Replacing Non-Recoverable State & Local Revenue Shortfalls Resulting from COVID-19 Mitigation Policies

A CONCEPT PAPER

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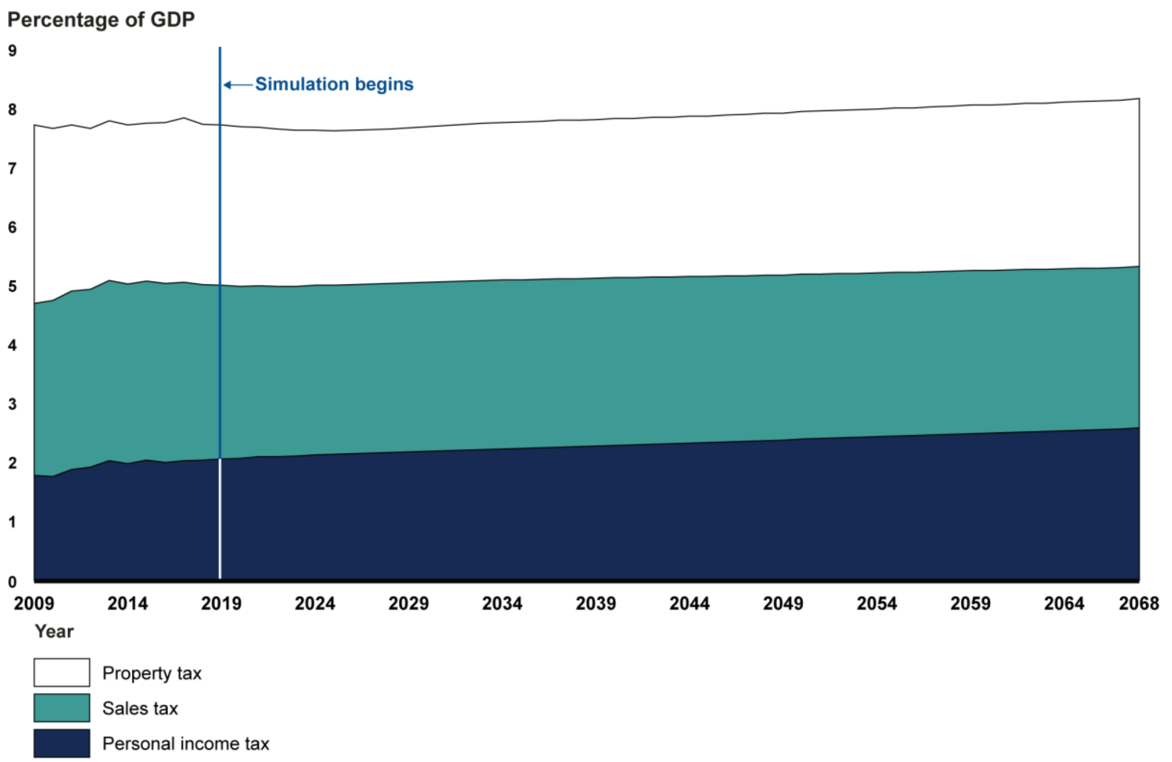
State and local governments and their utility agencies will need to address non-recoverable tax and fee revenue losses caused by the COVID-19 mitigation strategies, which typically closed businesses and increased unemployment. Governors, Mayors/County Executives, and utility leaders should issue Revenue Gap Anticipation Notes ("RGANS") pursuant to new Congressionally mandated federal guidance issued by the Federal Reserve Bank (FRB). These notes would be purchased and held by the FRB. RGAN obligations would not be repaid if the states and localities verify that they have used the proceeds to continue spending at pre-pandemic levels and that they experienced non-recoverable revenue losses at least equal to the amount to be forgiven by the FRB. In addition, the FRB and the Treasury Department should immediately take the actions requested by the NAST, GFOA and NASACT to stabilize the markets for traditional short and long term state and local debt, typically issued in tax-exempt form.

The Macro-economic recovery rationale:

The state and local public sector accounts for a significant percentage of the nation's GDP through their purchase of goods and services and the employment of people. The three major state and local tax sources account for a little under 8% of GDP, according to the most recent GAO estimates. That percentage of GDP is projected to rise gently in future years as illustrated in the following GAO graph. [1]

[1] *GAO-20-269SP State and Local Fiscal Outlook 2019 Update*

ILLUSTRATION: The Three Largest State and Local Revenue Sources as a Share of GDP



Source: GAO analysis of data from the Agency for Healthcare Research and Quality, Bloomberg, Board of Governors of the Federal Reserve System, Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Centers for Medicare & Medicaid Services, Congressional Budget Office, and the Social Security Administration. | GAO-20-269SP

Maintaining the state and local sector's ability to continue pre-pandemic levels of revenue and spending will significantly lessen the recessionary impact of the COVID-19 mitigation strategies. It may also contribute to the effectiveness of the mitigation strategies themselves by eliminating a potential financial incentive for the state and local decision-makers to ease social-distancing rules and other economically damaging measures prematurely. Maintaining state and local spending levels would be a considerable improvement over the 2008-2009 recession, during which state and local expenditures fell precipitously.

Sectoral recovery rationales include:

- Public Health and Safety - most of the nation's public health and safety services including 911 dispatch, policing, firefighting, school nursing, local public health officers, and pubic ambulance services are provided by state and local government;
- Essential public utility services - water supply, wastewater treatment, trash collection, and other public services need to continue operationally, and capital maintenance and improvement

projects must continue and even be accelerated as part of any counter-cyclical infrastructure investment initiative adopted by the federal government;

- Human capital/work force development - support of continuing state and local expenditure levels for pre-k, k-12, and post-secondary education will reduce the negative impacts of the mitigation strategies, such as school closings and the complete shift to online learning, on the development of the nation's human capital;
- Transportation - the nation's auto and truck transportation system economy depends on streets, roads and highways that are planned, built, and maintained by local and state governments with funding often coming from fuel excise taxes, tolls, fees, etc. as well as such federal sources as the Highway Trust Fund (HTF)[2]. Most of the nation's public transit systems are almost exclusively owned, operated, and maintained by the states and localities with most of the funding derived from fare-boxes, special taxes and fees, as well as more broad-based tax sources and such Federal sources as the HTF Mass Transit Account;
- Healthcare services - states and some localities contribute heavily to the federal Medicaid program's funding and provide many direct hospital and clinical services, including to special groups such as the incarcerated, severally mentally disturbed, and developmentally disabled populations.

The Yawning Non-recoverable Revenue Gaps:

States and localities are only beginning to estimate non-recoverable tax and fee revenue shortfalls attributable to the COVID-19 mitigation strategies suppressing economic activity within their borders. According to the preliminary estimates of the Urban Institute's State and Local Finance Initiative, state government revenues were still headed up in February:

"Preliminary data from 45 states show total state taxes grew 7.6 percent in February 2020 compared to a year earlier. Personal income taxes grew 12.5 percent, sales taxes grew 2.4 percent, and corporate income taxes grew 45.2 percent. Revenue growth in the median state varied substantially for all three major sources of tax revenues (see table). Overall, most states have seen healthy growth in tax revenue collections between July 2019 to February 2020 (the first eight months of fiscal year 2020 for 46 states), however this is largely before the economic disruptions related to state and federal actions caused by the COVID-19 pandemic. Total tax revenues grew 6.5 percent, personal income taxes grew 6.6 percent, corporate income taxes grew 12.5 percent, and sales taxes grew 5.9 percent in the first eight months of fiscal year 2020."[3]

[2] *Because the Highway Trust Fund receives roughly 85 to 90 percent of its revenue from excise taxes on motor fuel, this fund can be expected to face non-recoverable revenue losses similar to those faced by the states. Since 1993, fuel tax rates have been fixed at 18.4 cents per gallon for gasoline, and 24.4 cents per gallon for diesel. See Peter B. Peterson Foundation: https://www.pgpf.org/budget-basics/budget-explainer-highway-trust-fund*

[3] *Source: Urban Institute https://www.urban.org/sites/default/files/monthlystrh_feb2020.pdf with special thanks to Dr. Lucy Dadayan*

Some revenue shortfalls such as in personal income tax revenue in many states are being caused by delays in collection designed to give temporary relief to tax payers. Such delay-induced revenue gaps are likely to be recoverable, and states and localities should be able to manage such shortfalls through their traditional cashflow financing methods such as the issuance of Revenue Anticipation Notes ("RANs") with no forgiveness provisions into a stabilized municipal debt market, or to the FRB if the municipal debt market cannot be stabilized with sufficient speed. In their letter of March 31,[4] three groups representing state and local public finance interests (NAST, GFOA, and NASACT) have asked the FRB for a range of actions designed to stabilize the municipal markets for short and long term debt. The FRB and Treasury should implement the requested actions without delay.

TABLE I – National Trends in State and Local Tax Revenue Through February, 2020[5]

National Trends Tax source	**February 2020 ($ millions)**	**February 2019 ($ millions)**	**YOY percent change**	**YOY median percent change**	**Fiscal YTD 2020 ($ millions)**	**Fiscal YTD 2019 ($ millions)**	**YOY percent change**	**YOY median percent change**
Total state taxes	$57,297	$53,268	**7.6%**	**6.8%**	$574,308	$539,376	**6.5%**	**5.2%**
Personal income	19,474	17,303	12.5	1.0	250,149	234,583	6.6	6.0
Corporate income	633	436	45.2	(28.7)	28,208	25,081	12.5	9.1
Sales	25,601	25,012	2.4	6.8	204,595	193,180	5.9	5.6

In contrast, other tax and fee revenue shortfalls are resulting from the cessation or partial cessation of a wide range of economic activities such as purchases of non-essential goods and services, the loss/reduction of employment income not fully made up through benefit programs, and the loss/reduction in corporate profits. Business and personal income tax and sales and excise tax revenues will fall substantially from the time of the business closures and layoffs forward for many months. Depending on the length and severity of the economic slowdown, we are also likely to see non-recoverable gaps in real property tax revenue due to falling residential and commercial property values in the somewhat longer run.

Shortfalls will materialize at different rates for each source and in each state but it would seem apparent that sales and excise tax revenues are likely to be the most immediately impacted of the three major categories, followed by corporate and personal income taxes/fees. Property tax revenue shortfalls are likely to develop at the local levels more slowly but last longer than the shortfalls in tax revenues on which the states rely. All of these non-recoverable losses need to be swiftly replaced by an FRB forgivable debt facility being proposed here.

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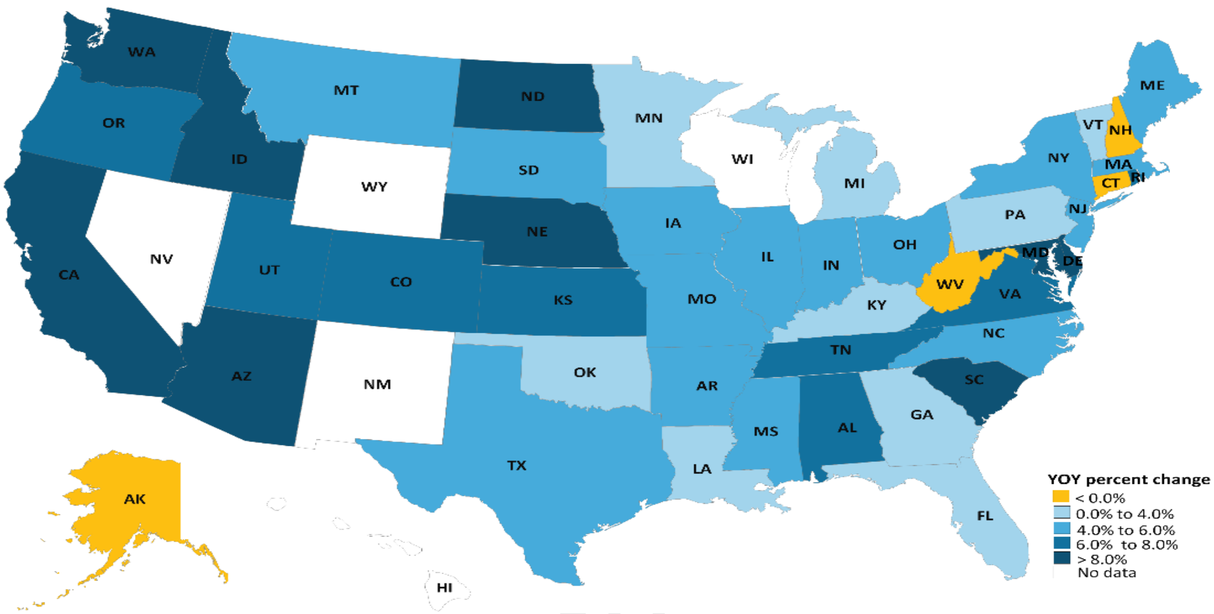
[4] *See https://nast.org/wp-content/uploads/NAST-4003-Facilities-Letter-FINAL.pdf for this excellent letter*

[5] Source: Urban Institute https://www.urban.org/sites/default/files/monthlystrh_feb2020.pdf with special thanks to Dr. Lucy Dadayan

ILLUSTRATION: Percent Change in State Fiscal Year-to-Date Tax Revenues-
July 2019 through February 2020, year-over-year percent change[6]



The Proposal:

Congress should mandate the Federal Reserve Bank (FRB) to buy state-issued "Revenue Gap Anticipation Notes ("RGANS") in amounts sufficient to replace: 1) their own non-recoverable sales, excise, income and other tax/fee revenue shortfalls as these shortfalls materialize, and 2) the tax and fee revenue shortfalls of the intermediate and local governmental and essential public service utility jurisdictions within their borders. <u>To the extent that the borrowing states and other entities agree to maintain pre-pandemic levels of spending for their budgeted purposes, these debt obligations will be</u>

[6] ibid

forgiven once the FRB has verified that pre-pandemic levels of spending have been maintained and that the shortfalls covered by the borrowings were non-recoverable.[7]

The concept of debt forgiveness granted in return for continued economic activity desired by the government has most recently been implemented with the passage of CARES Act provisions forgiving small business borrowings for enterprises that agree to continue paying their payroll costs from February 15, 2020, through June 30, 2020 (the "Paycheck Protection Program" established by Title I section 1102 of the CARES Act).

As both the states and the FRB have established commercial banking relationships, this State and Local Revenue Replacement Program could perhaps be most swiftly and effectively executed through the commercial banking system, by having the FRB agreeing to buy 100% of these RGAN notes immediately from the banks which have purchased them from the states, creating more bank reserves in the process.

The FRB could either seek appropriated funds from Congress to offset the "losses" generated by this required forgiveness (adding explicitly to the federal debt) or simply keep the RGANS on its books, adding to the money supply. In an on-lending operation, local governments and special purpose essential pubic service agencies will borrow revenue-gap filling funds from their state governments which would forgive the debt amount as the local entities demonstrate through their normal accounting/reporting procedures that they: 1) have experienced a non-recoverableCOVID-19 related revenue shortfall and 2) have maintained pre-COVID 19 mitigation program expenditure levels.

For both states and localities, the forgiven amounts of debt would be net of amounts received for other than COVID-19 purposes under the CARES Act, (e.g. Title VI, which sets up a "Coronavirus Relief Fund").

This FRB program should have a mandated duration of at least three years as some COVID-caused shortfalls in state and local revenues may persist for several years into the recovery if past experience is any guide.

The importance of speed and efficiency

To have maximum counter-recessionary value and to minimize the damage state and local revenue shortfalls do to the essential public service sectors for which these governing levels are responsible, the federal-level intervention must be as swift as possible and come with as little overhead friction (e.g. new bureaucracy, complex rules and regulations, etc.) as possible. The concept sketched out here would meet those tests. Other alternatives such as a general revenue sharing program similar to that implemented during the Nixon Administration or "block grant" programs of the kind implemented

[7] *This type of FRB operation would seem to resemble what former FED Chairman Ben Bernanke termed a "Money-Financed Fiscal Program", or MFFP, in a famous Brookings blog posting in 2016 see: https://www.brookings.edu/blog/ben-bernanke/2016/04/11/what-tools-does-the-fed-have-left-part-3-helicopter-money/*

during several subsequent administrations would take far longer to conceive, legislate, provide new administrative capacity, and execute.

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