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The Coming Policy Backwash from the COVID Revenue Wave.

As a recent study documents, federal fiscal stimulus created a budget windfall for states. Most cut taxes, and some now must scramble to make up for shortfalls. Congress is likely to impose tighter restrictions on future countercyclical aid, so it's a time for all levels of government to get their acts together.

Those of us who live near the ocean understand wave action. A surging wall of water approaches the shore, then crests and retreats. Often there's an undertow that follows. That's pretty much the story for state revenues over the period from 2020, when the COVID-19 pandemic began, to the present. States received massive amounts of federal countercyclical aid from Congress, while at the same time their sales tax receipts surged as homebound residents spent a substantial portion of their own federal helicopter money on everything from Pelotons to designer handbags.

In ways never seen before in the annals of public finance, a good number of states actually made money on the pandemic — for a year, anyway. Flush with this unanticipated windfall, 48 states and the District of Columbia cut taxes or issued one-time rebates. Even though Congress had enacted rules to discourage use of the federal money for state-level tax cuts, governors and legislators quickly found ways around that by pointing to their good fortune from locally collected revenues.

Now that the economy has normalized and their federal money has largely been spent, a number of states are struggling to make ends meet. Three dozen of them experienced a revenue drop in the past year, and at least five now have serious budget shortfalls. Nonetheless, most states reportedly met their fiscal 2024 budget projections, which had anticipated lower revenues. For most, the problem now is what to do to balance their budgets after all those high-tide tax cuts.

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