

# Uncertainty, Risks, and Budgets in the Age of Coronavirus

BY MICHAEL A. PAGANO AND CHRISTIANA K. MCFARLAND

## LIFE, INTERRUPTED

Beaches, parks and other public spaces across the nation closed to stem the spread of COVID-19, including one of Los Angeles County's most popular beaches in Hermosa Beach, California.





JAY L. CLENDENIN / LOS ANGELES TIMES VIA GETTY IMAGES

In March 2020, when state and local government leaders began issuing shelter-in-place orders and closing down businesses, the public health consequences of COVID-19 also became economic consequences. As unemployment soared at a rate never before seen and businesses shuttered overnight, it became clear to the government finance community that public treasuries had been hit with a tsunami the size and strength of which we have never experienced. Budgets that were proceeding toward approval were thrown in disarray, and revenue forecasts from just weeks earlier were trashed.

For a sense of scale, consider that total annualized state and local government income and sales tax revenues are about \$1 trillion, according to the most recent data.<sup>1</sup> Even if these taxes decline by 10 to 25 percent, revenue shortfalls would be in the range of \$100 to \$250 billion, and that's not including declines in other revenue sources, increases in pension liabilities, and increases in service needs as the unemployment rate approaches that of the Great Depression. But no one can precisely predict what kind of budget shortfalls state and local governments will face over the next year and beyond.

State and local government budgets are affected both sooner and later by the economy. It's up to elected and appointed officials to balance the service-delivery demands and needs of residents with their governments' capacity to cover the costs of these services. How can government leaders prepare for the economic uncertainty and fiscal strife that has already begun? This article discusses revenue volatility, including some of the ways in which widespread unemployment will likely affect metropolitan areas, and what history teaches us about the challenges of fiscal rebound and the possible effects on spending, revenue shortfall, and rainy day fund balances.

## Revenue Volatility

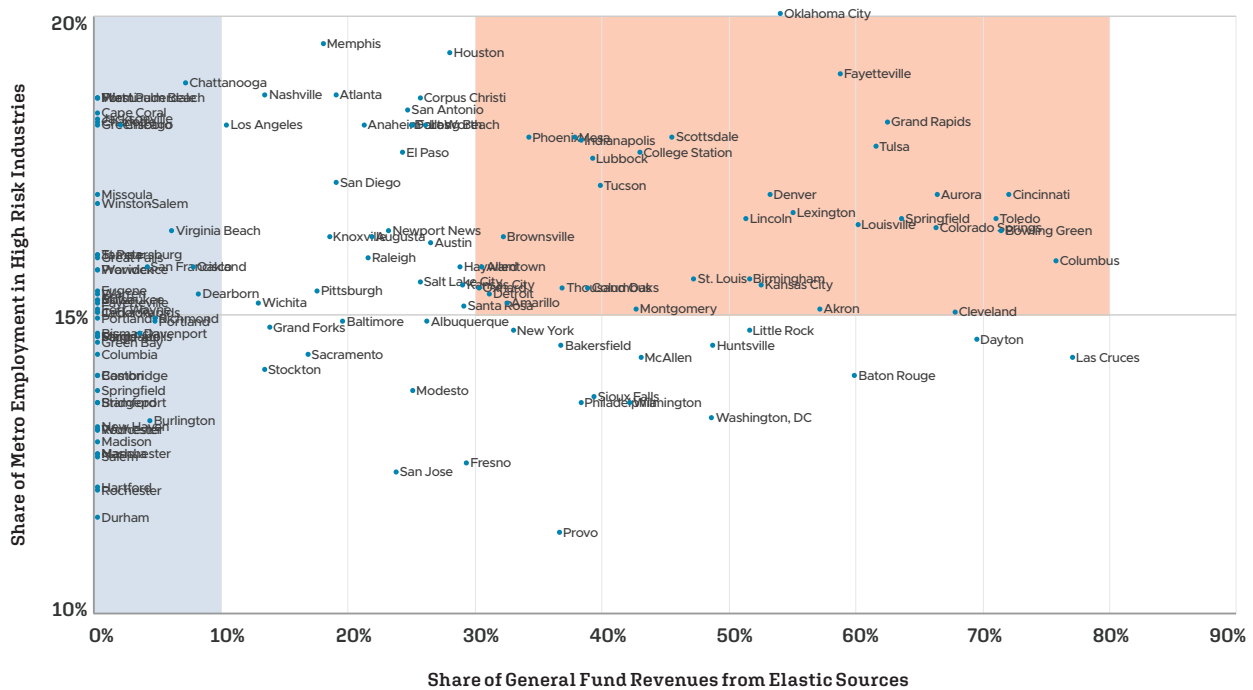
The Great Recession, which began in December 2007 and officially ended in June 2009, produced job losses of 8.7 million workers, a total that was surpassed in a brief two-week period in late March 2020. The COVID-19 impact is not yet fully known, but the shock to the tax systems of state and local governments is of such a magnitude that we aren't expecting a return to anything resembling normalcy any time soon.

A Brookings Institution analysis identified the metropolitan areas that were more highly dependent on employment in sectors that could be most affected by the coronavirus pandemic, based on Moody's chief economist's analysis, in which he categorized five employment sectors as "especially vulnerable" to a COVID-19-related economic downturn.<sup>2</sup> Moody's identified the following industry sectors as most likely to experience dramatic declines in employment: mining/oil and gas; transportation; employment services; travel arrangements; and leisure and hospitality. In Exhibit 1, we layered the metro-level employment data on city-specific revenue data to illustrate the general timing of the fiscal impact of COVID-19.<sup>3</sup>

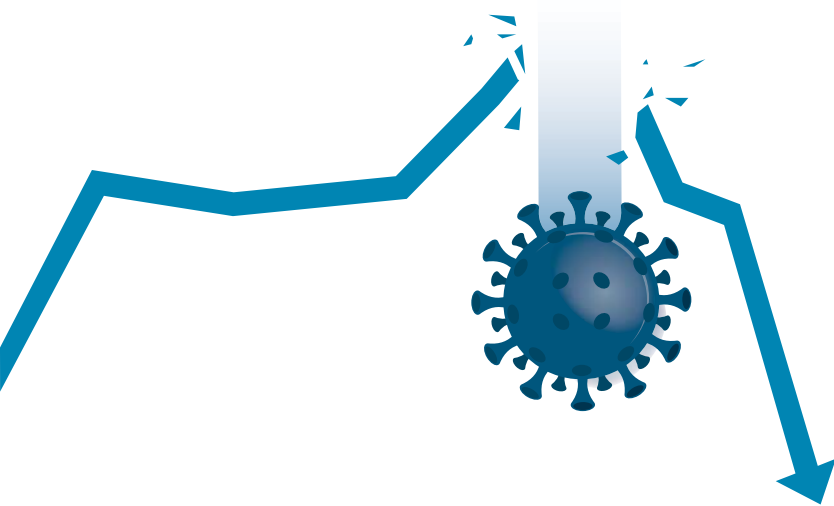
As the scatterplot indicates, cities that are more heavily reliant on the highly elastic income/wage tax and sales tax, as well as more highly dependent on the industries that are most likely to be damaged, are already experiencing the fiscal effects of COVID-19 (the yellow shaded area).<sup>4</sup> These are the cities and the larger metropolitan areas where businesses have been shuttered or drastically cut back, unemployment is rapidly increasing, and retail sales tax revenue or income tax revenue is dropping precipitously. These cities' fiscal positions are hit hard—and in short order.

Cities that are huddled along the Y-axis do not levy a sales or income tax, or the reliance is less than 10 percent of their general fund revenues (the green shaded area). As a consequence, they are highly reliant on the property tax, which will begin to decline in another year or so, when assessments are made and property tax bills are sent. These cities' revenues most certainly will register the impact of unemployment and shuttered stores, but collection of their major tax source—the property tax—lags the underlying economy's condition. As such, they have slightly more time to prepare for their next budget

**Exhibit 1:** Metropolitan Areas Most Likely to Experience Dramatic Declines in Employment, 2019



The cities of Billings, Reno, Casper, Orlando, Las Vegas, and Henderson had a 20-35% share of employment in high risk industries and up to 10% of general fund revenues from elastic sources. The City of Laredo, Texas, had a 29.7% share of employment in high risk industries and 17.03% of general fund revenues from elastic sources.



## How can government leaders prepare for the economic uncertainty and fiscal strife that has already begun?

cycle than the cities in the right of the X-axis (sales- and income tax-dependent cities) with a larger-than-average vulnerable employment base. This is to say, the fiscal positions of these cities will be negatively affected, but probably not immediately.

The timing of the COVID-19 pandemic is critically important to understand. Because local governments' revenue bases can rely on a mix of state aid (in some cases), user charges and fees, property taxes, and a host of other taxes and fees, the impact of the COVID-19 economic crisis will be highly variable both within and across states. Over time, however, all local and state governments will bear the colossal brunt of the economic shutdown.

Unfortunately, the framework identified in our analysis is starting to bear out. As an example, consider that the City of Cincinnati, Ohio—predicted to feel an immediate fiscal impact because of its heavy reliance on the income tax (72 percent of its general fund is derived from the municipal income tax) as well as the concentration of nearly 17 percent of its region's employment in high-risk industries—estimated an \$80 million deficit for FY 2021.<sup>5</sup> The City of Akron, Ohio—also highly dependent on the income tax (57 percent) and on high-risk industries (15 percent)—announced in March that one-third of its municipal workforce would be furloughed.<sup>6</sup> A more diversified tax base might have softened the eventual fiscal impact of COVID-19.



# 1,885%

At their peak in mid-April 2020, average weekly unemployment claims surged more than 1800%.

# \$7.67B

Best case scenario forecasted monetary global GDP loss in 2020. (Worst case, \$346.98 billion)

Source: statista.com



## Lessons from History

Looking back to the recent past, most states and many local governments navigated their fiscal policies through the Great Recession storm, but fiscal rebound, particularly for local governments, remained difficult. To illustrate the challenge of fiscal rebound, we have been collecting data on cities' general funds for over three decades and plotted the constant-dollar return to the pre-recession levels for the past three recessions.<sup>7</sup> Year 12 of the recovery (FY2018) indicates that cities' general funds have just about returned to the pre-recession level. (Exhibit 2).

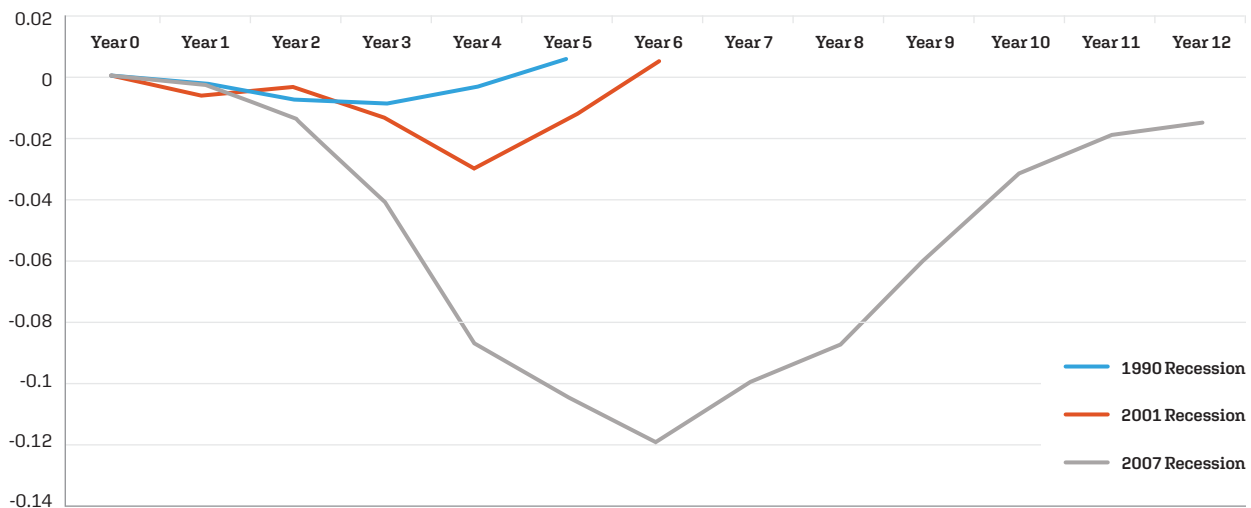
When terrorists struck on September 11, 2001, the national economy had already begun to weaken as a result of the dotcom bust the previous year. Local and state governments were beginning to prepare for dealing with declining revenues. Elected officials assured residents that even in the face of declining revenues, the health, safety, and welfare of people would continue to be upheld. Indeed, municipal spending in 2001 and 2002 did increase, even while the economy was soft, largely in response to people's need to feel safe. The lesson is that the COVID-19 impact certainly will not diminish outlays to protect the public health of

the residents of cities and counties, even as revenue productivity plummets. Local governments will find areas to trim and cut, but public health and related activities will not be one.

This is not to suggest that state and local governments will continue to spend at pre-COVID-19 levels, especially when the revenue declines will be deep and prolonged. Indeed, nearly 90 percent of cities across the country anticipate a revenue shortfall before the end of the year, according to the April 2020 National League of Cities (NCL) survey of about 2,500 cities.<sup>8</sup>

When the economy turns sour, GFOA recommends using fund balance to soften the landing. Fund balances are often built up during years of good revenue yield with the expectation that they can be used to help weather periods of financial stress. Many state and local governments have built up their fund balances (i.e., reserves) in the years since the Great Recession (see Exhibit 3, which shows the record high median value of states' rainy day and general fund reserve funds, according to the Government Accountability Office's assessment of the National Association of State

**Exhibit 2:** Rebound Time for Cities' General Funds



Source: General fund data collected from the comprehensive annual financial reports of a sample of cities for a National League of Cities annual survey, including data for fiscal year 2018. An earlier version, including data through fiscal year 2017, was published in Christiana McFarland and Michael A. Pagano, *City Fiscal Conditions in 2017*.

Budget Officers' data). This money may be available now to help until other financial recovery strategies can be implemented; cities have built a high level of reserves, according to data from NLC's annual survey. Using fund balance to soften the landing can help preserve organizational capacity to provide services—although it can only be used for a finite period of time. Using fund balance to fund ongoing expenditures without a larger recovery strategy could create an even more severe situation when the reserves run out.

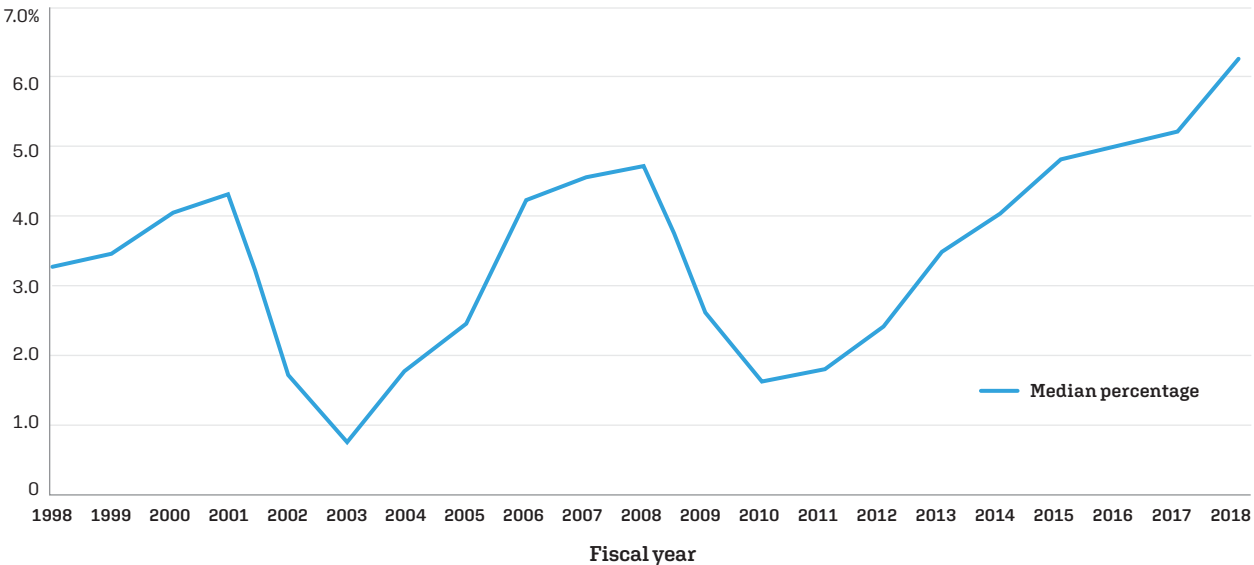
Cities have already begun tapping reserves to help make up their revenue shortfalls. If implemented appropriately, the tool has the effect of allowing near-normal service delivery and functioning of government responsibilities. The recommended best practice of how much ought to be held in general fund reserves, according to GFOA, is “no less than two months of regular general fund operating revenues or regular general fund operating expenditures.”<sup>9</sup> Unfortunately, cities also indicated that drawing down reserves will likely not be sufficient to make up budget shortfalls, and that service and personnel cuts are being planned.

## Planning for the Future: Incremental Response is Not Enough

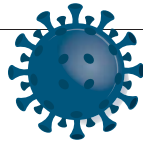
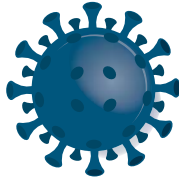
The uneven state and local fiscal impact of COVID-19's shocks to underlying economic bases is important for higher levels of government to keep in mind as they engage in the art of grant design. In the short term, for the federal response to be most effective, it should provide not only widespread support for revenue losses, but also account for the disparate fiscal and economic impacts of COVID-19 outlined above.<sup>10</sup>

A crisis of the magnitude state and local governments, not to mention the federal government, are facing will require non-incremental thinking and policy proposals. The future will be quite different than just a few months ago, and what worked before may need to be discarded. To begin with, government finances at the state and especially at the local level could be redesigned to better align with their underlying economies. And they must be much more mindful of the taxpayer's ability to pay, becoming less reliant on the benefits principle (fees and charges). Local governments' decades-long shift to user fees as a reflection of residents' valuing goods should be reimaged. Over a stretch

**Exhibit 3:** Median State Rainy Day Fund Balances as a Percentage of Total General Fund Expenditures, 1998–2018




Source: Government Accountability Office, “Intergovernmental Issues: Key Trends and Issues Regarding State and Local Sector Finances,” March 2020.



of 40 years, local governments have increased their own-source revenues on fees and charges. As admirable as an appropriate fiscal response as it is to assessing consumers' desires for a good, increased use of fees as the embodiment of the benefits principle comes at a price in that lower-income residents consume less than they would like or need.

This surge in user fees has happened as local governments' tax bases have simultaneously narrowed. The current crisis ought to push an agenda of better alignment of the economic base to its fiscal tools. For example, there is no sound economic reason—although there are many political reasons—to exclude more than half of the purchasing dollar from the sales tax. The sales tax incidence for low-income residents is much higher than on upper-income residents, whose consumer purchases of services are much greater than their purchases of taxable goods. Moreover, the property tax exemption granted to wealthy institutions should be reexamined in light of the services they provide to the indigent and others, unless an appropriate payment-in-lieu-of-taxes arrangement is established that is connected to the cost of providing government services. Also, because real estate ownership no longer reflects the relative wealth of individuals, why should property taxes (primarily) be the surrogate measure of a local government's economic base? A wealth tax or a progressive income tax, or some recognition that tax incidence should be considered when designing revenue systems, should be on the table.

Given that property (real estate) ownership was a good proxy of wealth over a century ago but not anymore, another bold idea that deserves renewed attention is land value taxation. This approach to revenue generation only considers the value of the land, not the homes, businesses or other structures on it. "George argued that taxes on land promote fairness because the value of land is determined by community rather than individual efforts. A tax on land is efficient in that it does not distort investment choices, whereas a tax on the value of improvements discourages economic development."<sup>11</sup> Cities, of course, need permission from their states to implement such a change, and municipalities in the State of Pennsylvania are some of the few with current access to this tool. Places that have implemented the land value



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tax, or an iteration of it that taxes land at a higher rate than property, have seen tremendous positive effects, including reduced tax liability for those living in at-risk neighborhoods, decreased blight and vacancy, and increased construction and property improvements.<sup>12</sup>

### Conclusion

Government officials need to float big ideas in a time of extreme crisis; incremental adjustments will most likely not be enough. This is a time for non-incremental changes.

The coronavirus pandemic has revealed the incredible will and competence of state and local governments to step up during extraordinary times. The pandemic has also revealed the extreme fiscal burden that state and local governments will bear as a result. ■

**Michael A. Pagano** is Dean of the College of Urban Planning and Public Affairs at the University of Illinois at Chicago, Director of UIC's Government Finance Research Center, professor of public administration, Fellow of the National Academy of Public Administration and former co-editor of *Urban Affairs Review*.

**Christiana K. McFarland** is the research director of the National League of Cities, co-author of NLC's annual *City Fiscal Conditions survey*, and principal researcher on economic development and city-state governance issues.

<sup>1</sup> 2017 Census of Governments: Finance.

<sup>2</sup> Mark Muro, Robert Maxim and Jacob Whiton, "The places a COVID-19 recession will likely hit hardest," Brookings Institution, March 17, 2020. The "most vulnerable" sectors identified in this report were derived from an analysis: See Mark Zandi, "COVID-19: A Fiscal Stimulus Plan," March 16, 2020 at [economy.com](http://economy.com).

<sup>3</sup> The metro area data do not align perfectly with the city-specific revenue data for many of the observations. Nevertheless, the revenue structure of neighboring cities within metro areas is generally similar. Consequently, the grouping of cities and metro areas by "most impacted" is generally accurate. Michael A. Pagano and Christiana McFarland, "When will your city feel the fiscal impact of COVID-19," Brookings Institution, March 31, 2020.

<sup>4</sup> The average of those five employment sectors as a percentage of total metro employment is 16.2 percent. The yellow-shaded area, therefore, includes those cities with a higher than average reliance on those employment sectors and whose general funds rely on income and/or sales taxes by at least 34 percent (the average for the cluster of cities in this sample).

<sup>5</sup> Sharon Coolidge, "Cincinnati city budget could plummet by \$80M; temporary layoffs ahead," Cincinnati Enquirer, March 27, 2020.

<sup>6</sup> Doug Livingston, "Akron furloughs 600 city workers to stop spread of coronavirus" Akron Beacon Journal, March 17, 2020.

<sup>7</sup> For example, see Christiana McFarland and Michael Pagano, *City Fiscal Conditions in 2019* (Washington, DC: National League of Cities, 2019). The data for cities' general funds are collected from a sample of cities with populations that are greater than 10,000, and the largest 200 cities, except for New York City, due to its size as an outlier, and Washington, DC, due to its political status. (See the Methodology section of each year's report for details.)

<sup>8</sup> National League of Cities and U.S. Conference of Mayors Fiscal Impact on Municipal Governments survey, April 2020.

<sup>9</sup> "Fund Balance Guidelines for the General Fund," GFOA, September 2015, at [gfoa.org](http://gfoa.org).

<sup>10</sup> Tim Bartik, "A proposal for timely, responsive federal aid to state and local governments during the pandemic recession," Upjohn Institute, April 20, 2020.

<sup>11</sup> Richard F. Dye and Richard W. England (eds.), *Land value taxation: theory, evidence, and practice*, Lincoln Institute of Land Policy, 2009.

<sup>12</sup> Joshua Vincent, "Non-Glamorous Gains: The Pennsylvania Land Tax Experiment," Strong Towns, March 6, 2019.