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What Inflation Means for State and Local Budgets.

Rising costs are starting to put pressure on budgets and may increase pension risk. Still, government balance sheets are in good shape and the economy remains in growth mode.

In February 2009, the economist Mark Zandi spoke at a conference hosted by Governing. He predicted that the still-painful Great Recession would be done by that fall. More precisely, he predicted it would be over on Sept. 15. As it happened, Ben Bernanke, then the chairman of the Federal Reserve, gave a speech declaring that "the recession is very likely over at this point" — on Sept. 15, no less.

No economic forecaster is ever perfect, but Zandi's track record has been good enough to make his current optimism heartening to hear. "It's fair to say, despite all the angst about recession risks, that the most likely scenario for the U.S. economy over the next 12 to 24 months is for it to evolve into a self-sustaining economic expansion," Zandi said.

Self-sustaining, meaning that economic growth will continue despite the approaching end of the extraordinary fiscal stimulus provided by Congress in response to the pandemic. And despite the fact that the Fed is putting on the brakes, raising interest rates and pulling back from its bond-buying spree. "I don't think there's going to be any debate by the summer that we're going to be at full employment," Zandi, the chief economist at Moody's Analytics, said last week. "I do think inflation is moderating and by the end of 2023, we'll be back to the Fed's targets of 2 to 2.5 percent."

Even assuming the economy doesn't head into recession, however, state and local governments are having to contend with a range of fiscal challenges. Inflation is at a 40-year high, meaning the cost of capital projects and even routine service delivery is going up. The tight labor market means governments are having to increase salaries, which in turn puts upward pressures on pension costs. Already, rising interest rates are limiting the success of governments in issuing taxable bonds. "I would not be surprised to see significantly lower volume by the end of the year," said Natalie Cohen, president of National Municipal Research. "Perhaps $100 billion less."

There have been some upsides for states and localities amid all the economic shifts. Inflation causes pain but it's also led to an increase in sales tax revenues. The hot housing market will also pay dividends, although policymakers will be under a lot of pressure to offer property tax relief as values surge. Most states remain in good shape financially, bringing rainy-day funds up to about 10 percent of general fund budgets, even as lawmakers simultaneously go on tax cut and spending sprees.

"I thought I'd have $200 million in the bank at the end of the year," said Matt Gress, Arizona's budget director. "Instead, we have a $4 billion surplus." Gress, like Zandi and Cohen, spoke at a webinar hosted last week by the Volcker Alliance and the Penn Institute for Urban Research.

States and localities face a number of fiscal challenges and a fair amount of uncertainty, but they're in much better shape than expected at the start of the pandemic. "States and localities are in about as good a shape as they've ever been coming into something like this," Zandi said. "That does give me some solace that states and locals can help navigate the economy through this bumpy period."

Recession Risks

Zandi puts chances of a near-term recession at about 1 in 3. He concedes that his fairly rosy forecast depends on three factors. The first is that the pandemic will wind down. COVID-19 is not going away, but each successive wave has caused less economic disruption, as businesses and households continue to adapt.

The second assumption is that the economic fallout from Russia's invasion of Ukraine will be contained. That war is far from over, but we may have already experienced the worst of its fallout in terms of rising oil and agriculture prices. Finally, Zandi assumes that the Fed, with its work normalizing and raising interest rates, will succeed in calming inflation without pushing the economy into recession.

Those are three big assumptions. A lot of economists believe the Fed has moved too slowly to dampen growth, while inflation is a problem around the world, not just a U.S. phenomenon. COVID-19 and the war in Ukraine remain unpredictable but clearly disruptive forces. Zandi attributes much of the growth in inflation to supply chain problems he thinks will be resolved, but not everyone is so sanguine.

At any rate, some of the damage has already been done. "Year over year inflation has reached new highs this year," Gress said. "They're among the fastest price increases ever recorded."

He notes that the metropolitan Phoenix area is seeing inflation at even higher levels than the nation as a whole, at just under 11 percent. A lot of that is being driven by housing prices, although gas has also been a driver. "The typical Arizona household has spent more than $4,500 for the same goods and services over the past 12 months," Gress said.

Rewards and Pitfalls for States

In the short run, inflation has done some good for state budgets. Since sales taxes are pegged to prices, consumers paying more for goods means they're paying more in taxes. In Arizona, for example, taxable sales were up 17 percent through March, with 40 percent of the growth driven by inflation.

States benefited during the pandemic as consumers shifted their purchases from services and experiences toward goods, which are more often taxable. Thanks to the Supreme Court's Wayfair decision in 2018, states and localities were poised to collect taxes on online purchases. And, of course, state and local budgets have been helped immensely by federal spending, including $350 billion in direct aid from last year's America Rescue Plan Act.

But governments are not immune to the costs of rising wages due to the tight labor market. Aside from their immediate impacts, wage gains also put pressure on pensions, which are generally tied to salary levels. Meanwhile, interest rates have already hurt stock prices, making it more difficult for pension funds to meet their own hopeful projections in terms of investment returns. "In a higher inflation environment, the states are set to have underperforming assets, compared to what the actuaries are expecting," said Les Richmond, vice president of Build America Mutual Assurance, a municipal bond insurer.

States face other challenges. A shaky economy could lead to increased Medicaid costs. And, while states overall have refilled their unemployment insurance trust funds back to pre-pandemic levels, some states — notably California — remain well below where they were.

But states are still in good financial shape at the moment. Indeed, as Zandi notes, all manner of balance sheets — not just those of governments but households and corporations as well — are healthy, while banks are highly capitalized and highly liquid, stress-tested to endure much rougher economic conditions than are currently the case.

“There are no major, fundamental, structural problems in the economy,” he said. “Go back to every recession since World War II and you have some segment of the economy that’s completely out of whack.”

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