

## U.S. Municipal Bond Market

# The Political Risk of Phase Five and the Next Three Weeks

### Summary

- The next three weeks could be the most impactful for state and local governments as it relates to the fiscal policy response to the COVID-19 pandemic.
- Meaningful aid for state and local governments is not a slam dunk, and political risk is high.
- The U.S. monetary and fiscal policy response to the pandemic has been overall substantial, but has surprisingly left state and local governments all, but untouched.

### Policy Response Left State and Local Government All But Untouched So Far

The next three weeks could be the most impactful for state and local governments as it relates to the fiscal policy response to the COVID-19 pandemic.

There is the potential for economic conditions to deteriorate further from here, despite general optimism, as a result of the reopening rollback. Meaningful aid for state and local governments is not a slam dunk, and political risk is high.

### Summary of U.S. COVID-19 Fiscal Policy Response, Expectation for Phase 5

Phase	Became Law	Legislation	Details	Amount (billions)
Phase 1	March 6, 2020	Coronavirus Preparedness and Response Supplemental Appropriations Act	Research and development, health-care services and supplies	\$8.30
Phase 2	March 18, 2020	Families First Coronavirus Response Act	Testing funds, paid leave, food stamp funding	\$192.00
Phase 3	March 27, 2020	Coronavirus Aid, Relief, and Economic Security (CARES) Act	Expanded unemployment, PPP, Fed Reserve & industry loans, payroll tax credits, created MLF, other	\$2,700.00
Phase (3.5 or 4)	April 24, 2020	Paycheck Protection Program and Healthcare Enhancement Act	Expanded PPP, hospital & testing funding	\$733.00
<b>Total Fiscal Policy Response Cost To Date</b>				<b>\$3,633.30</b>
Phase 5	August ?, 2020	Unknown	Potential: Individual unemployment benefits, employer liability protection, small business, state and local govt relief (\$500B-\$1T)	We expect \$1-2 trillion
<b>Potential Fiscal Policy Response Cost (High-end)</b>				<b>\$5,633.30</b>

Source: HilltopSecurities.

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Measures taken to reduce the spread of the COVID-19 pandemic have caused a substantial chunk of government revenues to vanish. State and local government budget shortfalls are forecast to be about \$1 trillion. So far, these governments have responded by laying off more employees through April than they did in the wake of the Great Recession. Even more government workers lost their jobs in May and June as they sought to meet balanced budget requirements. Many of those laid off were teachers. Without aid, state and local governments will continue to cut spending, service delivery will be hurt, as will the potential for a faster broad economic recovery.

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The \$150 billion of Coronavirus Aid, Relief, and Economic Security (CARES) Act state and local government rescue funds were not able to be used to shore up the holes that exist in budgets and service delivery. It is also a relatively small amount. The Federal Reserve's Municipal Liquidity Fund (MLF) made one short-term loan to one state. Although, New Jersey is considering the MLF, too. Further, the MLF played no part in the municipal bond market finally normalizing in the middle of April.

### The Next Three Weeks

For the next three weeks the focus will be on fiscal policy. Lawmakers return to Washington, D.C. next week. Both chambers will be in session until Friday, July 31. The Senate is scheduled to stay even longer, until the end of the following week, Friday, August 7. Legislators have the next three weeks to propose ideas and then come to a compromise that will shape not only what state and local government service delivery (including schools) looks like during the rest of the pandemic, but potentially for years to come.

Without federal aid, it is unlikely that we see massive tax or fee hikes. It is more likely that cuts will continue. Many of those cuts will be on the personnel side, adding to the layoffs we have already seen. It is difficult to think tax cuts will not be needed at some point, however.

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### Legislative Focus

The day after the CARES act was agreed upon (March 26), even before the President signed it into law, Speaker Nancy Pelosi made it clear that a focus of the Democrats was to attain more aid for state and local governments. Bipartisan consensus has been building for more aid since the beginning of June. This week, even former Federal Reserve chair Ben Bernanke weighed in with strong support in a New York Times op-ed titled, [Ben Bernanke: I Was Chairman of the Federal Reserve. Save the States. Congress must act decisively to avoid repeating mistakes of the recovery from the Great Recession.](#)

The Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act, passed by the House in May, included almost \$1 trillion of aid for state and local governments. But the HEROES Act was dead on arrival in the Senate. It is not even likely going to be a starting point for the negotiations.

The leading items up for negotiation in this Phase Five negotiation generally are assumed to be:

- Individual unemployment benefits
- Employer liability protection
- Expanded small business relief
- Aid for state and local governments (including schools) and other municipal entities

We expected and still expect that a total agreement that includes the above priorities could amount to \$1-2 trillion dollars, and aid for state and local governments could

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total between \$500 billion and \$1 trillion. We would characterize a number in this range as meaningful. A number less than something in this range would be problematic.

*We are expecting that the economic recovery is not only threatened, but it is very likely that trends could worsen from here.*

Now when the reopening rollback began at the end of June, we wrote that it almost ensured federal relief in July.<sup>1</sup> Our rationale was not only that the economy was not roaring back (as was being hyped), but that economic numbers were likely to worsen too.

So far, weekly jobless claims have remained extremely high (1.3 million filed for the week ending July 11, per data released July 16), and we have seen the Dallas Federal Reserve's national Mobility and Engagement Index fall since July 4. We are expecting that the economic recovery is not only threatened, but it is very likely that trends could worsen from here.

Government benefits for individuals have been key supporters of economic activity. Some of these benefits are set to expire at the end of July (nine days from now actually) and are a key issue for a Phase 5 negotiation as noted above. HilltopSecurities' Scott McIntyre wrote today about their importance:

It's these government benefits that have helped keep consumers afloat, and whether or not the federal assistance is extended later this month is critical to the economic outlook for the remainder of the year.<sup>2</sup>

### **Threat of Political Risk**

There is a political risk that aid for state and local governments does not materialize notwithstanding the lack of focus to date (the need), despite Speaker Pelosi's attention, and even though the above described economic expectation (could worsen). In the beginning of April, we highlighted the concept of political risk for state and local government aid,<sup>3</sup> just after the CARES Act was signed into law, which shortchanged governments and many other municipal entities.<sup>4</sup>

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The April and current circumstances remind us of decisions that faced lawmakers about 10 years ago. The results were not positive. This is one of the mistakes former Fed Chair Bernanke referred to in his op-ed.

The 2009 Recovery Act went a long way in helping the U.S. economy and state and local governments. However, many were expecting a Recovery Act Part II, and it did not happen because of a push for austerity. The political push for austerity measures are the leading reason a Recovery Act Part II did not happen 10 years ago. And now, whether the cause is a push for austerity or even opposition to bailing out governments—which some lawmakers see as irresponsible—the political risk is real.

Aid for state and local governments is no slam dunk.

### **Where are Republicans and the White House Now?**

In recent weeks, Senate Majority Leader Mitch McConnell has been careful to limit what he says in support of government aid. His focus recently has been on schools. Details emerged this week that Republicans and the White House want to tie billions of dollars of aid for schools to whether they open in the fall for in-person instruction.<sup>5</sup> This is likely going to be highly contested by Democrats.

In May, Republicans first shared negative sentiments about fiscally irresponsible states with large pension benefits. Today, these negative sentiments remain, which could be a substantive impediment to an agreement in the absence of a compromise.<sup>6</sup>

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### **A Fair Approach to State and Local COVID-19 Aid: Policy Idea**

It is possible to achieve the goals of both sides through negotiations and concessions. What exactly that compromise looks like is unclear at this point because neither side

has revealed its true primary desire nor started to play its hand. Back in May, an idea for a compromise was published by Wharton’s Robert Inman and Penn Law’s David Skeel:

It is possible to achieve both sides’ objectives. Congress should act as the insurer of last resort, covering the extraordinary costs of the covid-19 disaster. But it should not bail out past excesses; nor should it replace revenue loss that would have been caused by an ordinary recession, since fiscally responsible state and local governments should have rainy-day funds for that.<sup>7</sup>

*Inman and Skeel’s proposal is not the only potential approach, but it is an example of the type of back and forth that identifies the priorities of each side and helps frame potential discussion topics and outcomes.*

Their proposal is not the only potential approach, but it is an example of the type of back and forth that identifies the priorities of each side and helps frame potential discussion topics and outcomes. However, it could be difficult to come to such a complex agreement or compromise in such a limited amount of time. There is much nuance here, especially as it related to local governments. Time on the clock could also just run out. It could be especially difficult if aid for state and local governments is at the bottom of the list of priorities for lawmakers going into this very important three week period.

**The Impact: With Meaningful Aid, a Small Amount of Aid, or No Aid**

In a situation without aid or meaningful aid, local governments and schools, especially, are going to be most negatively impacted.

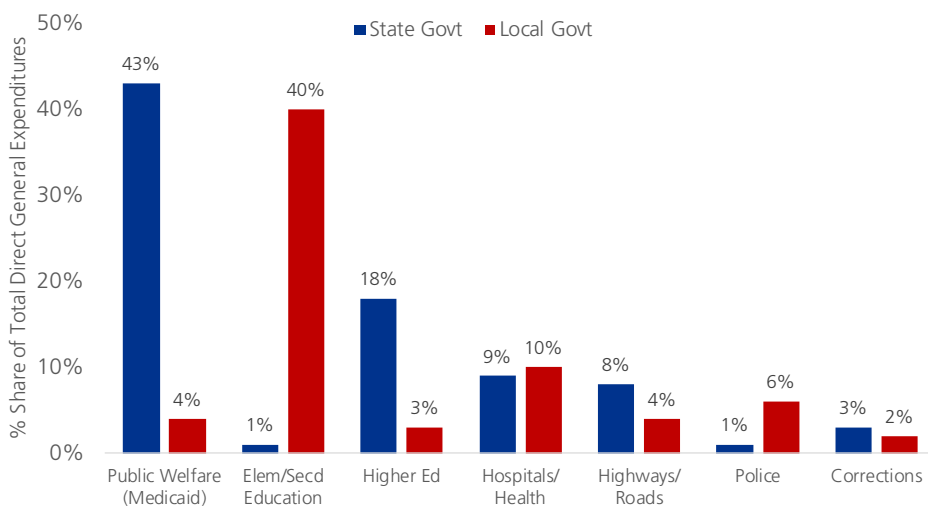
State governments have levers they can push, pull, or move around that help them maintain their fiscal statuses. The problem for local governments is that one of the levers states have at their disposal is related to local government aid. State aid that is redistributed to local governments will certainly fall at a higher pace without any or meaningful aid. Local governments, schools, higher education, and health care institutions are among those that will suffer without meaningful aid. Most worrisome is that these organizations are among those on the front lines of entities fighting to contain the spread of COVID-19.

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**State and Local Government Spending**

State and local governments currently spend about \$3 trillion on direct government expenditures, per Urban Institute data.<sup>8</sup> Typically, state governments directly raise more revenue, but those funds are often redistributed to local governments. The Urban Institute notes that states transferred about \$530 billion to local governments in 2017.<sup>9</sup>

**State and Local Direct General Expenditure Comparison, FY17**



Source: Urban Institute and HilltopSecurities.

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## Or September and October

If policymakers are not able to come to a compromise in the next three weeks for meaningful state and local government aid, there are also 15 days in September and October when both chambers will be in session. Additionally, the Senate is scheduled to be in Washington, D.C. during the week of Oct. 5-9. The election is on Tuesday November 3, 2020. Perhaps lawmakers will want to return to their districts just before the election with news of more aid.

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<sup>1</sup> Please see: Kozlik, Tom; [The New Surge Renders Thursday's June Jobs Numbers Meaningless, Almost Ensures Federal Relief in July](#); HilltopSecurities; June 29, 2020.

<sup>2</sup> McIntyre, Scott and Greg Warner; [Government Support Fuels Consumer Spending](#); Hilltop Securities; July 16, 2020.

<sup>3</sup> Please see: Kozlik, Tom; [Three Key Atypical Credit Risks & Market Update](#); HilltopSecurities; April 3, 2020; pages 3-4 for content about political risk.

<sup>4</sup> Please see: Kozlik, Tom; [Agreement on the \\$2+ Trillion CARES Act; Not Nearly Enough for State and Local Governments](#); HilltopSecurities; March 25, 2020 for more details about the funding included.

<sup>5</sup> Meckler, Laura and Erica Werner; [Trump administration, congressional Republicans eye tying school aid to reopening in the next funding bill](#); The Washington Post; July 15, 2020.

<sup>6</sup> Please see [interview of Senator David Perdue by Bloomberg's Kevin Cirilli](#); July 15, 2020.

<sup>7</sup> Inman, Robert and David Skeel; [Here's a fair approach to calculating covid-19-specific aid to the states](#); The Washington Post; May 5, 2020.

<sup>8</sup> [State and Local Finance Initiative](#); Urban Institute; Date accessed July 16, 2020.

<sup>9</sup> *Ibid.*

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