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How States Can Address Their COVID-19 Budget Shortfalls without Federal Bailouts

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KEY TAKEAWAYS

Bailing out states for reckless policy decisions would likely delay economic recovery, cause blatant inequities, and shift the costs to all taxpayers.

Instead of relying on a federal bailout, states can address near-term budget shortfalls by enacting sound policies that also generate long-term benefits.

States should safely re-open parts of society, scale back spending increases, encourage employment opportunities, and reform broken pension plans.

Regardless of the number of COVID-19 cases, state and local governments across the country are feeling the impact of the virus on their economies and budgets. While the federal government's response to date has gone, and will continue to go, a long way toward easing the financial burdens of COVID-19 containment measures, many individuals, families, businesses, and state and local governments will still face significant financial shortfalls that could last beyond 2020.

Many governors and federal lawmakers are calling for a nearly $1 trillion federal bailout for state and local governments, arguing that states face greater borrowing constraints and higher borrowing costs than the federal government. Instead of aiding the recovery and encouraging responsible budgeting, socializing state budgets would likely delay economic recovery, cause blatant inequities, and result in higher costs for everyone.

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Instead of relying on the federal government, state and local governments can and should use kitchen-table budgeting to address COVID-19 shortfalls, as well as long-term budget gaps. States can do this by safely re-opening parts of society, scaling back recent spending increases, making their public employee compensation and pension systems more efficient and more competitive with the private sector, and creating favorable tax and work environments. The federal government can help by freeing states from unfunded federal mandates.

The absence of federal taxpayer dollars for state and local government shortfalls could be a silver lining for state and local taxpayers, driving more efficient, priority-based budgeting as well as kick-starting action on necessary reforms upon which policymakers typically prefer to "kick the can down the road."

To address short-term shortfalls and set the stage for a robust recovery and long-term prosperity, state and local governments should:

Re-open Parts of Society Safely. Saving lives and livelihoods go hand in hand. In addition to the loss of lives that COVID-19 has caused, it has also resulted in significant consequences to Americans' health and well-being, and their financial security. While not all parts of society are ready to re-open at once, the only pathway to reversing the damage caused by COVID-19 is for local governments to apply an informed, data-driven, and surgical approach to re-opening parts of society.[1] All medical offices should promptly be allowed to re-open, as government closure of "non-essential" health care adversely affects Americans' ongoing health needs, has caused unnecessary furloughs of health care workers, and threatens the survival of medical facilities. Health care workers are well-trained to mitigate the spread of the disease while providing both essential and preventative care.

Additionally, child care providers should be allowed to re-open under new safety guidance, and schools should prepare to re-open as soon as possible this fall. With about one-third of children under age five attending some type of child care program, and both parents working in two-thirds of families with children, child care is essential for allowing parents to return to work.[2] Moreover, the evidence thus far shows that children are less likely to catch or pass the virus to others, though additional safety precautions should still be implemented.[3] Relaxing unnecessary regulations that drive up the cost, but not the quality, of care would help providers to focus on essential safety measures without driving up costs for parents.[4] States should give flexibility to child care centers to implement physical distancing and appropriate group sizes, as strict rules enforced for essential child care workers have severely restricted the supply of care and could more than double the already high cost of care if centers are required to maintain such standards.[5]

Other businesses, such as retail stores, restaurants, offices, and small-scale entertainment sites should be allowed to re-open so long as they can maintain appropriate physical distancing and other safety standards. In all instances of re-opening, employers should seek to provide flexibility and accommodations to at-risk workers, such as remote work options, back-office work, or high-grade personal protective equipment.

Cut Back on Recent Spending Increases. Between 2000 and 2019, state and local government spending increased 30 percent after adjusting for inflation and population, but not all states have grown equally.[6] Florida's state-level spending *decreased* 16 percent, Texas had a modest 5 percent increase, New York's spending rose 49 percent, and California's was up 52 percent.[7]

States that have experienced significant increases should analyze the sources of their increases and prioritize their spending by scaling back on unnecessary and inefficient spending. For example, Medicaid spending per recipient jumped 20 percent in New York—almost three times the rate of medical inflation—between 2016 and 2019.[8] Had costs remained at their 2016 levels, New York would have saved $20 billion in 2019.[9] New York Governor Andrew Cuomo's (D) pre-COVID-19 proposal to address the state's $6.1 billion budget shortfall included $2.5 billion in proposed Medicaid savings, but it is likely that the state could reduce total Medicaid spending further without simply shifting more of the state's costs to the federal government.[10]

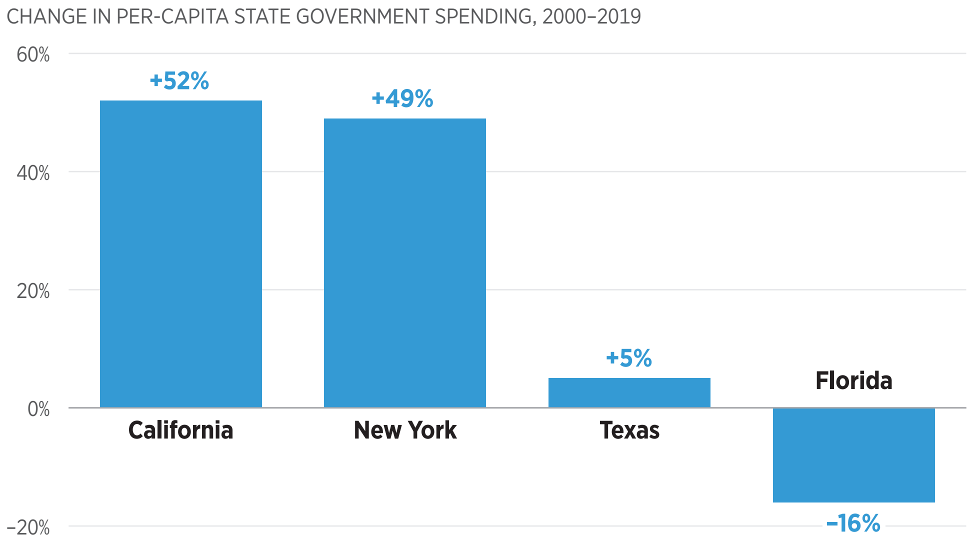
Moreover, states with high per capita spending should look to states with lower levels of spending to see how they may be able to better prioritize limited resources. When it comes to education, for example, Florida spends $9,075 per student,[11] allows choice in education options, and has experienced tremendous gains in achievement, particularly among minority students.[12] Meanwhile, New York State spends more than twice as much, at $23,091 per student, and has experienced fewer achievement gains.[13]

Bring Public Employee Compensation in Line with the Private Sector. According to the most recent data from the Bureau of Labor Statistics, average state and local employee compensation is 50 percent greater than private-sector compensation.[14] This gap has grown significantly in recent decades, driven primarily by rising benefit costs. Between 1998 and 2017, the real value of state and local employee benefits increased 90 percent, compared to a 39 percent rise in private-sector benefits.[15] Not all states provide equal compensation premiums, however. In Indiana, Kansas, North Dakota, and West Virginia, the difference between public-sector and private-sector compensation is less than 25 percent, while in Alaska, California,

CHART 1

How the Four Largest States Compare in State Spending

California and New York increased per-capita state government spending by around 50 percent since 2000. By contrast, Texas' increase during that time was modest, and Florida had a significant decrease.



SOURCE: Heritage Foundation calculations based on spending data from individual state governments and population data from U.S. Census Bureau.

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Nevada, Oregon, and Wyoming it exceeds 70 percent.[16] Actions that bring public-sector compensation in line with the private sector can significantly reduce government costs and increase efficiency while providing new ways to attract, reward, and retain a qualified public-sector workforce.[17]

Comprehensive reform takes time, but even small reforms can generate significant short-term savings for state governments. For example, skipping an annual 2 percent cost-of-living adjustment for 2021 could save states a collective $26 billion.[18] A one-year pay freeze could save up to twice as much. While some state lawmakers have the authority to enact temporary freezes or cuts, others do not. States that do not provide such authority should consider enacting emergency authority to adjust compensation costs.

Public-employee health care costs, at an estimated $234 billion per year across the states, are another area ripe for savings. States should integrate health savings accounts (HSAs) into their employee benefit plans. Coupling an HSA with high-deductible coverage has become a more popular option for private-employer-provided plans, and states should consider this combination as an option for their workers. Furthermore, as the Administration released new rules to expand the use of health-reimbursement arrangements by employers, states should consider incorporating these flexibilities into their public employees' benefits.[19]

Already, many states are taking measures to limit compensation costs in the short term: Pennsylvania froze many workers' pay; New York postponed pay increases; Hawaii proposed pay cuts and a hiring freeze for public-sector workers; and Ohio, Tennessee, and Virginia announced hiring freezes. Many other states have also taken measures. Yet, some, such as Illinois, remain intent on not curbing their spending and instead counting on federal bailouts. Illinois' general assembly just adopted a budget that includes record-high spending, a $6 billion deficit, no reductions in personnel costs, rather large pay raises for unionized state workers and lawmakers (Chicago teachers will receive a 24 percent pay raise between 2019 and 2024),[20] and excessive retiree costs that consume almost a third of the state's own-sourced revenues.[21] Illinois' plan to pay for this record-high spending is to borrow from the Federal Reserve and count on a federal bailout to pay back the loan.

Flexibility on compensation costs is crucial in a fiscal crisis, and there is no reason why some state and local government employee compensation should continue on autopilot—including significant pay increases potentially paid for by federal taxpayers—while other governments and private-sector companies are necessarily reducing their spending with short-term salary freezes, skipped retirement contributions, and even pay cuts.

Reform Public-Sector Pensions. Having promised more in pension benefits than they set aside to pay, most state and local governments across the U.S. face rising pension costs that consume a growing share of revenues. In Illinois, retiree pensions alone consume 25 percent of the state's general funds budget—up from less than 4 percent between 1990 and 1997.[22]

While all states face pension shortfalls, some states have acted to rein in their unaffordable costs as others have continued to increase their pension costs. An analysis by Andrew Biggs at the American Enterprise Institute showed that about a third of states reduced their pension costs for active workers since 2000, but the majority increased their pension costs.[23] Between 2000 and 2016, Colorado reduced its pension costs from 18 percent of workers' wages to 10 percent; Florida reduced its from 17 percent to 10 percent; and Oregon reduced its costs from 29 percent to 19 percent of workers' wages.[24] Meanwhile, California increased its pension costs from 19 percent of workers' wages to 26 percent, Hawaii's costs rose from 10 percent to 18 percent, and Nevada's costs jumped from 25 percent to 37 percent of workers' wages. In comparison, the typical private-sector company that provides a 401(k) retirement plan offers an employer match equal to 3 percent of workers' wages.

Solving unfunded state and local pensions requires comprehensive reforms that ensure that governments fully fund the pension promises they make, and that bring public-sector retirement benefits in line with private-sector benefits, including ownership and portability. Even small changes, however, could result in significant short-term savings that would compound over time. For example, eliminating pension spiking—the common practice of boosting an employee's salary in his or her final years of work, upon which pension benefits are calculated—could save states hundreds of millions of dollars.[25] In Illinois, the difference between 2 percent and 6 percent annual salary increases during a teacher's final years translates into $380,000 in additional pension benefits.[26] In the short term, skipping just one year's worth of an otherwise 2 percent cost-of-living adjustment to pensions could save states a collective $6 billion in 2021, and generate $66 billion in savings over the next 10 years. Moreover, suspending pension contributions and accruals for one year—similar to what some private-sector companies are doing to avoid layoffs or health benefit cuts[27]—could save states up to $234 billion. This alone would cover a significant portion of an estimated $279 billion in state and local revenue losses for 2020 (based on an estimated 15 percent revenue decline).[28]

Create Favorable Tax Environments. States have vastly different tax systems; some levy high, and highly progressive, income taxes while others have no income tax and rely primarily on more stable and economically efficient sales taxes and property taxes. During recessions, income falls more than spending (because people use both personal savings and safety net programs like unemployment insurance), leading to highly volatile income tax revenues. While individual income taxes declined 16 percent and corporate income taxes fell 25 percent from 2008 to 2010, sales taxes declined only 8 percent.[29] Excise taxes and levies on natural resources are also highly volatile. States that rely heavily on income taxes and excise taxes should shift their systems to rely on more stable and less economically damaging sales and property taxes. This could help high-income-tax states like New York, Connecticut, New Jersey, and Illinois that are losing residents to lower-tax states to become a more attractive place for people to live and work.

TEXT BOX 1

Responsible State Responses to COVID-19 Budget Shortfalls

In order to address their budget shortfalls, states should:

- Apply an informed, data-driven, and surgical approach to safely re-open health care and child care facilities, restart business activities, and prepare to re-open schools.
- Allow businesses that can operate with appropriate safety measures to re-open and to provide flexible accommodations for at-risk workers.
- Cut back on recent state-spending increases and look to examples of efficient state spending.
- Bring employee compensation in line with the private sector.
- Implement temporary pay freezes, hiring freezes, or pay cuts to save money and avoid layoffs.
- Limit public-sector health care costs.
- Reform public-sector pensions for short-term and long-term savings.
- Consider suspending pension accruals, similar to private-sector 401(k) suspensions.
- Create favorable tax environments by relying less on volatile income and excise taxes.
- Tax unemployment benefits as income (the $600 per week federal unemployment bonus has caused most unemployed workers to receive more from unemployment than from paychecks).
- Foster favorable work environments by removing unnecessary licensing barriers and enacting Right to Work laws.
- Repeal California's AB5 law; other states should refrain from enacting similar barriers to independent and gig-economy work that will be particularly important with high unemployment.
- Refuse to set excessively high minimum wages that limit job options, and pause or roll back recently enacted minimum wage increases.

In addition to these state actions, the *federal government* should:

- Remove the unfunded mandates that it places on states.

In the immediate term, the handful of states that tax income but do not tax unemployment insurance benefits should improve the equity and efficiency of their tax systems by taxing unemployment benefits at the same level as wages. Unemployment benefits are effectively income, and it is economically irrational and inequitable not to tax unemployment benefits the same as wages. This would provide a significant boost to those states' revenues in the short term, as one of four workers has filed for unemployment insurance since March, and the majority of these workers are making more than 130 percent of their usual earnings due to the new federal pandemic unemployment insurance program that, among other expansions, provides an additional $600 per week to every unemployed worker through July 31.

An analysis by J.P. Morgan estimated that these bonus benefits "may result in a remarkable 0.5% increase in personal disposable income this year vs 2019."[30] For equity's sake, individuals who are receiving as much, or more, from not working as they would from working should not pay less in taxes than those who are working.

Fostering Favorable Work Environments

Work is foundational to the American dream. In addition to providing income, work has positive effects on physical and mental well-being, it connects individuals to the community, and realizing one's value in work is central to personal contentment. With one of four workers having filed for unemployment insurance benefits since the COVID-19 pandemic began, policymakers must focus on cultivating an environment that produces opportunities for work. With a significant number of businesses—particularly small businesses—likely to either close their doors for good or to cut back on the number of employees, workers need options both within and outside traditional employment.

Do Not Outlaw Flexible Income Opportunities. Policies like California's AB5 law, which redefines the definition of an employee to effectively outlaw many forms of independent work, would be particularly damaging in the immediate term. According to the "Freelancing in America 2019" report (freelancers include contractors, gig-workers, and anyone who works for themselves), 76 percent of workers who do not freelance say they would consider freelancing if there were a recession. That is likely because independent workers tend to have more control over their incomes: 93 percent of full-time freelancers say "If I ever need to, I can work more to earn more money."[31] Freelance work also provides income opportunities that are otherwise not available, including for the 46 percent of freelancers who say they are unable to work for a traditional employer because of personal circumstances, such as health conditions and family situations.[32] California voters will have the opportunity to repeal this harmful law as part of a ballot initiative in the November elections. Meanwhile, policymakers should welcome and support non-traditional employment options and work platforms that open up doors, especially as COVID-19 has closed many employment doors in the short term and potentially long term.

Eliminate Unnecessary Licensing Requirements. Licensing is another area in which state lawmakers can help to reduce barriers to work. While certain professions, such as medical providers, require a specified level of training and proven knowledge to protect public health and welfare, individuals should not need to invest hundreds of hours and potentially thousands of dollars to obtain a government-sanctioned license to create flower arrangements, braid hair, sand floors, or fix residential doors.[33] Moreover, when licensed individuals want to move to another state, they often have to obtain a new license to practice the very same profession.

Variance in licensing requirements across states reveal that many licensing systems function more like cartels than public health protection measures, enacting barriers to entry that limit competition, reduce the supply of skilled services, and drive up costs for customers.[34] Moreover, licensing has been shown to disproportionately burden low-income Americans, military families and veterans, people with a criminal history, immigrants with work authorization, and dislocated and unemployed workers.[35] With one in four workers having filed for unemployment amid the COVID-19 pandemic, individuals need more options to earn incomes and should have the choice to purchase many goods and services from unlicensed, lower-priced providers.

Individuals should also have the option to move into another state without having to obtain a new license. Amid the COVID-19 pandemic, multiple states have enacted emergency measures to grant temporary licenses to out-of-state nurses and doctors. Such provisions should be made permanent and extended to more licensed professions. States should follow the actions that Arizona, Pennsylvania, and Montana took in 2019 by passing laws that effectively grant reciprocity to licensed individuals from other states.[36]

Support the Right to Work. Another way to invite more jobs into a state is to enact right-to-work laws, which allow workers to choose whether to join a union, as opposed to workers being forced to pay union dues as a condition of employment. Economic research shows that companies are more likely to locate in states with right-to-work laws, and that right-to-work laws result in higher employment, output, and personal income.[37] The benefits of right-to-work laws also include increased investment, higher research and development spending, and greater innovation.[38] The 22 states that do not have right-to-work laws should promptly enact them.

Reject, Postpone, or Eliminate New Minimum-Wage Increases. Finally, states should avoid imposing artificially high minimum wages. Research shows that minimum-wage increases—particularly large increases, such as doubling the minimum wage from $7.25 to $15—create a survival-of-the-fittest labor market, eliminating jobs for inexperienced, marginalized, and lower-skilled workers, while resulting in lower total incomes, higher prices, and higher deficits.[39] A $15 minimum wage translates into more than $35,000 in costs for employers, but many individuals have not yet accumulated the education and experience to produce $35,000 worth of value.[40] With small businesses and lower-wage workers already among the hardest hit by the economic impacts of COVID-19, setting artificially high minimum wages could drive more companies out of business and disproportionately eliminate jobs for lower-wage workers. States that have recently enacted minimum-wage hikes should eliminate or at least postpone scheduled increases and consider reversing recent increases to open up more doors to less-experienced or marginalized workers. This could particularly benefit young individuals who may not be able to attend school as planned by giving them more opportunities to obtain valuable work experience and income to prepare for their futures.

Better Federal Response than Bailouts: Release States from Unfunded Mandates

The federal government currently imposes requirements on states that result in unnecessary costs. One recent example, enacted in the Families First Coronavirus Response Act, is the new mandate for state and local governments and small businesses to provide up to 12 weeks of paid sick leave and family leave to their employees in 2020. While small businesses can receive tax credits to offset the costs, state governments are not eligible for the credits. Congress should remove this mandate, rather than sending money to cover the costs or expanding access to the tax credits.[41]

Similarly, Congress should remove unfunded mandates included in federal education funding. For example, by refocusing its activities on Title I ("Improving the Academic Achievement of the Disadvantaged") and allowing state and local governments to determine the best ways to fund educational services without interference from Washington, the U.S. Department of Education could free up financial resources for states. Moreover, Congress should make permanent the CARES Act's temporary relaxing of some educational funding requirements, such as allowing schools to carry forward unused Title I and other funds from year to year.[42]

Another way that the federal government drives up costs for state and local governments is through the Davis–Bacon Act, which was originally passed in 1931 as a Jim Crow policy to prevent African American workers from undercutting white workers on federal construction projects.[43] As such, it requires any construction project that receives federal funds—including many state and local government construction projects—to pay artificially high "prevailing wages," exceeding actual market wages by about 22 percent.[44] Both the Department of Labor and Government Accountability

Office have, for decades, criticized the methods used to calculate "prevailing wages" as unscientific and flawed.[45] A Heritage Foundation analysis estimated that repealing the Davis–Bacon Act could reduce construction costs by at least 10 percent.[46] This could free up state resources or, if used to increase construction, generate an estimated 30,000 new construction jobs that would provide opportunities for newly jobless workers without increasing spending.[47]

Conclusion

The COVID-19 public health pandemic has caused widespread hardships to American society, from federal, state, and local governments, to businesses small and large, and to every American household. It is impossible to erase the consequences of COVID-19, but it is possible—and necessary—to combat the public health crisis and address its economic consequences at all levels. Just as deciding in advance to split the tab equally at restaurants typically results in higher total costs (because each person has the incentive to spend more if he feels he is only paying a portion of his own tab), socializing state and local government shortfalls would exacerbate the economic consequences of COVID-19 and push even higher costs onto taxpayers.

Rather than seek federal bailouts, states can address their near-term financial shortfalls by enacting sound economic policies that will also generate long-term benefits. First, states should seek to safely re-open parts of society with an emphasis on medical care and child care. States should also implement more competitive and efficient governance through reform of public employee compensation and pension systems. Lastly, by taking steps to implement more pro-growth tax policies and more welcoming work environments, states can alleviate short-term revenue shortfalls and high unemployment levels, with the added benefit of creating more prosperous societies in the long term. Instead of providing bailouts, the federal government should help states to cope with revenue losses by relieving them of the burden of unfunded federal mandates.

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