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U.S. Municipal Bond Market

Clarifying the Magnitude of COVID-19 Related Federal Aid for State and Local Governments: $277 Billion, Much Restricted

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Summary

- It seems very unlikely Washington will come to an agreement on a fifth phase of COVID-19 relief before the Nov. 3 elections.
- Since March 2020, there have been zero dollars ($0) of unencumbered aid distributed to state and local governments by Washington.
- State and local governments were allocated about $277 billion (8% of the total $3.6 trillion of fiscal policy) in different forms, but nothing that would be considered flexible enough to be deemed unencumbered.
- Some have argued one reason additional relief is not needed is because only a portion of aid has been spent to date. We consider this argument to be groundless. In fact, the rate at which funds have been spent is close to what we saw in 2009-2010 after the 2009 Recovery Act.
- There is a strong argument to be made for unencumbered state and local aid because of the procyclical nature of state and local government revenues.
- The overall impact from a Blue "Democrat" Wave scenario would be more supportive and credit-positive for municipal credit conditions compared to the current course, which is what we would expect under the other two potential election outcomes.

Relief Talks Failed to Provide Aid Before Nov. 3 Election

It has been clear to us since talks broke down at the beginning of August that the likelihood of another phase of relief that included flexible and unencumbered aid for state and local governments was elusive. Now it seems very unlikely Washington will come to an agreement on a fifth phase of COVID-19 relief before Election Day. Therefore, we wanted to review what aid, unencumbered or otherwise, has or could flow through to state and local governments. Governments are looking for aid to stave off additional rounds of employment cuts, bring budgets as close to a neutral position as possible, and allow critical public service providers the ability to maintain service levels as close to pre-March 2020 as possible.

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Summary of U.S. Federal COVID-19 Relief for State and Local Governments, Post-March 2020 ($ billions)

Type	Allocated	Amount Used / Disbursed
Unencumbered Aid to State & Local Governments Post-March 2020	$0.0	$0.0
CARES Act Coronavirus Relief Fund (Restricted to COVID-19 purposes, not budget shortfalls)	$150.0	$34.0
Medicaid Matching Funds Increase	$85.0	$56.1
Transit Grants	$25.0	$16.5
Education Funding	$17.0	$11.2
Total State and Local Govt. Aid	**$277.0**	**$117.8**
Federal Reserve's Municipal Liquidity Facility $35 billion SPV backstop	$500.0	$1.6

Source: Committee for a Responsible Budget and HilltopSecurities.

Please see disclosure starting on page 7.

Unencumbered Federal Aid to State and Local Governments – Zero Dollars

Since March 2020, there have been zero dollars ($0) of unencumbered aid distributed to state and local governments by Washington. We define unencumbered aid as dollars that state and local governments would be able to use to shore up budgets affected by COVID-19 related shutdowns and lower levels of economic activity (and revenues) that could persist well in 2021 and beyond. The U.S. federal government unleashed a massive $3.6 trillion fiscal policy program in response to the COVID-19 outbreak in March and April. State and local governments were allocated about 8% of that amount ($277 billion) in different forms, but nothing flexible enough to be considered unencumbered.

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More Detail About What COVID-19 Relief Washington Did Allocate to State and Local Governments

Overall, the federal government's fiscal policy response to COVID-19 has been substantial from an over dollar amount standpoint. It was record-breaking in fact. Washington allotted a total of $3.6 trillion through four phases of COVID-19 relief in March and April 2020.

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Summary of U.S. COVID-19 Fiscal Policy Response

Phase	Became Law	Legislation	Details	Amount (billions)
Phase 1	March 6, 2020	Coronavirus Preparedness and Response Supplemental Appropriations Act	Research and deveopment, 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 Health-care Enhancement Act	Expanded PPP, hospital & testing funding	$733.00
Total Fiscal Policy Response Cost To Date				**$3,633.30**
Phase 5	Most likely after election, if at all	Unknown	Serious negotiations for a Fifth Phase of COVID-19 relief stopped during the first week of Aug. despite recent reports of negotiations.	Reps- $500B-1T; White House- $1.8-2T Dems- $2.2T

Source: HilltopSecurities.

The third phase of the federal government's COVID-19 relief, the Coronavirus Aid, Relief, and Economic Security Act or CARES Act (read more about the CARES Act here), was the most sizeable of the four we have seen so far. Additionally, view "Eligible Purposes" on page two of the Coronavirus Relief Fund [CARES Act, Title V]: Background and State and Local Data from the Congressional Research Service) which included about $2.7 trillion of total relief funds. The $277 billion that was allocated to state and local governments, according to the Committee for a Responsible Federal Budget, was in the form of:

- Coronavirus Relief Fund, only for COVID-19 specific purposes ($150 billion);
- Medicaid matching ($85 billion);
- Transit grants ($25 billion); and
- Education funding ($17 billion)

A little over half of the $277 billion aid went into a restricted account (the $150 billion Coronavirus Relief Fund from the CARES Act). We consider this money too restrictive to be available for general budget purposes. These dollars could only be used for

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COVID-19 specific expenditures.

The CARES act also allocated $454 billion that was made available to the Federal Reserve to purchase securities. Soon after the CARES Act became law, the U.S. Federal Reserve established its Municipal Liquidity Facility (MLF) with $35 billion of the $454 billion allocated under the CARES Act. This $35 billion gave the Fed the ability to purchase $500 billion of short-term eligible municipal notes. There are purposeful limitations that were baked in the Fed's MLF. It was meant to serve as a backstop in case the capital markets froze, which they essentially did from the middle of March and into April. The MLF is not currently meant to be an unlimited or below market credit line.

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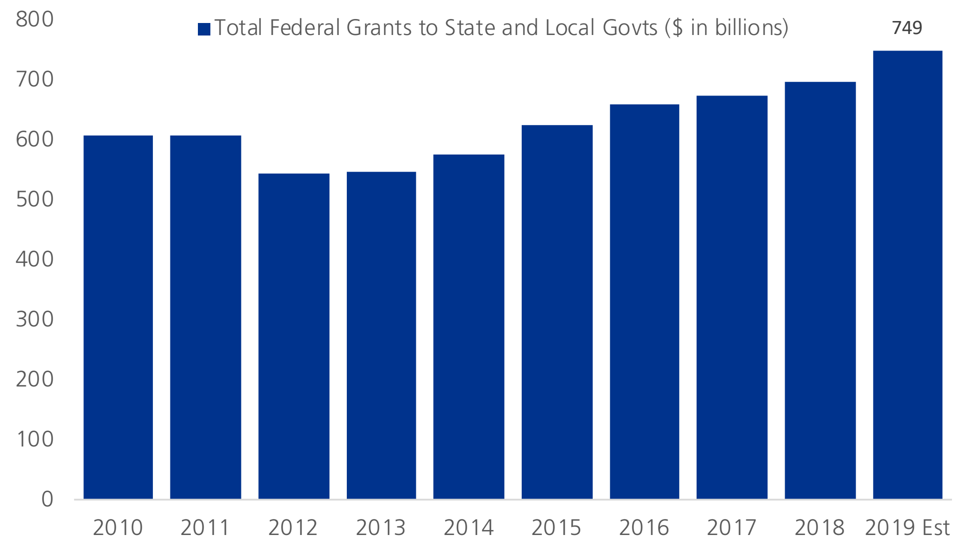
As a backdrop, we also want to highlight that on an annual basis the federal government provides state and local governments additional grants, estimated to be about $749 billion in FY19, that consist of the following functions: health (60.6%), income security (15.2%), education and training (9%), transportation (9%), community development 2.9%), and other (3.3%), according to the Office of Management and Budget (OMB) numbers we analyzed via the Congressional Research Service. These annual federal grant allocations have mostly increased in recent years.

Total Federal Grants to State and Local Governments ($ billions)



Source: OMB, Congressional Research Service, and HilltopSecurities.

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Criticism of Lack of Use Should be Considered Groundless, Compares to 2009

An argument some are using as to why state and local governments do not need additional unencumbered relief is because only 25% of the $150 billion allocated for COVID-19 specific purposes under the CARES Act had been spent, according to July 2020 Treasury Department data. See our summary showing that only $34 billion of the $139 allocated to state and local governments had been spent as of June 30.

A similar criticism has been made of the Fed's MLF. The Fed has the capacity to purchase up to $500 billion of short-term eligible municipal notes. So far, the Fed has only purchased $1.6 billion from the State of Illinois and the New York Metropolitan Transportation Authority. However, this lack of spending theme is also a common criticism of the other Fed programs funded with the $454 billion authorized under the CARES Act. So far, only $195 billion (of the $454 billion) has been specifically committed to cover losses under the Fed's programs. We wrote last week (Oct. 14) that the Fed's Important, supportive MLF Offered to Public Finance Entities & Municipal Bond Market Should be Extended. This week, the U.S. Treasury Department noted that "at this time" they do not see the need for the MLF to be extended.

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Use of 2009 Recovery Act Funds Occurred at a Similar Pace

For comparison purposes, we can associate the pace at which state and local governments have so far spent their 2020 aid with the pace they spent federal relief from the American Recovery and Reinvestment Act of 2009 (Recovery Act). The pace was markedly similar. The Recovery Act allocated approximately $282 billion for programs administered by state and local governments. A U.S. Government Accountability Office study, conducted a little over a year after the Recovery Act (Recovery Act One Year Later States' and Localitites' Uses of Funds and Opportunities to Strengthen Accountability, March 2010), reported that only about 30% (or $89 billion) of the $282 billion was paid out as of Feb 12, 2010. The below table shows the actual amount for FY09 and forecasts thereafter.

For comparison purposes, we can associate the spend pace of 2020 aid with the 2009 Recovery Act, which was markedly similar.

A large portion of these funds were allocated and spent on education, and specifically they were withdrawn from a State Fiscal Stabilization fund to pay teachers and education staff. As you can see, a portion was used in FY09, but the majority of the education money was forecast to be spread throughout FY10-FY11.

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Summary of State and Local Government Actual/Forecast 2009 Recovery Act Outlays

Program(s)	FY09 (Actual)	FY10 (Forecast)	FY11 (Forecast)	FY12-19 (Forecast)
Health (Medicaid)	59%	39%	17%	1%
Education	28%	37%	46%	8%
Transportation	6%	9%	14%	40%
Income Security	3%	7%	10%	21%
Community Development	3%	5%	7%	13%
Energy & Environment	1%	3%	7%	17%
Total (%)	**100%**	**100%**	**101%**	**100%**
Total ($) in billions	$52.90	$103.70	$63.40	$61.90
% of $282 billion	**19%**	**37%**	**22%**	**22%**

Source: GAO as of March 10 and HilltopSecurities.

The Case for State and Local Government Aid

State and local government revenues are generally considered procyclical. This means that revenue collections typically will rise when the economy is expanding but decline during economic contractions. However, the cyclical behavior differs depending upon the expenditure function. "State and local governments' current tax receipts have declined in each of the six national recessions since 1973," according to a U.S. Government Accountability Office report (State and Local Governments: Knowledge of Past Recession Can Inform Future Federal Fiscal Assistance, March 2011). The revenue decline was most severe in the wake of the 2008 Financial Crisis. We do not yet know the severity of the current downdraft, but the resulting impact could be even more severe than the last economic contraction.

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Cyclical Behavior of State and Local Government Expenditures, 1977-2008

Expenditure Function	Correlation with GDP	Cyclical Behavior
General Expenditures	0.34	Procyclical
Capital Outlays	0.50	Procyclical
Current Expenditures	0.23	Procyclical
Elementary and Secondary Education	0.60	Procyclical
Higher Education	0.29	Procyclical
Health and Hospitals	-0.36	Countercyclical
Highways	0.53	Procyclical
Police and Corrections	0.38	Procyclical
Public Welfare	-0.31	Countercyclical
Other Expenditures	0.40	Procyclical

Source: GAO and HilltopSecurities.

Many entities were able to get through fiscal year 2020 but fiscal year 2021 and 2022 could require even more severe budget steps in order to manage forecast revenue losses.

A lack of unencumbered aid should be considered surprising considering the duress state and local governments have been under and are expecting in coming budget cycles. Many entities were able to get through fiscal year 2020 but fiscal year 2021 and 2022 could require even more severe budget steps in order to manage forecast revenue losses.

State and local government employment was slashed to below the post-2008 Financial Crisis lows in April 2020. While some jobs have come back, total state and local employment (September 2020 at 18.675 million) is still below the worst of what we saw in July 2013 when it bottomed out at 19.054 in the wake of the 2008 Financial Crisis. Without direct and unencumbered relief, state and local governments will be forced to lay-off additional workers during the mid-year budget lookback period and again in the spring and summer when many are formulating budgets for the next fiscal year.

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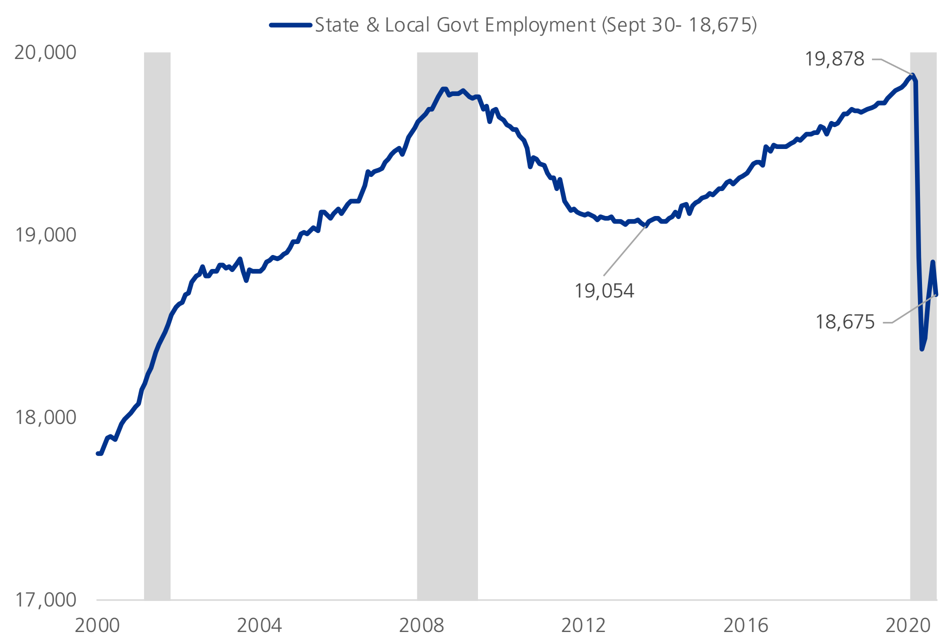
State and Local Government Jobs Remain Below Financial Crisis Lows



Source: Bureau of Labor Statistics and HilltopSecurities.

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The Center on Budget and Policy Priorities (CBPP) has forecast $555 billion in cumulative state budget shortfalls between fiscal years 2020-2022. The CBPP notes that near the end of fiscal 2020 states had about $75 billion in rainy day fund money, which is far short of the amount needed to bridge the budget shortfall gap states are looking at currently. We also cite CBPP data (see States Grappling With Hit to Tax Collections) that was updated as of the beginning of October showing there are several states that are forecast to see general fund revenues down substantially in fiscal year 2021. States at the extreme end of the spectrum, including California (-21% [high-end]), Colorado (-20), Hawaii (-23%), Massachusetts (-31% [high-end]), and Nevada (-26%), are expecting significant revenue declines as a percent of pre-COVID-19 revenue projections for FY21.

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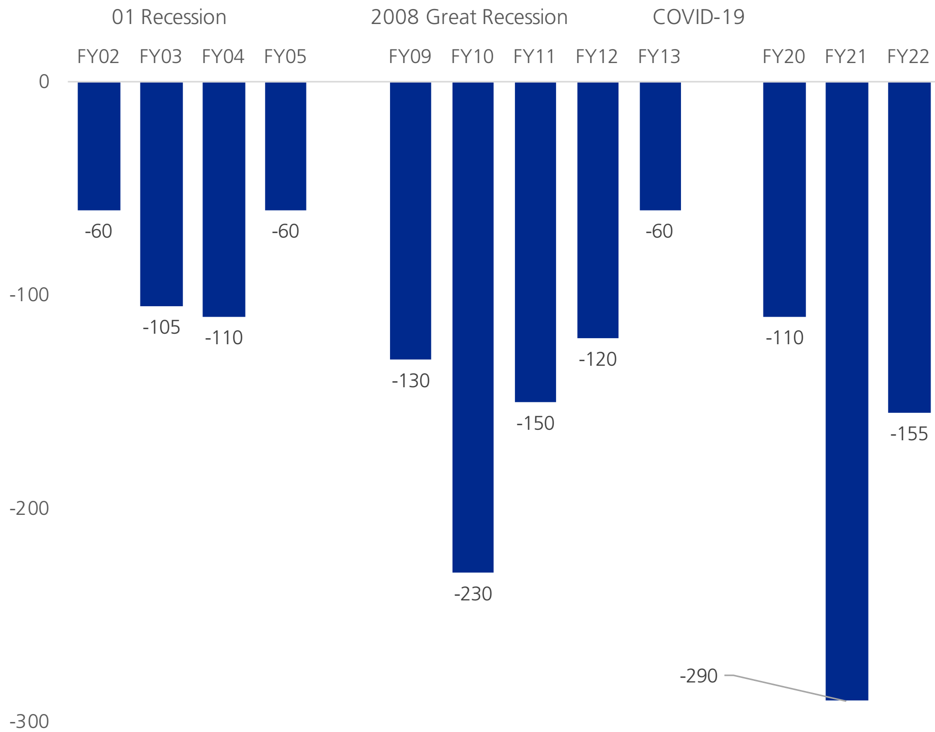
COVID-19 Related State and Budget Shortfalls ($ billions)



Source: Center on Budget and Policy Priorities and HilltopSecurities.

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Potential Economic, Market, and Policy Impact from 2020 Elections

We have already written that we expect that public finance downgrades will outpace upgrades, probably for years. This expectation was based on the performance of how state and local government credit responded in the wake of the 2008 Financial Crisis. While there was not substantial unencumbered aid, there was at least some aid focused on states, generally, and for schools, specifically, that flowed through for about three years of budget cycles that helped to fill the gap left by lower revenues. This dynamic is one of the reasons state and local government employment did not bottom out until 2013 in the wake of the previous economic contraction.

A key development we will be watching is whether there is another round of COVID-19 related relief targeted toward state and local governments, in addition to other public finance entities. We indicated in our Sept. 29 report, Election 2020: Results Will Impact the Economy, Markets, and Municipal Bonds, how we expect different election results could potentially impact different variable or policy topics.

It is under a Blue "Democrat" Wave scenario where former Vice President Joe Biden is elected president, Democrats take control of the Senate, and Democrats maintain control of the House that would be most constructive for related policies. For example, another (or fifth) phase of COVID-19 relief is very likely to materialize, and there is a better chance the total amount of relief could be close to a $3 trillion HEROES Act-like

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amount. An infrastructure-focused stimulus package could also materialize. The overall impact from a Blue "Democrat" Wave scenario would be more supportive and credit-positive for municipal credit conditions compared to the current course, which is what we would expect under the other two potential election outcomes.

Recent HilltopSecurities Municipal Commentary

- What We're Watching This Week: Third Wave, Election 2020, Government Relief, October 19, 2020
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- 29 days, October 5, 2020
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Readers may view all of the HilltopSecurities Municipal Commentary here.