Policy Memo

To: Dr. John Yinger

From: Ulises Sepulveda

Subject: Analysis of COVID-19's impact on New York State's economy and tax revenues in fiscal year (FY) 2021, and recommendations for tax revenue resilience-building and fiscal sustainability

Date: May 09, 2022

Introduction

The budgets of state and local governments come under severe stress during economic downturns. The fallout of the COVID-19 pandemic posed unprecedented challenges to New York State's economy and impacted local and state finances in the fiscal year (FY) that ended on march 31st, 2021.

Unlike the federal government that can issue both short and long term general obligation debts, local and state governments have legal authority restrictions to issue debt for unforeseen spending or revenue distresses. Furthermore, local governments also face legal limits on raising tax rates. These constraints place tremendous pressure on balancing state income streams and expenditures during economic disruptions. The purpose of this memorandum is to analyze and evaluate the impact of the COVID-19 pandemic on New York State's economy and tax revenues in FY 2021, making several recommendations for tax revenue resilience-building and fiscal sustainability.

Impact of COVID-19 crisis on NY State's economy

The impact of the COVID-19 pandemic on NY's economy has been drastic, particularly on small businesses. Small businesses are the backbone of NY's economy, accounting for 98% of businesses. For instance, 80% of small businesses in NY continue to report a negative overall impact from COVID-19. Even a year after the COVID-19 pandemic began, small businesses continue to suffer. This is in spite of gradual reopening and employment recovery.

Seventy-eight percent of small businesses with less than 500 employees reported an overall negative impact in their business in the first week of March 2021 as per the U.S.

Census Bureau. This share has declined from 94 percent in April 2020 to approximately 72 percent in March 2021. Therefore, the state tax streams are affected negatively since tax collection falls due to lack of business and economic activity.

Job losses from the resulting economic shutdown were massive. Employment declined by nearly 2 million jobs from February to April 2020 in New York. According to data from State Department of Labor, less than half of the jobs lost during that time have been recovered. Employment is still more than 1 million jobs below pre-pandemic levels.

The leisure and hospitality industry sector was the most impacted. This sector suffered a 30 percent employment decline of the State's total despite representing only 9.8 percent of total employment. On a positive note, the leisure and hospitality sector has recovered the largest number of jobs, nearly 260,000 since May 2020. Nonetheless, these gains represent only 43 percent of the jobs lost.

The construction industry is furthest along in its recovery, regaining almost three-quarters of the jobs lost. Job growth has also been strong in retail trade, and health care and social assistance, which gained 170,700 and 143,200 jobs respectively. These job gains represent 67 percent and 59 percent of jobs lost respectively. On a different note, the information industry has regained just 16 percent of jobs lost, although it suffered comparatively few losses.

While some New York industries are on the path to recovery, others are not on the same track. Some industries such as the educational services, government, and financial activities continue experience job losses. The finance and insurance industries, lost about 7,000 jobs since May 2020, in addition to the 8,100 job decline in March and April of 2021 after seasonal corrections.

Policy Memo

NY State revenue amid the COVID-19 pandemic outbreak in FY 2021

Real property taxes and sales taxes are major sources of local revenue in New York State. Based on NY's 2021 Financial Condition Report, property taxes remained the largest source of local government revenue, accounting for $36.6 billion out of the $85 billion in total revenue without including New York City. School districts and towns received $22.9 billion and $4.3 billion in revenues from property taxes representing 53 percent of total revenue. Villages received $1.4 billion while fire districts are the most dependent on property taxes pulling $0.8 billion.

It is important to note that the allowable levy of 2 percent is increasing again after a declining property tax. The calculated allowable levy growth dipped below 2 percent for all local governments. As low inflation rates during the pandemic took hold, allowable levy growth dropped. While it did not approach the near-zero growth seen in 2016, these reductions reduced local government budgetary flexibility. With inflation increasing, allowable levy growth increased to 2 percent for local governments with fiscal years beginning on January 1, 2022.

State aid is the next largest revenue source for local governments. This is a major source of funding for school districts, accounting for $16.2 billion. State aid also represents an important revenue share for local governments, specifically for social service programs in counties and for highways in cities and towns.

Sales and use taxes are also another important source of revenue for local governments, representing $11 billion. These are also the largest single revenue source for counties. However local sales tax collections declined by $1.8 billion. This resulted from the impact of COVID-19 on New York's economy, especially during the 2020 spring shutdowns. As restrictions ease, sales tax collections improved in spite New York City's collections were still below pre-pandemic levels.

Policy Memo

Measures enacted to offset the effects of COVID-19 on state and local budgets

The American Rescue Plan Act of 2021 provided New York State approximately $45 billion in fiscal relief to governmental entities and major institutions. New York State received $12.6 billion, New York City received $5.9 billion and other local governments received $4.9 billion. There was an additional funding of $9.0 billion for K-12 education, $2.6 billion for higher education institutions including the State and City Universities of New York, and $6.5 billion for the Metropolitan Transportation Authority and Medicaid reimbursement, among other programs.

Similarly, New York State issued $634 million of voter-approved General Obligation (GO) bonds to finance a variety of critical projects. These bonds supported environmental, transportation and education projects as well as refinancing for older bonds while achieving $50 million in savings to taxpayers. The bonds, which were priced by competitive bidding, outperformed expectations.

GO bonds were anchored on the full faith and the good credit score of the State of New York. This guarantee is attractive to investors in the municipal bond market. The market priced these tax-exempt GO bonds between 1 to 2 basis points (bps) below the benchmark Municipal Market Data (MMD) index. Other similar GO bonds were priced up to 45 bps higher. Hence, these reduced interest rates translate to long-term savings for New York State taxpayers.

Recommended actions for tax revenue resilience-building and fiscal sustainability

Recommendation #1: Tax and Expenditure Limits (TELs) as fiscal measures to achieve long-term fiscal sustainability

Tax and Expenditure Limits (TELs) shape local fiscal policy. TELs restrict the growth of government revenues or spending by either capping them at fixed-dollar amounts or limiting their growth rate. This is to match increases in population, inflation, personal income, or some sort of combination of these factors.

TELs are important in cities that rely on property taxes as a major revenue source. Terms and conditions can vary across states and over time. For example, California imposes a 2 percent limit on annual property tax levy growth, while Pennsylvania sets the growth limit at 10 percent. As such, the priority is keeping revenue and spending in check for balanced budgets.

Many municipalities tend to set property tax rates below maximum allowable thresholds. For both political and economic reasons, municipal leaders face intense pressure to keep property taxes low. The difference between a municipality's maximum allowable property tax levy and its actual tax levy can be defined as the TEL gap. This gap is a crucial element of a city's fiscal flexibility. A large TEL gap suggests that a state's property tax limitation is less restrictive, whereas a small TEL gap reflects a more restrictive property tax limitation.

On average, states with TELs implemented have higher gross state product growth, personal income growth, and population growth. For instance, Colorado's Taxpayer Bill of Rights (TABOR) allows government spending to grow each year at the rate of inflation-plus-population. Before TABOR, state government taxes and spending were rising at more than double the rate of inflation plus population growth. After TABOR, Coloradans' personal income growth was 15.6% greater than the national level. Similarly, TABOR returned $3.3 billion to taxpayers over a decade. Over this period, private job growth in Colorado was 37.8%, but shrunk to 4.5% shortly after becoming inactive the subsequent year. Consequently, New York State can adopt a similar approach for budget-balancing and comprehensive fiscal policy without cutting back on public services.

Today TABOR is still active, however policymakers ought to be cautious as states can bypass a TELs through different spending procedures. Stricter TEL laws are associated with local level governments receiving more state aid or diversifying their revenue sources to bypass a TEL. TELs also come with caveats as TELs can lead to lower service levels without improving government efficiency in service delivery. In turn, level of service is not only negatively affected but also the quality of these services suffers. There needs to be a balance between imposing restrictions on revenues or spending through TELs and maintaining service quality. As such, budgets can be balanced with comprehensive TELs while improving government efficiency and delivering quality services

Recommendation #2: Strengthening Rainy Day Funds (RDFs) for continuity of public services

The COVID-19 crisis and resulting economic disruptions strain state government budgets. Unlike the federal government, states are required to balance their general fund budgets each year. Since the economy shrinks during crisis, state income tax revenues tend to fall and budget gaps rise. In this case, rainy day funds (RDFs), also known as budget stabilization funds, are an important tool for managing fiscal uncertainty, enabling NY State government to avoid counterproductive tax increases or service cuts. Hence, RDFs allow states to set aside surplus revenue for use during unexpected deficits for public service continuity.

Every state has some type of rainy day fund, though deposit and withdrawal rules vary across each state. Currently, NY State's rainy day reserves stand at $3.3 billion, which is well below the statutorily authorized $6.4 billion or 5% of state operating funds. Determining the right size of the fund is complex. Based on past revenue trends, 15 percent of tax revenues covers the necessary state spending funds in case of a future economic downturn. This target size would help to mitigate a recession or emergency.

Regular deposits are required during economic expansion. According to citizens budget commission (CBC), annual deposits of 75 percent of all tax revenues in excess of 3 percent growth are reasonable. Spending on services grows in excess of long-term inflation and still generates substantial RDF resources. Finally, the impact of modest deposits in good times will be offset by preserving the services constituents need during economic hardship.

RDFs withdrawals should be limited to periods of recession or emergency. As a savings account to tackle the most crushing service cuts and tax increases during an economic downturn or catastrophic emergency, RDFs provide relief to mitigate volatility and promote structurally balanced budgets while keeping public services running. Economic triggers should be defined in law and procedures to ensure compliance. Lastly, fund rebuilding requirements should be clear and achievable.

The need for reserve fund safeguards is vital for tax revenues health and public services continuity. The time to prepare for serious problems is before they arrive.

Conclusion

After analyzing and evaluating the impact and implications of the COVID-19 pandemic for New York State's tax revenues in fiscal year 2021, I believe that the set of comprehensive recommendations I put forth can contribute to tax revenues resilience-building and fiscal sustainability. TELs are not a magical fiscal solution for balancing state and local governments' budgets, there are tradeoffs to be made without hampering service level and quality. Lastly, strengthening rainy day funds is crucial for public service continuity in New York State.

References

New York's Economy and Finances in the COVID-19 Era (March 18-30, 2021). (2021, March 18). Office of the New York State Comptroller.
https://www.osc.state.ny.us/reports/impact-covid-19-march-18-2021
This report on NY State's economy and finances in the COVID-19 era details the impact of the pandemic on the small business, job loss and the state's budget, highlighting important measures, trends and outcomes.

NY State 2021 Financial Condition Report. (2021, March).
https://www.osc.state.ny.us/files/reports/finance/pdf/2021-financial-condition-report.pdf
This comprehensive report covers the NY State financial conditions in FY 2021, providing information and analysis across the full spectrum of New York State Government. Two important sources of information for this memo include the sections on local government, taxes and implications for the future for FY 2021.

State Tax Revenue Passes a Recovery Milestone. (2021, May 7). The Pew Charitable Trusts. https://www.pewtrusts.org/en/research-and-analysis/articles/2021/05/07/state-tax-revenue-passes-a-recovery-milestone
An interesting analysis of how collections overcome early pandemic losses in most states and nationwide.

Implications of the covid-19 pandemic for state government tax revenues. (2020, June).
https://www.nber.org/system/files/working_papers/w27426/w27426.pdf
This working paper assesses the Covid-19 pandemic's implications for state government sales and income tax revenues.

Shoag, D., Tuttle, C., & Veuger, S. (2019). Rules versus home rule local government responses to negative revenue shocks. National Tax Journal, *72*(3), 543–574.
https://doi.org/10.17310/ntj.2019.3.03
This is a fascinating study on how home rule leads to smaller revenue drops and stronger bond ratings.

The Nation's Fiscal Health: Actions Needed to Achieve Long-Term Fiscal Sustainability. (2021, September 8). U.S. GAO. https://www.gao.gov/products/gao-19-611t
A critical view on the US national's fiscal health, calling for actions to achieve long-term fiscal sustainability.

City budgets in an era of uncertainty: Understanding the fiscal policy space of cities. (2018). https://www.brookings.edu/wp-content/uploads/2018/07/20180718_Brookings-Metro_City-fiscal-policy-Pagano-Hoene-final.pdf
This report lays out the implications and impact of tax and expenditure limits(TELs).

Evans, G. (2021, September 24). Tax Expenditure Limits Prevent Government's Balancing Act. Kansas Policy Institute. https://kansaspolicy.org/tax-expenditure-limits-prevent-governments/

This thought-provoking article covers some of the benefits and pitfalls of TELs.

Urban Institute. (2017). Tax and Expenditure Limits: How States Restrict Revenues and Spending. https://www.urban.org/sites/default/files/publication/94926/tax-and-expenditure-limits_4.pdf
This report highlights how states restrict revenues and spending, assessing whether TELs work.

Lav, I. J., & Leachman, M. (2018, July 18). State Limits on Property Taxes Hamstring Local Services and Should Be Relaxed or Repealed. Center on Budget and Policy Priorities. https://www.cbpp.org/research/state-budget-and-tax/state-limits-on-property-taxes-hamstring-local-services-and-should-be
An excellent reporting covering the shortcomings of TELs using 4 case studies and how can these be improved.

Strengthening New York City's Rainy-Day Fund. (2022). Strengthening New York City's Rainy-Day Fund. https://www.osc.state.ny.us/files/reports/osdc/pdf/report-13-2022.pdf
A set of interesting tax policy recommendations are put forth for an strengthening NYC's rainy day fund.

The Rainy Day Fund New York Needs. (2019, June 10). Citizens Budget Commission of New York. https://cbcny.org/advocacy/rainy-day-fund-new-york-needs
A fascinating framework proposal for NYC's rainy day funds.

When to Use State Rainy Day Funds. (2017, April 13). The Pew Charitable Trusts. https://www.pewtrusts.org/en/research-and-analysis/reports/2017/04/when-to-use-state-rainy-day-funds
Introductory yet exhaustive literature explaining how and when to use RDFs.

Boadi, K., & McNichol, E. (2011, February 3). Why and How States Should Strengthen Their Rainy Day Funds. Center on Budget and Policy Priorities. https://www.cbpp.org/research/why-and-how-states-should-strengthen-their-rainy-day-funds
This research study makes the case for strengthening rainy day funds.