PERSPECTIVE

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THE SILENT MAJORITY: STATE AND LOCAL GOVERNMENTS TALK BACK

Political wrangling over the management of federal finances has certainly been an attention-grabber throughout 2013. In what seems like a Christmas miracle, Senate and House budget negotiators announced a bi-partisan agreement that will temper the fiscal restraint hitting the economy next year and beyond. If the House and Senate vote in favor of this deal, the previous $90 billion in spending cuts for 2014 is likely to be cut in half. Consequently, our original estimate that sequestration will drag economic growth by 0.6 percentage points will also be shaved in half. This is good news indeed, but it will still mark the fourth consecutive year that the federal government will directly drag economic growth. Fortunately, the same will not be said of state and local government activity.

Far less attention gets placed on the fiscal transformation that has occurred within the silent majority – state and local governments (S/L). Their consumption and investment is 1.5 times that of the federal government and accounts for roughly 4 percentage points more of GDP. It is even bigger on the jobs front, employing seven times the number of people as the federal government.

Aggressive cost containment by S/L governments through the recession and recovery period is now paying off in spades. Many governments, particularly at the state level, are opening up their coffers on everything from infrastructure to education. Regardless of the budget agreed upon by the federal government, the re-expansion of S/L government budgets will provide an important offset. Their improved finances add another crucial pillar to the foundation of the US recovery.

The recession and the weak recovery left plenty of scorched earth within S/L governments. An unprecedented drop in tax revenues and stringent balanced budget guidelines culminated in 777,000 job losses, three quarters of those at the larger local government level. Although we have been cheering on the recovery in private-sector jobs since the spring of 2010, the bloodletting in local governments did not subside for another two-and-a-half years. Worse yet, state government workers have only seen a reprieve since the summer of this year.

S/L governments have since added back 104,000 workers, with a burst of state hiring occurring in the past four months. This resumption in jobs reflects a broader restoration in spending and investment under a strengthening tax base. Nominal tax revenues have exceeded prior peak levels for all but nine states. For fiscal year 2014, state tax revenues are projected to rise 4% nationally, with exceptional 8-11% gains expected by a number of states, like Massachusetts, New York and New Jersey (to name a few). Moody's reported that 85% of the states they polled were collecting higher-than-expected revenues through June of this year.[1] And, the Rockefeller Institute reported that revenue growth persisted into the third quarter of this year, which marks the first fiscal quarter of 2014.

With higher tax revenues and surplus budgets comes a replenishing in investment and spending. After a three-and-a-half-year drought – the longest on record – S/L government spending expanded in the second and third quarters of this year. The third quarter, in particular, saw a surge of spending that contributed 0.2 percentage points to real GDP growth. There is every indication that this is just the beginning of a new trend. Forty-two governors recommended higher general funding for FY2014, of which 18 proposed increases of 5% or more. In other words, spending increases will slightly exceed nominal GDP growth, as governments try to restore much needed services and investment. In fact, some states, like Florida, are enacting record spending budgets, while also bulking up reserves, paying back loans and contributing to the state pension plan.

Not only are an increasing number of states injecting funds back into the economy, but they are providing an added stimulus through tax cuts. In 2013, 18 states passed tax cuts into law, and the trend will likely continue going forward.[2] So, even with fiscal restraint persisting at the federal government level, state governments are giving the economy a needed boost after several lean years.

So far, the discussion has been centered on state governments, but local governments are also staging a comeback. Although the troubles of Detroit and Philadelphia's Pontiac City School District have been well publicized events, they do not represent the norm. They are but two among over 87,000 local governments, school districts and special districts that are experiencing firmer finances within a strengthening economy. Local governments have a higher reliance on property tax revenues, which have proven to be stable in spite of plummeting home values during the recession. The durability of these taxes was due to lags in assessment values or changes in assessment practices. Given the broad national rebound underway in home prices, local governments should continue to see steady revenue growth. For 2014 and 2015, Moody's expects local government revenues to increase by roughly 5%. In addition, states have been restoring funding cuts to local governments, which particularly benefits school districts. Jobs within local educational services were heavily slashed between 2008 and 2012, but they have rebounded by 47,000 new positions over the past year.

By no means are we suggesting that pre-2008 conditions have returned. However, state and local governments have learned to operate with reduced cost structures alongside a strengthening economy and tax base. Even modest restorations in budgets cause a meaningful addition to economic growth following three consecutive years of cuts. Our forecast has a conservative estimate that S/L governments will add 0.2 percentage points to real GDP growth in each of the next two years, following an average drag of 0.3 percentage points over the last three years. We consider this to be conservative because the historical contribution during expansions has been more than double that amount. However, given the uneven nature of this economic recovery and the early stages of budget implementation, we prefer to err on the side of caution.

The bottom line is that any economic drag emanating from the federal government must be counterbalanced against the stimulus stemming from S/L governments. Now that an imminent budget deal will reduce the impact of sequestration in 2014, there is a good chance that spending and investment by the overall government sector will add to real GDP growth for the first time since 2010.

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End Notes

1. 2014 Outlook – US States, Moody's Investor Service, December 5, 2013
2. http://www.forbes.com/sites/realspin/2013/11/22/its-very-simple-states-should-cut-taxes-to-boost-economic-growth/