

The Next Big Crisis

How the forthcoming state and local budget crises could slow down the American economy.

By David A. Graham | Newsweek Web Exclusive

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It's a lagging indicator's lagging indicator, and one that could give the economy a kick in the shins just as it's getting back on its feet. Even though growth is picking up and the nation could add jobs as early as this spring, many cities and states won't hit financial bottom until as much as three years from now, which will add thousands to unemployment rolls and slow the recovery locally.

Since local governments get most of their money from income and property taxes, high unemployment and precipitous drops in real estate values take a large bite out of revenue, but there is typically a lag of between one and three years as taxes are collected on the previous year's income and property values are reassessed. And unlike the federal government, which can help to drive growth by running deficits, most state and local budgets are required to balance their budgets, meaning that layoffs, steep cuts in public services, or tax increases could be on the horizon nationwide.

"I think this is one of those sleeper issues—essentially these shortfalls will translate into 'anti-stimulus'," says Ethan Pollack, a policy analyst at the Economic Policy Institute, who estimates the combined shortfalls for state and local governments at \$469 billion over the next three fiscal years. "At the best, that can lead to a protracted, slow, jobless recovery, and at the worst, a double-dip recession."

The beginnings of that wave are being felt in places like Bossier City, La., a town of about 65,000 across the Red River from Shreveport. Facing a deficit of about \$6.5 million in its operating budget, Bossier City passed a 2010 budget this month that cuts 80 positions—including 45 posts in the fire and police departments—and institutes a 15 percent reduction in operating expenses across departments. (The actual number of laid-off workers is 46, because many of the eliminated positions were vacant.)

The cuts were controversial in the city, with citizens filling council meetings, and some city officials spoke out against the layoffs. "Unfortunately, the city's got to take this sort of action in order to balance the budget," says city spokesman Mark Natale. "It's certainly a hard decision, but like many entities, city government isn't immune to budget cuts."

Other cities are going to have to make similar painful cuts. Because previous downturns were less severe, governments were able to make up for shortfalls by trimming around the edges and cutting down on less-essential services. Now, like Bossier City, some cash-strapped cities are even cutting down on usually sacrosanct police and fire services. "There are some questions for communities out there about what they want their community to look like," says Chris Hoene, director of research at the National League of Cities. "Should the city provide just public safety, or are they concerned about quality-of-life issues? You're looking at having libraries, schools, and city governments that are only open four days per week."

The problem is wider than just government services, though. According to EPI, each dollar cut from a local budget translates into 88 cents of lost activity in the private sector, compared to only 53 cents lost overall in the public sector. For example, each police officer has to be uniformed and equipped with a gun and a car, all purchased from private

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companies. If he or she is laid off, then business will fall off at restaurants and shops near the police station.

States, which are often major contributors to city budgets, could make matters worse by cutting aid off in an effort to balance their own budgets. The nightmare scenario is California, which has taken steps ranging from cuts in funding for its famed state universities to issuing IOUs for short-term debts. The Golden State's notoriously byzantine and dysfunctional political system makes the crisis tougher than it is for other states, so California's drastic problems are unlikely to be mirrored elsewhere. There are large projected deficits across the country, however. In the past, many states kept "rainy-day" funds to make up for shortfalls, but after dipping into those coffers during the downturn of the early 2000s, many may not have had time to build the funds back up.

So where will the fix come from? Although some economists—including Peter Orszag, chief of the federal Office of Management and Budget—say increased taxes on the wealthy are the best alternative to across-the-board tax bumps or budget cuts, there's little appetite for raising taxes on anyone, given current conditions. More likely, says Nicole Gelinas, an expert on municipal finance at the Manhattan Institute, is an infusion of federal dollars. "They won't call it stimulus, but it will be aid to state and local governments," she says. "I think they're trying to be very careful with the word 'stimulus,' because everyone hates 'stimulus,' but it's popular to say we're going to keep your children's teacher's job." February's American Recovery and Reinvestment Act effectively bailed states out by providing money for Medicaid and education that took pressure off other budget areas, but more money is needed. Gelinas says the feds should require that local governments reform wage structures this time because labor costs aren't sustainable.

Not surprisingly, the American Federation of State, County and Municipal Employees, the union that represents many state and local governments, disagrees. Employees across the country have seen everything from furloughs to layoffs to benefit concessions. "Our prisons are overcrowded, our workers in the prisons are overworked, veterans' homes are understaffed," says Danny Homan, president of the union's Iowa council. "I don't care where you go in state government right now, we're doing more for less. We're to the point now where there is no more to do with less, so the next alternative is eliminating services, eliminating programs, or serious delays in the services we provide to Iowa's most needy citizens."

In some places, employees are working with governments to prevent job losses. In Oregon's Multnomah County, home to Portland, the union went to county commissioners with a plan for a wage freeze that had been approved by members and that saves some 100 jobs. "We heard lots of stories from our members: women saying their husbands had lost their jobs, or their kids were moving back in, and they as the county employee were the only breadwinner," says Michael Hanna, the local union president and a county information technology worker. "For them to have their wages frozen was difficult, but the argument we were making to them was that at least you still have a job and benefits, and we can still provide the services to the community and not add to the unemployment rolls, which is a further drain on the state's resources."

If there's any silver lining, it's that widespread suffering in communities of all sizes might create momentum for action. When recession pounded the United States during the 1970s, big cities were particularly slammed. Back then, some politicians took a dismissive attitude, epitomized by President Gerald Ford's refusal to allow a 1975 bailout of New York City, memorialized by the *New York Daily News* headline "Ford to City: Drop Dead." "You wouldn't see that today," Gelinas says.

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