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With $350 Billion, States Won't Hold America Back This Time.

To judge the success of this latest round of fiscal aid, watch local government employment.

Credit-rating firms typically take a gradual and measured approach when evaluating the effect of a recent development on a certain company or segment of the economy. So it was eye-catching last week when Moody's Investors Service sent out a report that declared in no uncertain terms: "The $1.9 trillion American Rescue Plan Act will be a credit positive measure across all municipal finance sectors."

Within hours, Moody's formally revised its outlook on U.S. states and local governments to stable from negative, given the legislation's provision for $350 billion in aid. "It will help stabilize state finances and, coming amid most states' legislative budget sessions, likely allow them to avoid downstream funding cuts for local governments, colleges and universities, and other programs," analysts led by Nicholas Samuels wrote.

This kind of infusion into state government coffers was far from a sure thing. Democrats had been arguing for such aid since the beginning of the pandemic, while Republican opposition grew stronger as revenue collections turned out to be better than initially estimated. California, for instance, is now expecting a $15 billion budget surplus this fiscal year. "The notion that our states and municipalities are in some kind of fiscal crisis just couldn't be more wrong. It's just factually untrue," Senator Patrick Toomey of Pennsylvania said earlier this month.

Simply looking at the bottom lines of state budgets doesn't tell the whole story, however. The most straightforward sign that federal assistance was necessary is the level of state and local government employment, as measured by the Labor Department. At a combined 18.58 million people, the number of jobs is down about 1.4 million from February 2020 and only slightly higher than the low set in May 2020.

It's stunning to think back on the Great Recession and realize that state and local government employment didn't reach its ultimate low point until July 2013, more than four years after the downturn officially ended. That's because governors and mayors were in full-blown austerity mode: In addition to trimming payrolls, many also put off critical infrastructure projects, shortchanged their pension funds at precisely the wrong time and even found ways to borrow to cover deficits.

Toomey, who has never held state or local office, doesn't know what it's like to make those difficult choices because the federal government doesn't ever really need to balance its budget because it issues the U.S. dollar. Yes, the pandemic didn't turn out to be quite as dire for certain areas of the country, particularly those with high-wage earners who could work from home and benefit from record-high stock prices and a surge in home values. Overall, the net worth of households and nonprofits at the end of 2020 stood at $130 trillion, an increase of more than 10% from a year earlier. But everything about municipal finance is local: For every state like California that held up better than expected, there are those such as West Virginia and Mississippi, where the labor force participation rate has plunged to less than 56% compared with the national average of 61.4%.

According to Moody's, states will be allocated funds based primarily on their share of unemployed workers, which seems as good a way as any to distribute aid. Still, as the Bloomberg Editorial Board wrote earlier this month, there's no reason federal support couldn't be more systematic, with money automatically flowing into a state's coffers when its economy enters a downturn, as measured by objective figures such as the level of joblessness. The Federal Reserve acted swiftly to prop up credit markets, for example, and they responded with a V-shaped recovery. The same can't be said about the state and municipal workforce.

Of course, it would be troubling if state and local government employment declined further in the coming months and would fly in the face of arguments for why the money was needed in the first place. The stimulus could be considered a success only after a few more rounds of monthly jobs data, which at a minimum should show steady upward growth in payrolls and ideally would reveal a sharp bounce back at least to the low point of the last economic recovery. That would require a gain of about 500,000 jobs nationwide, or about the amount added from May to August last year. Given where the country is in the vaccination process, that seems like a manageable hurdle.

Speaking of setting a low bar: No one necessarily expects public-sector employment to be the engine that propels the U.S. economy back to its pre-pandemic heights. All that's needed for a more robust recovery than the last one is for states and municipalities to not serve as a drag on growth. The Metropolitan Transportation Authority is an obvious example — to the extent these federal funds can help it move forward on capital projects and avoid steep service cuts to New York City's subways, that should bolster the $1.8 trillion economic output of the metropolitan area. Another troubled borrower, the Chicago Board of Education, won an upgrade from Moody's last week thanks in part to "a very sizable infusion of federal funds." The third-largest U.S. school district is still rated speculative grade but at least isn't doomed to failure.

Meanwhile, municipal bonds, which I called arguably the most expensive asset class anywhere last month, remain about as rich as ever, holding their ground in the face of a sharp selloff in U.S. Treasuries. Before, analysts largely credited a supply-demand imbalance for the strength of munis. Now, on top of that, the market "reflects a substantial amount of optimism — and I think well placed optimism about the strength of credit quality," Morgan Stanley's Michael Zezas said.

At this point, many indicators are trending in the right direction for an economic recovery. State and local government employment hasn't yet picked up, but $350 billion available through 2024 should be enough to avoid repeating the mistakes of the post-2008 period.

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