Covid-19's Fiscal Ills: Busted State Budgets, Critical Local Choices

Jason Saving

Senior Economist, Communications and Outreach Department

Federal Reserve Bank of Dallas

Views expressed here are those of the presenter and do not necessarily reflect those of the Federal Reserve Bank of Dallas

Introduction

- **State tax revenue** has **plunged** in the COVID era
- One example is Texas, where monthly tax revenue in **April 2020** was half that of April 2019
- To be sure, that was the **worst month** and is <u>not</u> representative of the post-COVID period
- But the fiscal picture in states across the country remains challenging

That matters for…

- Individuals seeking government services
- Firms seeking government assistance (or whose sales rely on the fiscal well-being of individuals)
- Taxpayers who will ultimately bear the brunt of currently overextended governments at all levels
  - Note: debt-financed federal grants are <u>not</u> a cure for this, as they transfer wealth from future generations rather than creating it

Which led me to ask these questions:

- What can we learn from the Great Recession about our current situation?
- Using Texas as an example, just how bad is our current situation, and are there trends in tax data that help us better understand that situation?
- Then I’ll conclude with a few thoughts on policy responses and the importance of safely resuming normal business operations as soon as we responsibly can

Lessons from the Great Recession

Why are governments fiscally stretched during recession?

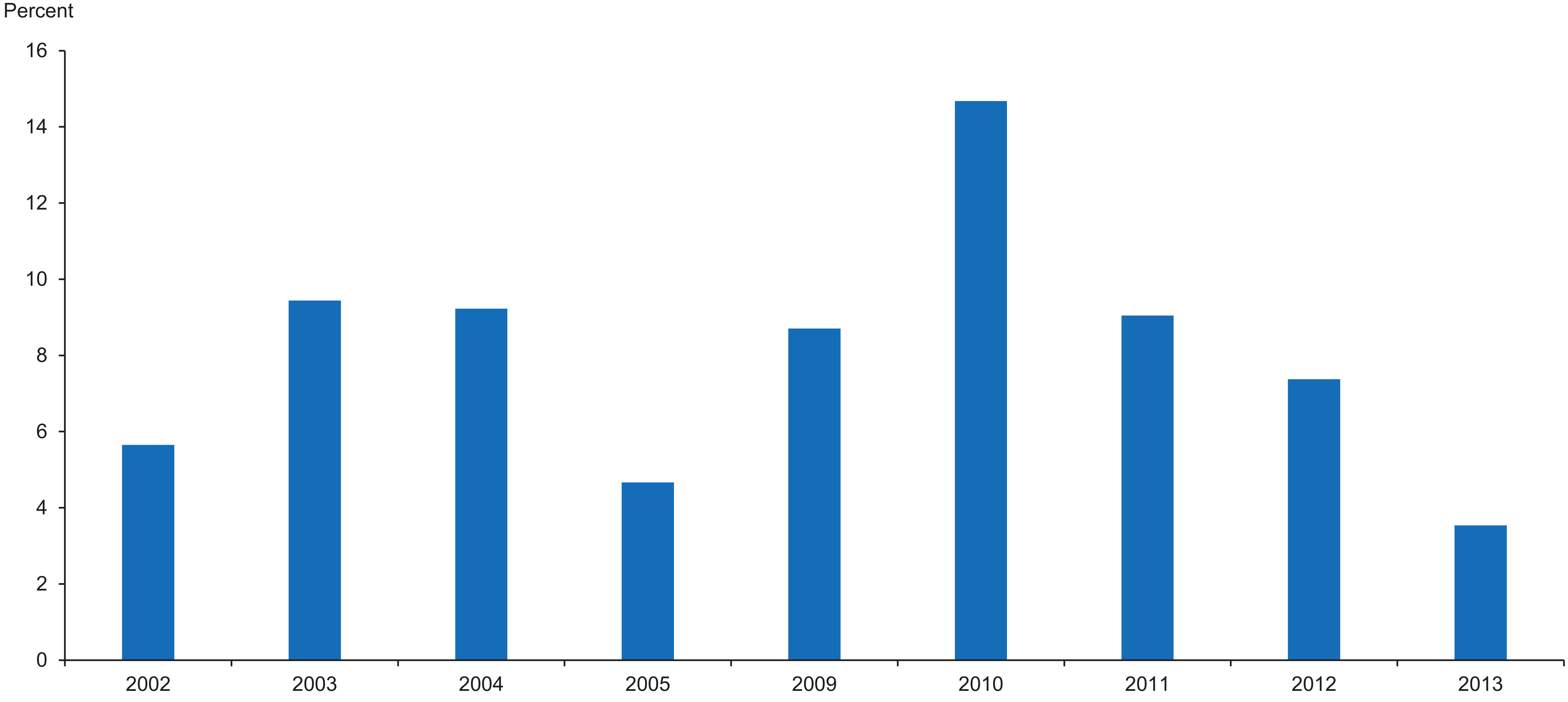
- Demand for government services rises as people find themselves with less income than they had before
- Tax revenue falls as output and income decline

How to handle the business cycle

- **<u>Orthodox prescription:</u>** Run surpluses during expansion which are then spent down during recessions
- **<u>Standard practice:</u>** Spend surpluses during expansion and then deficit-spend while pretending the fiscal stresses from recession were unforeseeable
- Works at the federal level, where deficit spending is permitted
- Doesn’t work at the state and local level, where it isn’t*
    - (At least not to the same degree it is at the federal level)

This causes state fiscal shortfalls to emerge...

Shortfalls Neared 15 Percent of General Revenue Following Great Recession



NOTE: The chart shows cumulative shortfalls across the 50 states as a share of general revenue. The Great Recession occurred from December 2007 to June 2009.
SOURCES: Center on Budget and Policy Priorities; Census Bureau; author's calculations.

Notes for this slide

- These are NOT deficits by year.
  - States aren’t allowed to run deficits, though there are partial workarounds
- Rather, they are the aggregate 50-state gap between revenue and expenditure that states ultimately closed through fiscal adjustments.
- What fiscal adjustments?
  - Mainly **higher taxes** and **lower spending**.

Notes for this slide

- Most state spending goes to health and education
- Much of state health spending is unchangeable because of federal mandates and other factors
- Therefore, adjustments tended to fall on **education**
- Lasting consequences for both K-12 (Texas, etc…) and universities (California, etc…)

But the way in which states choose to raise their revenue impacts their business-cycle exposure

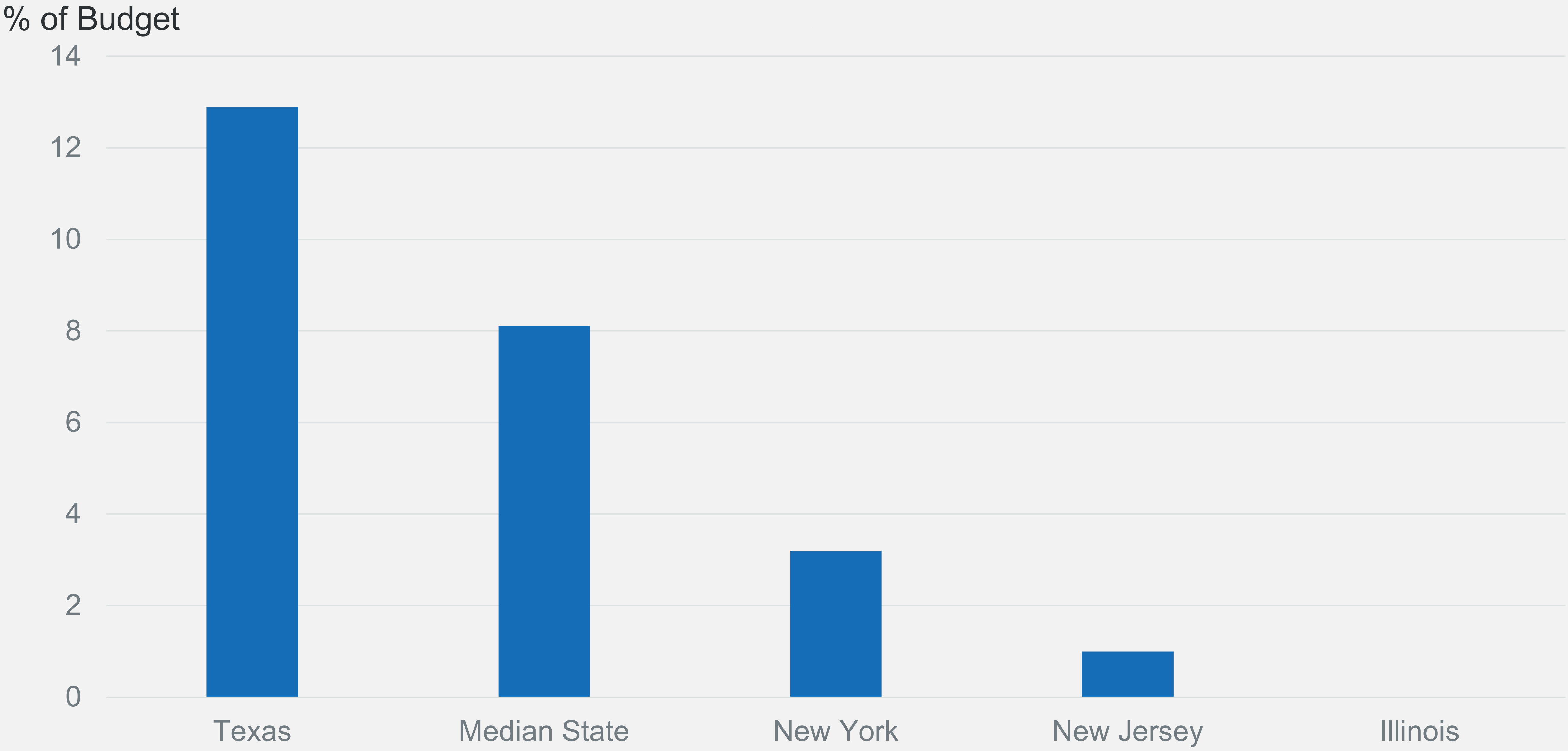
- In 2009, sales tax receipts fell 3.9 percent…
  - …while state individual income tax receipts fell 11.9 percent…
  - …and state corporate income tax receipts fell 22.6 percent
- Because **consumption varies less than income** over the course of the business cycle, this is not surprising
- Suggests states that elect to have more revenue volatility will need higher rainy day fund balances

But the way in which states choose to raise their revenue impacts their business-cycle exposure

- In 2009, sales tax receipts fell 3.9 percent…
  - …while state individual income tax receipts fell 11.9 percent…
  - …and state corporate income tax receipts fell 22.6 percent
- Because **consumption varies less than income** over the course of the business cycle, this is not surprising
- Suggests states that elect to have more revenue volatility will need higher rainy day fund balances

Do we see this reflected in 2020 Rainy Day Fund data?

Many States Simultaneously Choose Volatile Revenue Streams, Low Rainy Day Funds



Caveats in interpreting that slide

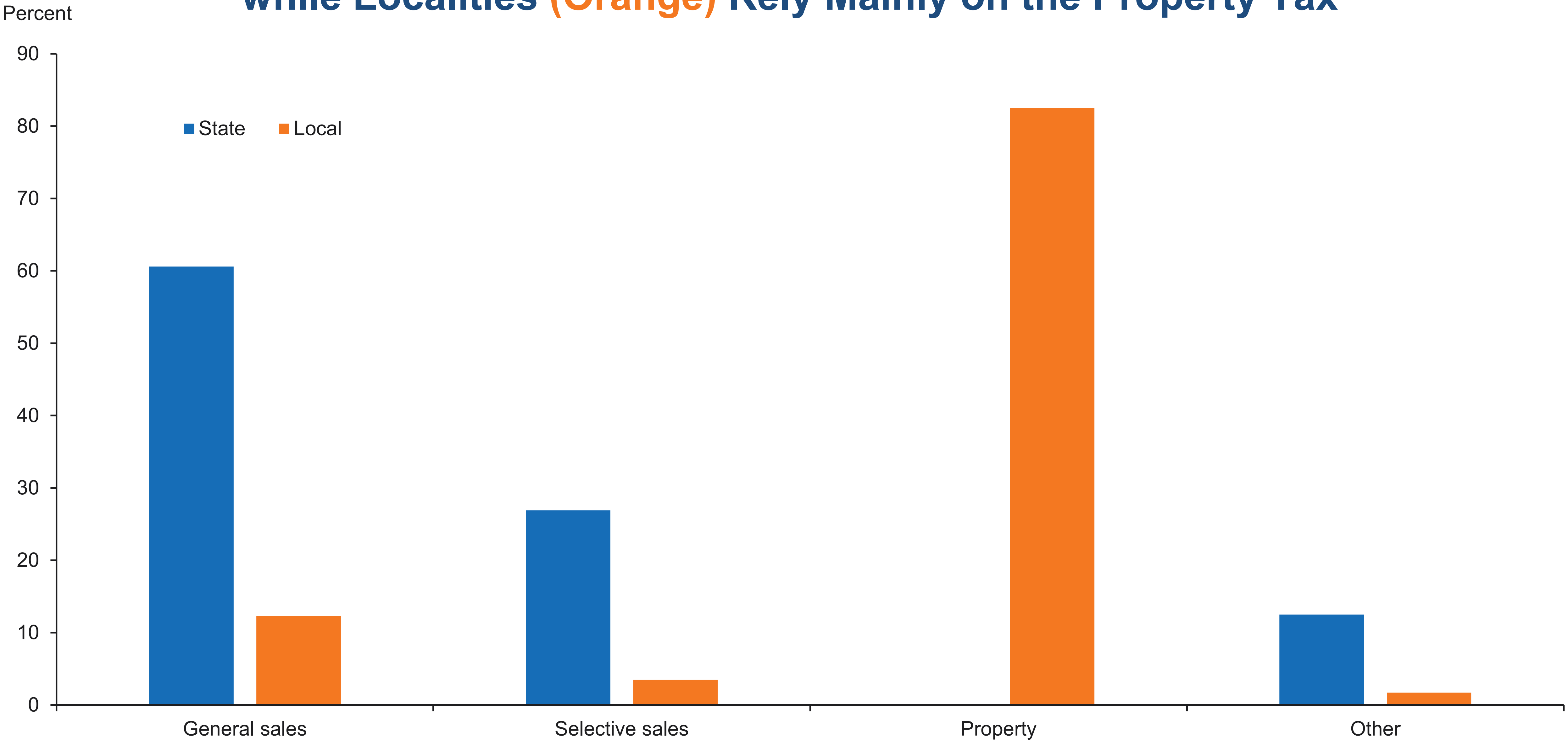
- Not true that Texas can do without a rainy day fund
    - Still affected by recessions, and has some volatile sectors like energy making up part of its economy
- Not true that NY, NJ, IL should necessarily have prioritized a rainy day fund over other fiscal policy needs
    - Beyond the scope of this presentation to make that judgment
- Still true that rainy day funds can play an important role in helping states cope with revenue volatility

How Did Texas Tax Revenue Weather Fiscal 2020?

Revenue Trends for Fiscal 2020

- State tax revenue **up 5.6 percent** in **first half** of fiscal year
- State tax revenue **down 10.6 percent** in **second half** of fiscal year
- In line with public finance theory from an earlier slide, sales tax receipts fell only half as far (4.7 percent) as overall tax revenue
- Remarkable since the **sales tax** makes up **60 percent** of state tax revenue

In Texas, State Tax Revenue (Blue) Comes Primarily from Sales Taxes while Localities (Orange) Rely Mainly on the Property Tax

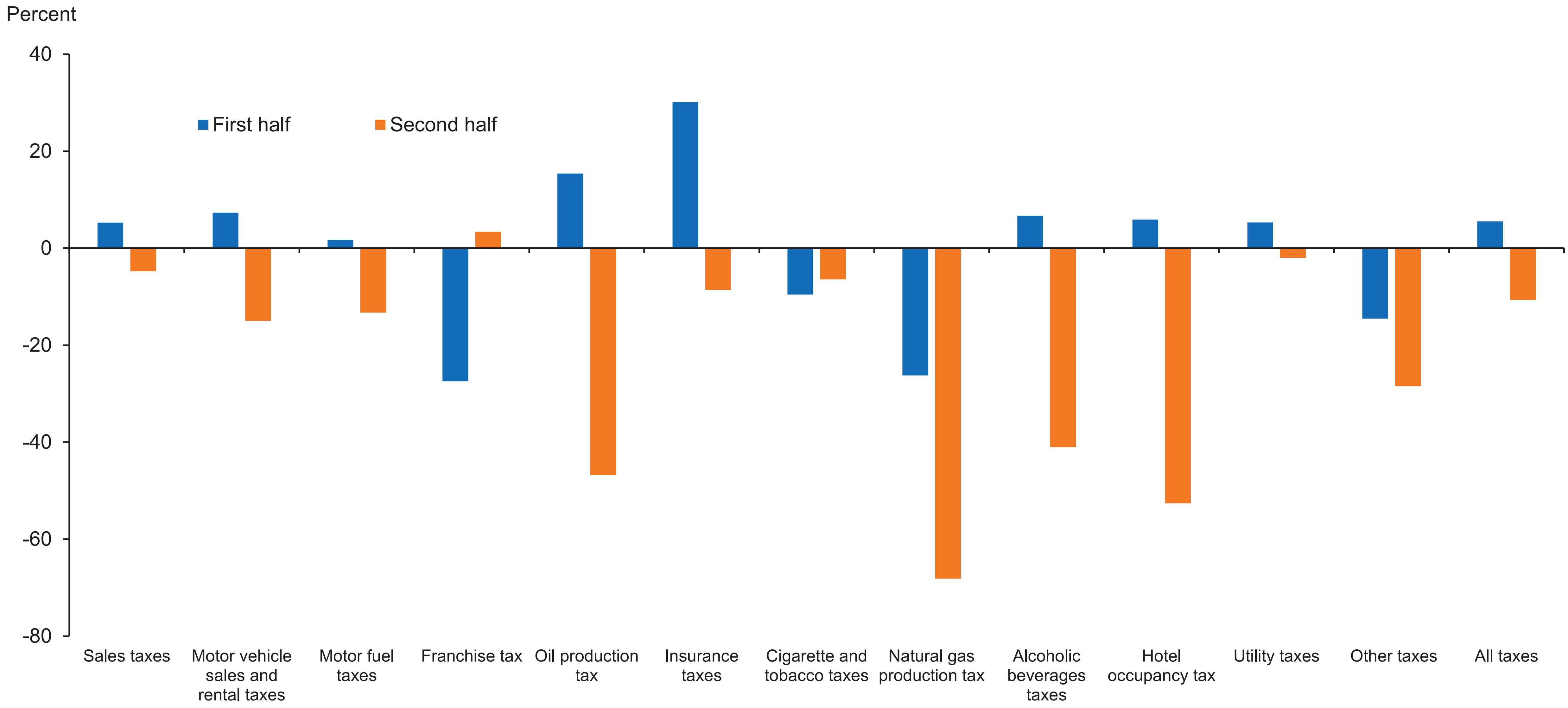


NOTE: Selective sales includes taxes on motor fuel and automobiles.
SOURCES: 2017 Census of Governments; author's calculations.

Trends in Other Taxes

- Logically, if the sales tax comprises a majority of state tax revenue but fell only half as much as the overall tax take, there must have been other taxes that plunged
- The next chart breaks this down by type of tax
- H1 revenue growth is in blue, H2 in orange
- Sales tax is shown on the far left.
  - Note that several other taxes have H2 bars that are much more negative.
- Will show data briefly, then discuss on the following slide

Texas Sales Tax Revenue Dips in H2; Most Other Taxes Plunge



SOURCES: Texas Comptroller of Public Accounts; author's calculations.

Tax Takeaways from Texas

- **Alcohol, hotel** tax revenue plunged by **40%+** due to social distancing regulations, business closures, and more cautious behavior
- **Oil and gas** tax revenue down even more, in percentage terms
  - (But this is a continuation of pre-COVID trends)
- Only one tax—the **franchise tax**—showed gains in H2
  - A media report claimed this was an optimistic sign. But in reality, firms were simply paying taxes on their 2019 revenue
  - Contained no information about how firms were faring in the COVID era

What can we say about Texas localities?

- Much less → there is comparatively little data about them
- Can draw inferences based on state revenue trends
- Declines in alcohol/hotel revenue harm travel hubs like San Antonio
- Declines in retail traffic and international border crossing harms border retail hubs like McAllen
- Low severance tax revenue harms oil hubs like Midland/Odessa, though as previously noted, these energy woes partially predated COVID

We do have monthly sales tax data by city, and it tells an interesting story

- Might expect that in the COVID era, social distancing restrictions would disproportionately affect larger cities who have reaped pre-COVID benefits from clustering
- Very preliminary evidence supports this. 73% of the state's 1100+ cities saw sales tax revenue growth in fiscal 2020 but each of the state's five largest cities saw declines.
- Might COVID change the calculus on how much people and firms want to cluster together? Food for thought.

Looking Forward

- Cities and states faced the unpalatable choice of **cutting services** or **raising taxes** to address budget shortfalls
- And yet, personal income has held up better than many expected, due in part to unprecedented-in-peacetime federal stimulus programs
- This enabled many jurisdictions to make small-than-expected fiscal adjustments
- Unanswered question: can income-tax-reliant states expect to experience less fiscal volatility in future recessions, or is the recent experience a one-time aberration? Time will tell.

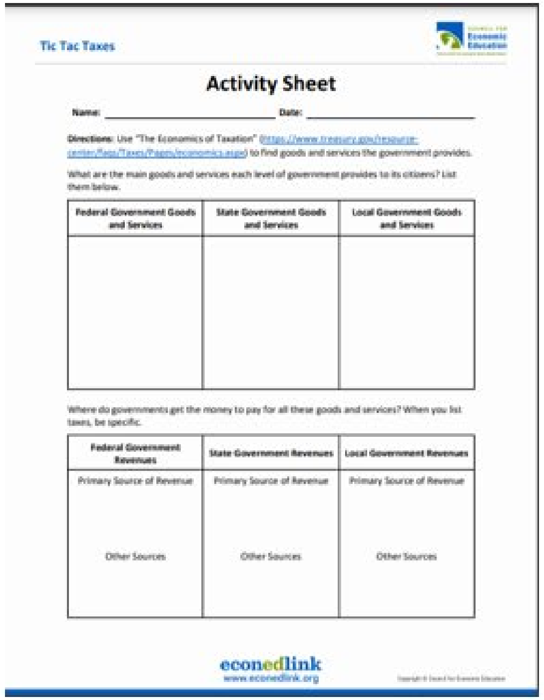
Connections In the Classroom: Busted State Budgets

Allison Clark | Exhibit Specialist

6/22/21

Connections In the Classroom: Embed

Tic Tac Taxes Activity Sheet


Tic Tac Taxes

Activity Sheet

Name: ______________ Date: ______________

Directions: Use "The Economics of Taxation" (https://www.treasury.gov/resource-center/faqs/Taxes/Pages/economics.aspx) to find goods and services the government provides.

What are the main goods and services each level of government provides to its citizens? List them below.

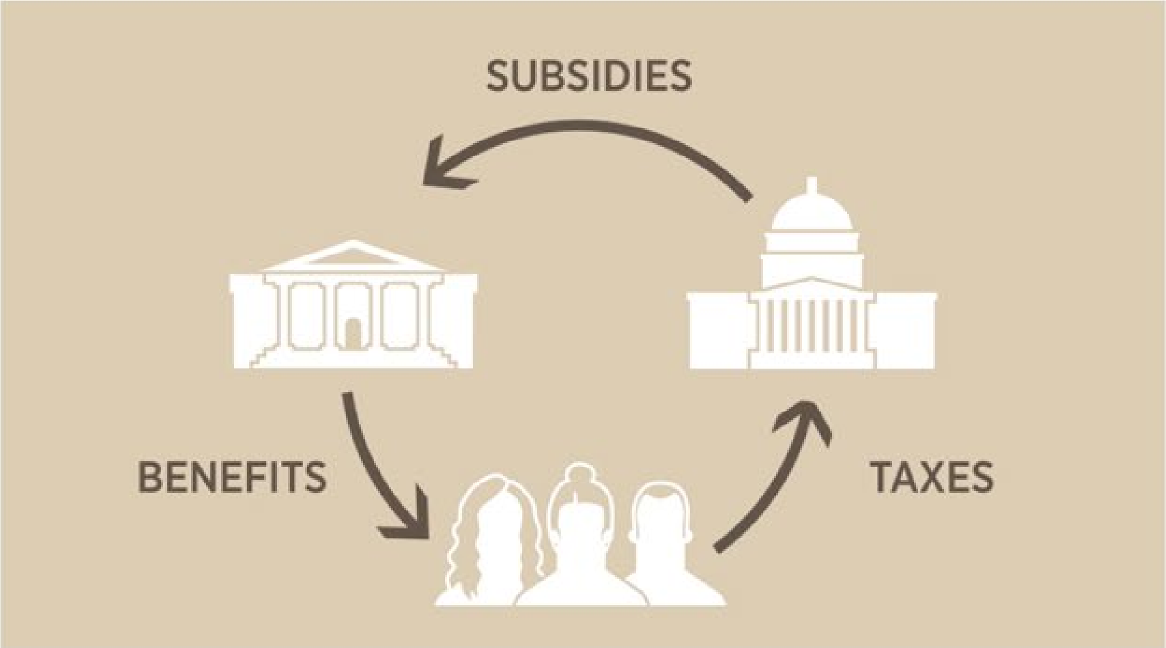
Federal Government Goods and Services	State Government Goods and Services	Local Government Goods and Services

Where do governments get the money to pay for all these goods and services? When you list taxes, be specific.

Federal Government Revenues	State Government Revenues	Local Government Revenues
Primary Source of Revenue	Primary Source of Revenue	Primary Source of Revenue
Other Sources	Other Sources	Other Sources

econedlink
www.econedlink.org

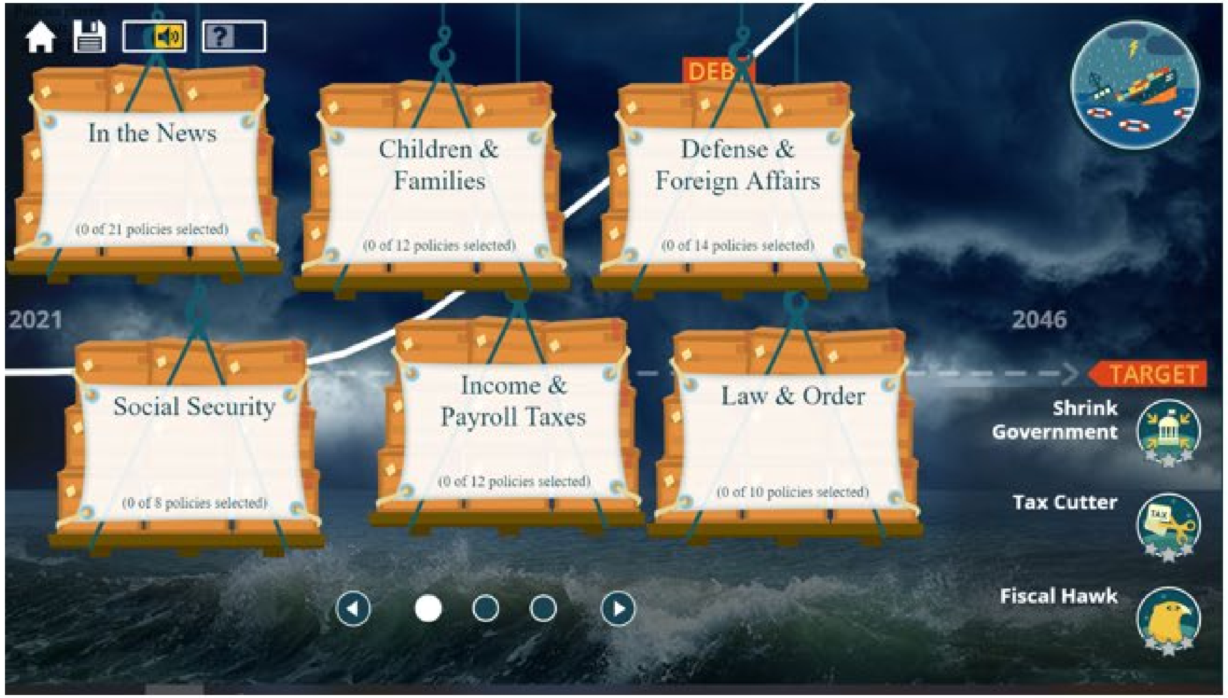
Externalities Video



Connections In the Classroom: Embed

Policy Infographic

The Fiscal Ship



Connections In the Classroom: Extend

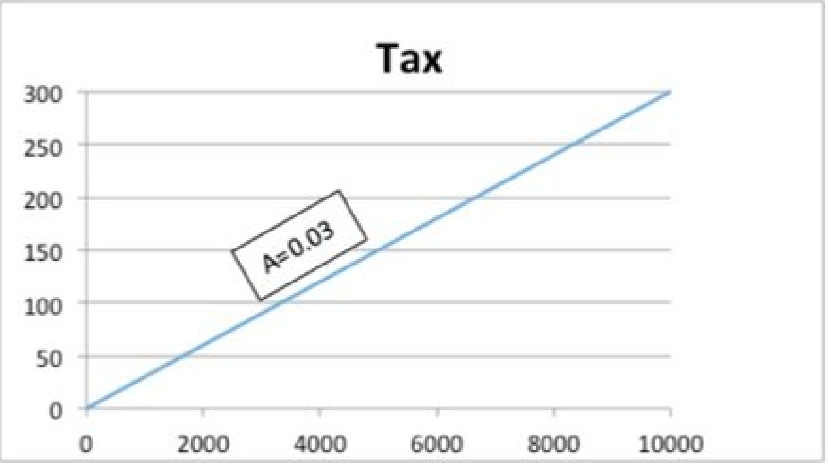
[*Southwest Economy* – 2017 Q3](#)

Texas Taxes: Who Bears the Burden?

By Jason Saving

[The Mathematics Behind Progressive, Regressive, and Proportional Taxes](#)

ncome	Tax
0	0
1000	30
2000	60
3000	90
4000	120
5000	150
6000	180
7000	210
8000	240
9000	270
10000	300



Connections In the Classroom: Extend

Government Spending and Taxes