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Think the Economy Is Bad? Wait Till the States Cut Back

Struggling as we are with the housing bust, the credit crunch, shrinking consumption, rising unemployment and faltering business investment, we can be forgiven for thinking that all the big shoes have dropped. There is another one up there, however, and it is about to come down.

State and city governments have yet to shrink the economy; indeed, they have even managed to prop it up. They have quietly maintained their spending at pre-crisis levels even as they warn of numerous cutbacks forced on them by declining tax revenues. The cutbacks, however, are written into budgets for a fiscal year that begins on July 1, a month away. In the meantime the states and cities, often drawing on rainy-day savings, have carried their share of the load for the national economy.

That share is gigantic. At \$1.8 trillion annually in a \$14 trillion economy, the states and municipalities spend almost twice as much as the federal government, including the cost of the Iraq war. When librarians, lifeguards, teachers, transit workers, road repair crews and health care workers disappear, or airport and school construction is halted, the economy trembles. None of that, or very little, has happened so far, not even in California, despite a significant decline in tax revenue.

"We are looking at a \$4 billion cut to public schools and deep cuts that will result in thousands of Californians losing their health care," said Jean Ross, executive director of the California Budget Project, offering a preview of coming hardships. "But the reality is we have not pulled money off the streets yet."

Quite the opposite, the states and municipalities have increased their spending in recent quarters, bolstering the nation's meager economic growth. Over the past year, they have added \$40 billion to their outlays, even allowing for

scattered spending freezes and a few cutbacks in advance of July 1. Total employment has also risen. But when the current fiscal year ends in 30 days (or in the fall for many municipalities), state and city spending will fall, along with employment — slowly at first and then quite noticeably after the next president takes office.

Sometime next year, the decline will reach an annual rate of \$50 billion, Goldman Sachs estimates. "It is a big reason to expect a weak economy in 2009," said Jan Hatzius, chief domestic economist at the firm.

The \$90 billion swing — from more spending to less — could be enough to push down a weak economy to zero growth or less, because state and city spending has accounted for as much as half of total economic growth since last fall. (A robust economy has a growth rate of 3 percent to 4 percent, compared with the 0.9 percent or less of the last two quarters.) The \$90 billion stimulus package now going out from the federal government to millions of Americans in the form of tax rebate checks. The hope is they will spend this windfall on consumption and in doing so sustain the economy. That might happen — for a while. But with the cutbacks in state and city outlays canceling out the consumption, the next president, struggling to revive a weak economy, will almost certainly have to consider a second stimulus package.

But what should it be? Should it be a reprise of the checks, relying again on private-sector spending for rejuvenation? Or should Washington channel extra federal money to city and state governments so they can sustain their outlays for the numerous programs that otherwise would be shrunk? The answer, even on Wall Street, is often: subsidize the states and cities.

"If you want to make sure that federal

Local governments bolstered growth with their spending. But tax revenues are plunging.

money gets spent, and jobs are created, you give it to them," said Nigel Gault, chief domestic economist at Global Insight, a forecasting firm.

Like many others, Mr. Gault contends that more than 50 percent of the \$107 billion in stimulus checks now going to households is likely to produce no stimulus at all. Instead, it will be used to pay down debt or buy imported goods and services. Imports bolster production in other countries; not in the United States.

Still, rebate checks have been a standard tool for years in efforts to revive the American economy. So have tax cuts and — the most popular tool of all — the Federal Reserve's lowering of interest rates. Each tool assumes that people will respond to the incentive with more spending and investment, and markets will then work their magic. Not since the 1970s, when politicians still paid attention to the teachings of John Maynard Keynes, has public spending — government spending — surfaced in mainstream political debate as a potentially effective means of counteracting a downturn.

Government has to step in, Keynesians argue, when private spending is not enough to lift the economy, despite the nudge from tax cuts or lower interest rates or rebate checks. This downturn might be one of those moments, involving as it does the bursting of a huge housing bubble. That has precipitated sharp declines in various tax revenues on which the states and cities depend, forcing them into extraordinary spending cuts — not yet, of course, but after

July 1.

The issue barely dents the presidential election campaign. The Republicans in particular are less than enthusiastic about Keynesian economics, with its use of government to rescue markets. They, and many mainstream economists, for that matter, argue that government is inefficient, bureaucratic, wasteful and unable to spend fast enough to counteract a downturn. The two Democratic candidates, in contrast, argue that a second stimulus package, if one is needed, should include federal subsidies to the states and municipalities, not to start new projects but to prevent cut-backs in existing ones.

No state seems more vulnerable than Florida, with its plunging home prices and slashed property-tax assessments, not yet on the books but soon to be. In anticipation, the legislature in May approved a \$66.5 billion budget for the coming fiscal year, down from \$72 billion in the current one.

Schools are a target, said Michael Sittig, executive director of the Florida League of Cities, "but none has been hurt yet. Nevertheless, everyone is scared. Everyone is in the mode of trying to figure out how to get through next year" — starting 30 days from now. ■