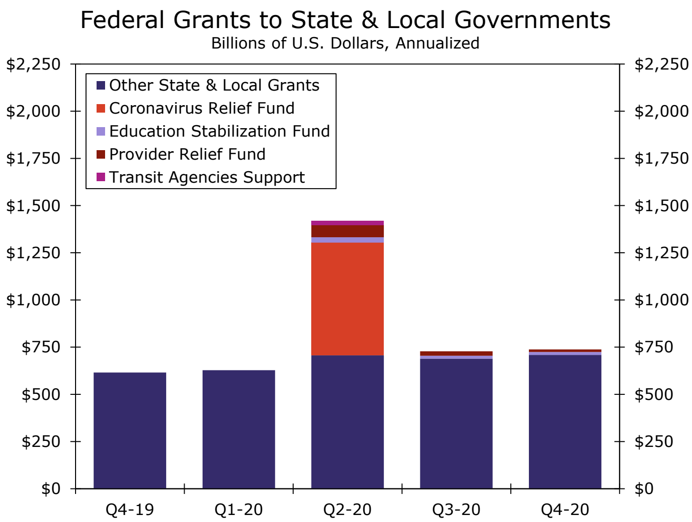
Federal Aid to the Rescue

The biggest pot of money came in President Biden's American Rescue Plan.

When COVID-19 hit the United States in full-force in March 2020, Congress passed and the president signed the Coronavirus Aid, Relief and Economic Security (CARES) Act. The CARES Act provided some fiscal relief to state and local governments through a variety of different measures. It created the $150 billion Coronavirus Relief Fund to aid state and local governments with expenses incurred in the fight against COVID-19. The CARES Act also appropriated some money for certain activities typically funded by state and local governments. This funding included $30 billion for the Education Stabilization Fund to support K-12 and higher education and $25 billion for public transit agencies. A previous bill, the Families First Coronavirus Relief Act, increased the federal share of Medicaid spending by 6.2 percentage points until the public health emergency was over.

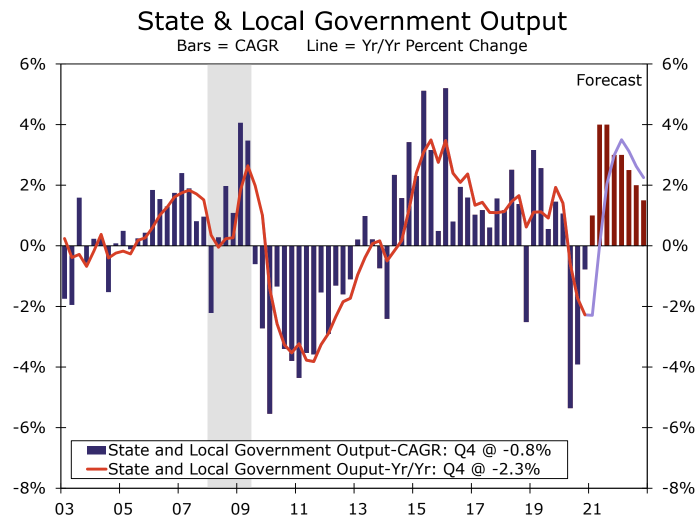
Figure 5 shows how federal grants to state and local governments jumped in Q2-2020 in the wake of the CARES Act and remained elevated over the remainder of 2020. While we do not have any 2021 data on federal transfers yet, they will eventually show that federal grants to the states surged in the first half of this year. The COVID relief bill signed at the end of 2020 added to the CARES Act's activity-specific state and local aid, including $82 billion more for education and $30 billion more for public transportation and highway funding. The biggest pot of money came in President Biden's American Rescue Plan (ARP), which was enacted in mid-March. The ARP allocates $360 billion to state and local governments for covering revenue shortfalls, responding to the COVID-19 emergency and its economic fallout as well as making investments in water, sewer and broadband. On top of this direct state and local aid, the ARP also allocates about $160 billion for education, $30 billion for transit agencies and other indirect funding for a variety of state and local adjacent activities.

Figure 5



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

Figure 6



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

Aggregate state and local tax receipts were about $1.9 trillion before the pandemic, so $360 billion in direct aid represents about 20% of annual state and local tax revenue. When combined with the hundreds of billions of dollars for education, public transit, Medicaid and other items, as well as modestly positive tax revenue growth in 2020, most state and local governments are financially well-equipped to ramp up hiring and investment in the quarters ahead. Our forecast for state and local output exhibits a much shallower decline and much faster rebound than what occurred in the previous expansion (Figure 6). That said, while the aggregate numbers signal a relatively healthy outlook, there are still some disparities among individual states and municipalities.

Warning: Individual Results May Vary

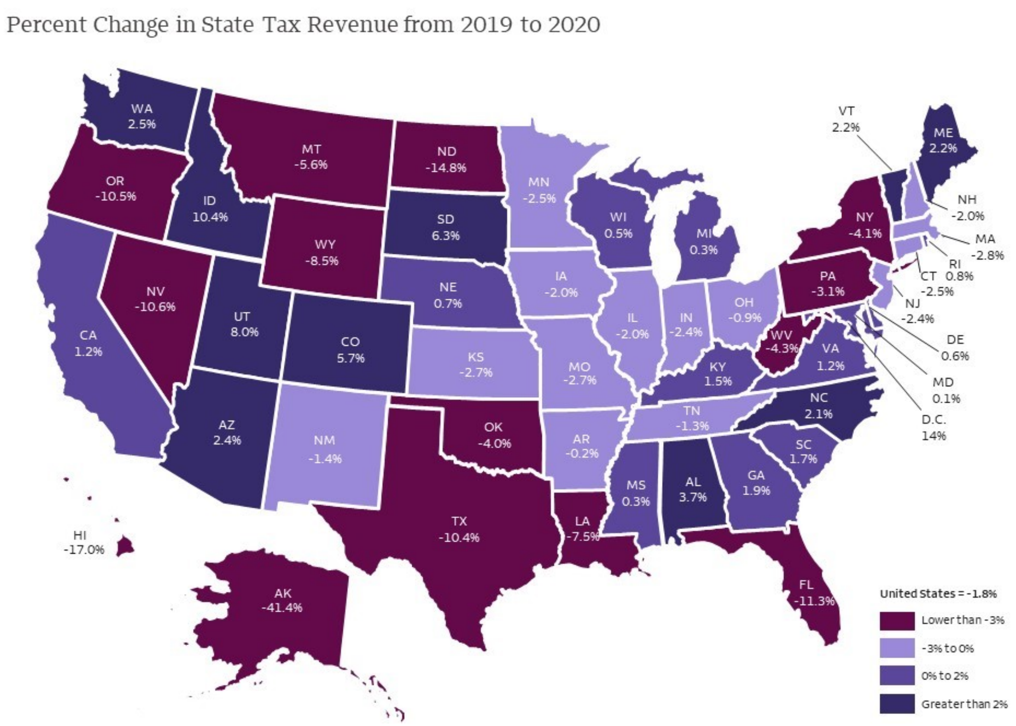
While nearly everywhere in the United States saw a drop off in economic activity at the onset of the pandemic, the extent of the decline and the pace of the recovery has varied widely across the country.

While nearly everywhere in the United States saw a drop off in economic activity at the onset of the pandemic, the extent of the decline and the pace of the recovery has varied widely across the country. COVID prevalence and government restrictions have varied from locale to locale, and some sectors of the economy (and the local economies in which these sectors are dominant) have been hit harder than others. These dynamics have left some state and local governments reeling while others have been relatively unscathed. Tax revenues were higher in 2020 than 2019 in almost half of the 50 states, but several states saw double-digit declines. Alaska saw the single largest drop as state revenue fell more than 40% after oil & gas markets collapsed at the onset of the pandemic. Other energy producing states, such as Texas, Wyoming and Oklahoma, also saw larger than average declines in state tax revenues. Meanwhile, the significant reduction in travel hit states with large tourism industries hard. Florida, Nevada and Hawaii all saw double digit declines in their state tax revenue compared to a year earlier.

Every state saw employment decline when the country started to lockdown last spring, but these job losses were most heavily concentrated in high-contact service industries like retail and leisure & hospitality. Many office-using workers in finance, technology or other professional services were more readily able to shift to working from home. The resilience of these often higher-paying professional jobs helped buoy income tax revenue in Colorado, Virginia and other states with a high portion of workers in industries conducive to working from home. The desire for more space to accommodate these new work from home arrangements also pushed many to look for homes and apartments outside large cities.

The flight from the urban core compounded problems for many large cities, which were already facing a dearth of commuter traffic, leading to a faster decline in economic activity and, thus far, a slower recovery than the nation as a whole. The unemployment in the nation's two largest metro areas, New York and Los Angeles, only recently dipped below 10% and remain 6.0 and 5.6 percentage points above their year-ago unemployment rates, respectively (for context, the national unemployment rate is about 2.5 percentage points above its year-ago level). While it is still unclear the extent to which remote working arrangements and housing preferences will return to pre-pandemic norms as the public health situation improves, municipal budgets in the hardest-hit cities may remain under pressure in the meantime. As an example, projections from New York City's 2021 financial plan show that property taxes could fall for the first time in 25 years in FY2021 as decreased sales activity and declining property values for offices and apartments weigh on collections. That said, much like aggregate state & local government finances, the fiscal health of many large cities has not deteriorated as much as initially feared thanks to a stronger-than-expected recovery and grants from the federal government.

Figure 7



Source: Urban Institute and Wells Fargo Securities

Moreover, the movement away from large cities has been a boon for suburban and rural municipalities. Data on requests for address changes from the postal service compiled by commercial real estate firm CBRE show rural and suburban neighborhoods have seen the largest increases in net in-migration over the past year. This shift has pushed some economic activity from the urban core to the surrounding areas and should bolster residential and commercial property values, and by extension, help strengthen property tax collections. Nassau County, a New York City suburb on Long Island, has seen home prices surge. Home prices were up 7.7% in February, below the nation as a whole but well above the 2.5% increase in 2019. Similarly, home prices in Westchester County to the north of New York City were up 9.5% year-over-year in February. For both counties, aside from the even larger year-over-year increases in January, this is the fastest pace of home price appreciation since 2006.

This race for space largely involved people moving to nearby suburbs, but some did take the opportunity to move to states with fewer restrictions, better weather and more affordable housing, particularly in the Sun Belt and Mountain West. Idaho saw the fastest tax revenue growth in 2020 and, perhaps not coincidentally, also experienced the fastest population growth of any state.

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