

## Commentary

### The Next Storm: The Coming State and Municipal Financial Crisis

Since last summer, there has been a lot written about the economy. The sub prime, housing and banking problems have been well documented. One area that has been virtually ignored by the press is the developing financial crisis among the states and municipal governments. I believe this is the next major financial storm on the horizon and the storm clouds are rapidly approaching.

Recently the Chicago Sun Times published a story about how Illinois business and taxpayer groups were pressing Governor Blagojevich to get concessions from union workers on pension benefits and health care. The story went on to say that Illinois has more than \$90 billion in unfunded debt and they are pressing the Governor to reform and reduce the costs of pension and retiree health care programs. The article quoted experts saying that because of this huge unfunded debt, "Illinois is headed toward financial implosion."

Illinois's state pension gap is pegged at \$44 billion beyond what it can pay. And experts are now saying it is probably more than that because of declines in the stock market. The \$44 billion figure was reported last June and since then, the S&P500 is down 7%.

But Illinois is not alone in this financial quagmire. Most states and local municipalities are in the same negative situation. And within the next month this financial situation will take a turn for the worse.

So far this year, most state and city governments have maintained their spending at pre financial crisis levels. Budgets were passed prior to the financial crisis and bureaucrats never give back approved budget dollars making sure every dime is spent. Therefore state and city governments have not contributed to any economic weakness and in fact, they have had a key stimulus role in perking up economic statistics. They have yet to shrink the economy. As a matter of fact, states and cities have

increased their spending over the past year by \$40 billion, money that was budgeted before anyone had a clue what a sub prime mortgage was.

Now everyone knows what a sub prime mortgage is and economic reality has set in. New budgets have been approved and massive cutbacks are in place for a fiscal year that starts for most places on July 1.

Here are the figures. The states and municipalities spend roughly \$1.8 trillion a year in a \$14 trillion economy. That means that combined, they spend almost twice as much as the federal government including the Iraq war. That represents a huge economic stimulus to the national economy. But next year as people, programs and projects are cut at the local level, the economy should start to feel it.

Remember not one of these cuts have happened yet in any state, not even in California, despite a very significant decline in tax dollars since last summer. Jean Ross, executive director of the California Budget Project is quoted as saying "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. But the reality is we have not pulled money off the streets yet." And that is the key; these cuts have not hit the economy yet.

Goldman Sachs is estimating cuts in state and municipal spending next year at around \$50 billion. These cuts could be the catalyst that moves the economic GDP from less than 1% growth to a negative growth number next year. Statistics show that state and city growth has accounted for almost half of total economic growth since last fall. When these cuts begin next month, and these extra revenues are absent from the economy, a slower economy will inevitably follow. Now add in significantly less real estate tax revenues due to falling home values that help fund everything from schools to libraries to park districts and it is easy to increase the shortfall near

the \$100 billion range which coincidentally, is close to the \$107 billion in federal stimulus checks that just went out.

The state and municipal financial crisis is coming and will be very significant as we head into 2009. The state of Florida has already set the tone by approving a \$66 billion budget for the coming year, down from \$72 billion in the current one. This 8% drop in spending when combined with housing values falling at close to a 20% annualized rate (26% lower in Miami alone) and inflation rates nearing 4%, does not warrant a positive economic spin for this state.

The rest of the states and municipalities will experience similar issues as Florida. As economic conditions at the state and local level deteriorate there will be outrage expressed by citizens and elected officials alike and they will demand action. Along with service cuts, I think the raising of taxes at both the federal and local level is a given. Combined with higher inflation across the board and increased taxes at all levels, the consumer led “Starbucks” economy will be coming to an end. What will lead the next economic up cycle is unknown. But I believe it will not be the consumer.

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