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Headwinds and Perils

As the technical recession fades, thoughts turn to the likely course of the upturn. In a mid-November speech, Federal Chairman Ben Bernanke indicated that he expected growth to continue in 2010, but called attention to some headwinds including credit and labor markets. Other headwinds include additional weakness in commercial real estate, the emergence of a newly frugal consumer and developments in the state and local government sectors. State and local spending fell at an annual rate of 1.1 percent in the third quarter GDP estimate. State governments educate, incarcerate and regulate within the context of a balanced budget requirement, and are one of the bastions of unionization and defined benefit pension plans. We have fifty different laboratories with different mixes of taxes and spending. The states covered in the column are mostly outliers- with only Idaho having a state sales tax along with personal and corporate income taxes. Oregon has no sales tax, nor does Montana, and Washington has a sales tax as well as a business and occupations tax, and a state property tax.

The Rockefeller Institute reported that 49 states had year over year revenue declines in the second quarter of 2009 with revenues down by 16.6 percent. (Vermont revenues rose with a large estate tax settlement. Might be best to stay out of Vermont!) Personal income and sales tax revenues fell while corporate income tax revenues increased. Revenues have weakened with the real estate collapse impacting things like transfer taxes and sales taxes on construction supplies; falling employment and little nominal wage growth decimate income tax collections; and the plethora of capital losses in the financial markets dry up capital gains revenues. Near zero interest rates mean interest income declines as do tax revenues. A long period of weakness in consumer spending drags down sales tax revenues. According to the Census Bureau, Idaho's second quarter revenues fell 21.4 percent, Montana's dropped 17.7 percent, Oregon's dipped 27.3 percent and Washington receipts fell 8 percent. This is happening as demands for some state services, such as Medicaid and higher education, are increasing. This particular cycle, with the recession lasting about one and one half years, is different than the previous two which were 8 month recessions light. Rainy day funds, accounting actions, furloughs and freezes enabled governments to get through these earlier episodes. Legislatures that dealt with shortfalls in fiscal 2009 are soon to be back in town facing similar issues with fewer options. The Federal Stimulus Bill provided some funds to state and local governments and set off a scramble for stimulus dollars borrowed from savers around the world-- here at home, in Asia and the Middle East. Local media are filled with stories that, like baseball scores, list jobs created or saved with apparent precision and no mention of the repayment or source. But the stimulus package will start to draw to a close in 2011.

California is the poster child for fiscal chaos, but the problems are more general. A recent Pew Center on the States study "Beyond California: States in Fiscal Peril" highlighted other states in difficulty including Arizona, Rhode Island, Nevada, Florida, New Jersey, Illinois, Wisconsin, Michigan and Oregon. State actions to change spending and taxes will be a drag on the upturn. We are coming back a different place. Earlier assumptions may no longer be valid, and choices about tax systems, services provided and compensation systems will have to be re-examined at the state and local levels with very different constraints than the Federal.