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How the State Budget Crisis Could Derail Economic Rebound.

Holes in state budgets, growing wider as the coronavirus pandemic persists, are a big risk to economists' predictions that the U.S. economy begins to grow again later this year.

Current economic conditions present a substantial challenge for state budgets, say a team of strategists at Morgan Stanley. With nearly 30 million Americans so far unemployed due to the virus and efforts to contain it, joblessness is reducing taxable income and declining retail activity is cutting sales-tax revenue, among other dynamics. Already, unemployment has hit 20% or more in eight states including Michigan, New York and Georgia.

State and local government jobs accounted for 13% of total nonfarm payrolls in 2019, Morgan Stanley notes, and a heavy round of state and local job losses added to the mix would put further upward pressure on the unemployment rate. Since state and local governments can't run deficits, they have to cut expenses—often in the form of layoffs—when tax revenue declines. The strategists say the state and local sector has historically lagged behind in both recessions and recoveries, meaning job losses at the state and local level haven't yet started to pile up.

In terms of broader gross domestic product , state and local government spending equates to state and local government hiring, Morgan Stanley says, because about 75% of state and local spending within the GDP calculation is on the compensation of state and local government employees. Investment spending, such as on highways and other infrastructure projects, accounts for the remaining amount of state and local output. Such spending accounts for about 2% of total U.S. GDP, they say, which means a 10% decline in state and local investment spending would shave 0.2 percentage points from real GDP growth in any given year.

Heading into the pandemic, many states already faced substantial budget shortfalls. Now, estimates are getting revised even lower. In Illinois, where unemployment has hit 12%, the state now projects a 2021 revenue shortfall of 11% of total tax collections. That's as individual income tax is projected to be down 7% and 9% in 2020 and 2021, respectively, corporate income tax is expected to fall 12% and then 18%, and sales-tax revenue is estimated to be down 8% and 18% in 2020 and 2021, respectively.

Illinois is just one example. For states in aggregate, Morgan Stanley predicts the current recession will wipe out three years of state tax revenue growth in its base-case scenario and six years in its bear case. The result is a budget gap ranging from $40 billion to $380 billion over this year and next, the strategists say.

"We see the hole in state and local government revenues as a downside risk to the U.S. outlook should [state and local governments] need to take severe measures in order to balance budgets as they approach the important July 1 date when the state fiscal year begins," the Morgan Stanley strategists say. They suggest the impact on the broader economy will be much greater than the hit during the last recession, when state total tax collections fell 9.5% from peak to trough as income-tax revenue dropped 15% and sales-tax revenue slid 8%. That added up to help produce a 2.5% decline in overall real GDP. Already, the analysts predict a 5.5% contraction for 2020.

Aside from broader economic implications of struggling state and local governments, there are a couple of upshots for investors. One is around downgrade risks if there isn't more fiscal aid targeting states. The Morgan Stanley strategists say they like the high-grade muni market, but they advise investors to stay underweight states and locals relative to enterprise credits such as electric and water utilities.

Second, the analysts say there are two sectors that stand out as particularly exposed to state budgets. Non-residential construction and machinery may be negatively affected, as states reduce capital spending, while gambling may get a lift as more states consider authorizing and taxing sports betting and online gaming to mitigate revenue shortfalls.

Barron's

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May 5, 2020 10:02 am ET