State Budget Challenges and the Municipal Liquidity Facility

Statement of Chris Edwards, Cato Institute

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Members of the commission, thank you for inviting me to testify. I will discuss the Municipal Liquidity Facility (MLF) within the broader context of budget challenges facing the states. Congress and the Federal Reserve created the MLF to provide loans to state and local governments with short-term financing needs during the recession.

Earlier in the year, news stories described the state budget situation as devastating, but with the economy rebounding state tax revenues likely won't fall as much as previously thought. The states are facing budget challenges, but they can restrain spending and tap rainy day funds to balance their budgets without further aid from Washington.

While the MLF was a well-meaning response to the crisis, it is not appropriate for the nation's central bank to finance the states. State governments are not subdivisions of the federal government. They have large independent fiscal powers to tax, save, borrow from markets, and adjust spending to handle economic ups and downs. As for local governments, they should look to state governments to backstop their finances within our federal system.

State Budget Challenges

State governments must balance their general fund budgets each year, which is more difficult during recessions if revenues are falling. Early in the crisis, news articles speculated that state tax revenues were plunging so fast that there would be "financial devastation."[1] Moody's Analytics projected that state general fund revenues would fall 15 to 20 percent.[2]

However, recent data suggest more manageable state budget gaps. U.S. Bureau of Economic Analysis (BEA) data for the second quarter of 2020 (April to June) show that total state and local tax revenues dipped just 3 percent from the first quarter (January to March). Sales and excise tax revenues were down 6 percent, income tax revenues were down 2 percent, and property tax revenues rose 1 percent.[3] Compared to the second quarter of 2019, state and local tax revenues for the second quarter 2020 were down 3 percent.

Commentators often conflate the budget situations of state and local governments, but they are quite different. While income and sales tax revenues have dipped for state governments, local governments raise 72 percent of their tax dollars from property taxes, which rose modestly in the second quarter.

During the recession a decade ago, local tax revenues nationwide did not fall because property tax revenues were flat for two years and then started rising again, and that was true even though home prices fell substantially at the time.[4] During the current recession, home prices are rising. Average U.S. home prices in July were up about 5 percent from a year earlier, and prices are expected to continue rising modestly.[5] Commercial property prices are down this year, but the drop is substantially less than during the last recession, at least so far.[6]

An August National League of Cities analysis that projected large budget gaps for city governments is based on an assumption that property tax revenues would plunge.[7] But so far, that does not seem to be happening.[8] Of course, the recession is hitting some cities and states harder than others, but there is no national crisis in local government finances.

The modest overall decline in state and local tax revenues during the second quarter of 2020 can be compared to the huge increase in federal aid for the states in that period. State and local tax revenues fell $13 billion from the first to the second quarters, but overall federal aid increased by $193 billion, according to the BEA.[9] Overall state and local revenues (from taxes, federal aid, and other sources) rose from $716 billion in the first quarter of 2020 to $893 billion in the second quarter.

State and local budgeting is more challenging than during the boom years, but there has been no collapse in funding for schools and other services. Congress has aided states with the $150 billion Coronavirus Relief Fund, $442 billion for the unemployment compensation expansion, $172 billion for extra Medicaid benefits, $30 billion for education funding, $111 billion for disaster relief, $66 billion for SNAP benefits, $26 billion for public transportation, and other aid.[10] Some federal relief money is still in the pipeline flowing to local governments.

A September survey of 37 states by the National Conference of State Legislatures found that general fund tax revenues are estimated to be down 10 percent in 2021 compared with pre-crisis projections.[11] That expected drop from projections translates into a drop from the 2019 revenue peak of about 4 percent.[12]

Also, regular federal aid for state and local governments amounts to almost $700 billion a year and pays for one-quarter of state and local budgets.[13] Thus, a 4 percent drop in state tax revenues translates into a smaller percentage drop in overall state revenues even without all the additional federal aid passed this year.

How should states deal with budget gaps? They should freeze or cut spending and tap their rainy day funds. Going into the recession in 2020, rainy day fund balances totaled 8.7 percent of annual general fund spending for the states as a whole, which is substantially higher than the 4.8 percent going into the last recession in 2008.[14] Many states have started drawing from their rainy day funds for their 2021 budgets.

However, the size of rainy day funds varies widely. Going into the recession, the funds totaled 10 percent or more of annual spending in 20 states, but they totaled less than 5 percent in 12 states.[15] Among those less-prudent states, New Jersey, Pennsylvania, Illinois, and Kansas had saved virtually nothing going into 2020. It is hard to sympathize with state governments that have empty rainy day funds after an 11-year economic expansion.

Municipal Liquidity Facility

With $35 billion from Congress, the Federal Reserve created the MLF in April to loan through a special purpose vehicle up to $500 billion to state governments and large local governments. To date, the MLF has lent $1.2 billion to the state of Illinois and $450.7 million to New York's Metropolitan Transportation Authority (MTA).

The MLF is a foray into a new activity outside of the Fed's role of ensuring stability in the financial system. When there was pressure a decade ago for the Fed to lend to state and local governments, then Fed chair Ben Bernanke was opposed. He said regarding state and local loans and possible defaults: "This is really a political, fiscal issue," not a central bank issue.[16] This year, Robert Pozen warned against expanding the MLF: "The central bank's independence would be undermined if it became a big purchaser of long-term bonds from financially weak but politically influential local governments."[17]

The two MLF loans have saved the issuing entities interest costs, but that is not a goal worth undermining federalism for and pushing aside market interest rates.[18] Market interest rates reflect important information about risk. State and local debt issuers have strong incentives to balance their books and act with fiscal prudence to boost their credit ratings and ease access to borrowing at lower interest rates. It makes no sense for the Federal Reserve to undermine market signals and essentially reward fiscally unsound jurisdictions with loan subsidies.

In general, state governments are far more fiscally responsible than the federal government, not just because they have formal balanced-budget rules, but also because of the discipline of credit markets. Federal Reserve intervention undercuts incentives for state fiscal responsibility. The MLF has been little used, but the precedent it creates is troubling.

It is not a surprise that the State of Illinois was first in line to receive a loan because it has perhaps the most poorly managed state finances in the nation.[19] It has the lowest credit rating among the states and one of the highest relative loads of debt and unfunded liabilities.[20] Illinois has billions of dollars of unpaid bills to state suppliers, which proliferated even when the economy was growing.[21]

Federal aid to ill-managed jurisdictions undermines their incentives to make needed fiscal reforms. For Illinois, state-source general fund revenues are expected to fall 4 percent in 2021, but the state is increasing program spending 2.2 percent and overall spending 5.9 percent based on funding from the MLF and other new debt.[22] Despite the recession and inability to balance its books, the state is going ahead this year with $261 million in pay raises for state workers.[23] Illinois should at least be freezing spending—as other states are doing—to get out of its vicious debt cycle.

New York's MTA was in deep trouble even before the recession.[24] It has a huge debt load and large looming costs for deferred maintenance and capital investment.[25] Subway ridership was dipping even before this year, and the health crisis may deliver a long-term blow.[26] New York's subways and buses have high operating costs which fares only partly cover.[27] Rather than borrowing from the federal government or the central bank, the MTA should be restructuring. It is out of the purview of this hearing, but transit agencies can be run without massive debts and bloated costs. Hong Kong successfully privatized its subway two decades ago, and the efficient system gets no taxpayer subsidies for operating or capital costs.[28]

Congressional and Federal Reserve subsidies or bailouts undermine incentives for state and local policymakers to pursue needed reforms. That can also be true of business bailouts, but there is a difference between businesses and governments: businesses don't directly control their revenues, and this year revenues at many businesses plunged because of health-related closings. By contrast, governments always have the power to tax and thus can raise whatever revenues they need. Spending cuts and rainy day funds are preferable means of closing budget gaps, but ultimately state and local governments have powers to raise revenues that businesses do not.

The New York Fed's FAQ on the MLF says that it "… discourages use of the Facility as the unusual and exigent circumstances that motivated the program recede and economic conditions normalize."[29] Economic conditions and the municipal bond market are normalizing, indicating that the MLF should be discontinued on its own terms.

Looking Ahead

When tax revenues fall during recessions, state governments should tap their rainy day funds, cut low-value programs, freeze salaries, and postpone new initiatives. Millions of American businesses have tightened their belts in recent months, so why not governments? Today's lean budget climate is an opportunity for state and local agencies to improve efficiencies.

Some analysts support greater aid to the states believing that it creates a large multiplier effect to boost the economy. However, a 2019 review of the academic literature by the University of California's Valerie Ramey suggests that the government spending multiplier is likely less than 1.0, meaning that higher government spending shrinks the private sector. Ramey found:

> For multipliers on general government purchases, the evidence from developed countries suggests that they are positive but less than or equal to unity, meaning that government purchases raise GDP but do not stimulate additional private activity and may actually crowd it out. …. In summary, most estimates of

> government spending multipliers for general categories of government spending for averages over samples are in the range of 0.6 to 0.8, or perhaps up to 1. The evidence for multipliers above one during recessions or times of slack is typically not robust.[30]

Thus, while the government may be able to boost measured GDP in the short run with more spending, the government will end up being larger and the private sector smaller. Also, more government debt from extra spending means higher taxes down the road and thus reduced output in the long run.

Policymakers should consider that debt-financed spending pushes costs forward onto younger generations of Americans. Federal debt held by the public has now eclipsed $20 trillion, and state and local governments are also pushing trillions of dollars of debt and unfunded retirement costs onto future taxpayers. With the economy now recovering, it is not fair or prudent to increase government borrowing and spending further. Going forward, the states should close budget gaps by using rainy day funds and restraining spending.

After the economy recovers, the states should prepare for the next downturn by reducing their debt loads and building larger rainy day funds. After its budget crisis a decade ago, California created a more robust rainy day funding mechanism.[31] The state's fund grew from 4.6 percent of annual spending in 2014 to 13.7 percent by 2020.[32] A California legislative report noted that the new mechanism, "takes volatile revenues off the table in good economic years so that they can be used to reduce the need for cuts in bad economic years."[33]

States can also reduce boom-bust cycles in their budgets by adopting more stable sources of tax revenue. Sales tax revenues are usually more stable than income and capital gains tax revenues during recessions, although this recession may be somewhat different.[34] Also, flat-rate income taxes are generally more stable revenue sources than highly progressive income taxes.

In sum, state and local governments are not helpless in the face of recessions, and they should be better prepared next time. The MLF is an unneeded central bank expansion into state budget policy. States can borrow in private markets, and local governments should look to state governments if they run into financial troubles. Expanding federal aid and loan programs for the states will undermine incentives for the states to pursue needed spending reforms and better prepare for the next downturn.

Thank you for holding these important hearings.

Chris Edwards

Director of Tax Policy Studies

Cato Institute

cedwards@cato.org

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[5] CoreLogic, "U.S. Home Price Insights: Through July 2020 with Forecasts from August 2020 and July 2021." Zillow estimates an even larger home price increase. See Zillow Research, "Zillow Weekly Market Report Through September 5," September 10, 2020.
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[8] For a discussion of why property tax revenues tend to be stable, see Robert McClelland, "Will Covid-19 Cause a Decline in Property Taxes?" Tax Policy Center, June 30, 2020.
[9] U.S. Bureau of Economic Analysis, Table 3.3, https://apps.bea.gov/iTable/index_nipa.cfm. The BEA data is annualized, so I divided by four.
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[11] National Conference of State Legislatures, "Coronavirus (Covid-19): Revised State Revenue Projections," September 10, 2020. Jared Walczak summaries other state revenue projections at Jared Walczak, "State Forecasts Indicate $121 Billion 2-Year Tax Revenue Losses Compared to FY 2019," Tax Foundation, July 2020.
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[13] Federal aid was $682 in 2019, which accounted for 25 percent of total state and local government revenues. U.S. Bureau of Economic Analysis, Table 3.3, https://apps.bea.gov/iTable/index_nipa.cfm.
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[16] Jon Hilsenrath And Neil King Jr., "Bernanke Rejects Bailouts," *Wall Street Journal*, January 8, 2011.
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[33] California Legislative Analyst's Office, "CalFacts 2018," p. 12.

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