Ben S Bernanke: Challenges for state and local governments

Remarks by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the 2011 Annual Awards Dinner of the Citizens Budget Commission, New York, 2 March 2011.

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I am pleased to have the opportunity to speak to a group that has such a long and distinguished record in identifying and addressing crucial issues affecting the governments of the city and state of New York. I will focus this evening on a top challenge not only for New York, but also for states and localities across the nation – namely, the imperative of achieving fiscal sustainability in both the short and the long term. I will first discuss the fiscal pressures currently confronting states and localities, then turn to longer-term challenges and opportunities faced by these jurisdictions.

Recent state and local fiscal developments

As you know well, the deep recession of 2008 through 2009 and the subsequent slow recovery have battered state and local budgets. As the recession took hold, revenues dropped precipitously, especially at the state level. Driven partly by balanced-budget requirements under their constitutions, many governments have responded by cutting numerous programs and reducing workforces. As necessary as these cuts may have been, they have left some jurisdictions struggling to maintain essential services. The fiscal problems of state and local governments have also had national implications, as their spending cuts and tax increases have been a headwind on the economic recovery. Moreover, concerns about both the current fiscal condition of these governments and their longer-term commitments to provide pensions and health benefits have recently led to strains in municipal bond markets.

The recession's effects on state governments have been substantial. In calendar year 2009, state tax revenues were about 12 percent lower than they had been in 2008; declines in wages, salaries, capital gains, and profits reduced income tax revenues, and sales tax collections dropped along with household and business spending. Reflecting somewhat better economic conditions, state tax revenues for the first nine months of 2010 were 3 percent higher than during the comparable period a year earlier – a relatively modest improvement in comparison to the earlier decline. Meanwhile, on the spending side of the ledger, demand for publicly financed medical care and other public services soared as the economy weakened. Most notably, Medicaid caseloads rose from less than 43 million at the start of the recession in December 2007 to more than 50 million in June 2010 – an increase of nearly 18 percent. The experience of New York state has not differed greatly from that of other states: Tax revenues here decreased about 13 percent in 2009 and then rose about 7 percent during the first nine months of 2010. Meanwhile, the state's Medicaid enrollments increased from about 4 million at the end of 2007 to 4-3/4 million in mid-2010 – about in line with the national trend.

In contrast to the sharp drop in state tax revenues, local tax revenues across the country have held up relatively well over the past couple of years. In part, this difference reflects localities' greater reliance on property taxes. Changes in real estate values typically feed through to tax assessments and property tax bills with a considerable lag; some jurisdictions have also raised their property tax rates to offset weakness in assessed values. The continued softness in real estate prices, however, does not bode well for local government revenues. Moreover, many localities have been hard hit by reductions in state aid, which in 2008 accounted for about 30 percent of local revenues. Indeed, the fiscal 2011 budgets of more than 20 states contained either outright reductions in local aid, changes to revenuesharing agreements, or cuts in funding for specific programs that are run by local governments – such as education for grades kindergarten through 12, road maintenance, and property tax relief.[1]

Assistance from the federal government – mainly through the stimulus grants included in the American Recovery and Reinvestment Act of 2009 (ARRA) and the additional Medicaid and education grants provided last summer – has relieved some of the fiscal pressure on states and localities. In addition, many of them have tapped financial reserves – or "rainy day" funds – and pursued asset sales and other one-time actions to satisfy balanced budget requirements. Nonetheless, many governments have laid off or furloughed workers, frozen salaries, and cut other operating expenses. Job cuts have been especially pronounced at the local level, where payrolls have fallen roughly 350,000, or more than 2 percent, over the past 2-1/2 years; nearly half of the loss of local jobs has been in education.

In addition, state and local governments have cut their capital expenditures. To be sure, construction of highways and transportation facilities has been well maintained over the past couple of years, partly because of the infrastructure grants and the Build America Bond program provided under the ARRA. But outlays for the construction of schools to serve students in grades kindergarten through 12 now stand about 30 percent below their pre-recession level. One might ask why states and localities are choosing to reduce capital expenditures, as these expenditures provide employment and economic benefits while typically not being subject to balanced budget requirements. One reason is that some projects are funded at least partially out of operating budgets and thus must compete with Medicaid and other high-priority programs for scarce dollars. Another is that a sizable share of debt service payments on the bonds used to finance capital projects comes from operating budgets, further limiting the flexibility and willingness of governments to undertake new infrastructure projects. Finally, starting new capital projects may be difficult to justify politically in a period of general austerity.

At least a few states have raised taxes and fees to address budget shortfalls. As you know, in 2009 the state of New York enacted a package of revenue measures that included a temporary surcharge on taxes paid by high-income individuals. California also raised income and sales taxes that year. And after having seen its credit rating sink to among the lowest in the nation, Illinois recently implemented a sizable increase in income taxes.

Despite the many difficult adjustments to date, state and local fiscal repair is far from complete, and governors, mayors, and legislators will confront more tough decisions as they develop their budgets for fiscal year 2012. Although the economy is recovering, it is still operating well below potential and unemployment remains high. Stimulus grants from the federal government are winding down this year and will largely have ended by 2012. Demands on Medicaid and other social service programs will likely remain elevated. Moreover, reserve funds are low, and the list of unused one-time fixes has been substantially depleted.

Nonetheless, some positive developments have emerged lately. For example, closest to home, Mayor Bloomberg announced last month that the city of New York has revised up its estimates of tax revenue for both the current and upcoming fiscal years. As I noted earlier, state revenues nationwide have been rising recently, and states are generally reporting that collections are running in line with – and, in some cases, a bit ahead of – expectations. Accordingly, considerably fewer states are facing midyear budget gaps that will need to be addressed before the end of the current fiscal year than the 40 or so that reported such gaps in 2009 and 2010.

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[1] See National Governors Association and the National Association of State Budget Officers (2010), *The Fiscal Survey of States* (Washington: NASBO, Fall)

Much will depend on the continuation of the economic recovery. If the economy continues to strengthen at about the pace projected by the Federal Reserve and many private forecasters, states and localities may start to get a little breathing space. Tax collections will rise with income and spending, and the use of Medicaid and other income support programs should ease as the labor market improves. However, because the pace of near-term economic growth expected by most forecasters is relatively modest given the depth of the downturn, some time will likely be required before state and local fiscal conditions return to something approximating normal.

Continued evidence that states and localities are addressing fiscal shortfalls should help calm the municipal bond market. Generally, that market seems to be functioning reasonably well. Around the turn of the year, though, investor concerns about the fiscal situations of many governments, including those of some populous states, resulted in increased yields on municipal bonds relative to Treasury bonds as well as a widening of credit default swap spreads for a number of states. Fortunately, although these measures of risk in the municipal bond market remain elevated, they have been looking somewhat better recently, presumably reflecting expectations of continuing improvement in the finances of states and localities. The Federal Reserve will continue to monitor the municipal bond market closely.

Longer-run fiscal challenges for states and localities

Although my focus thus far has been on the near term, state and local governments are also confronting some difficult fiscal challenges in the longer term. Indeed, with the retirement of public employees who are part of the baby-boom generation and the continued rise in health-care costs, meeting obligations for pension and retiree health-care expenses will become increasingly difficult for many states and localities. Estimates of state and local governments' unfunded pension liabilities for the nation as a whole span a wide range, with some researchers putting the figure in the neighborhood of $2 trillion to $3 trillion.[2] Some governments are beginning to take difficult steps to address this problem, although their ability to change plan provisions is limited by the strong legal protection (including, in some states, constitutional protection) accorded to accrued pension benefits of public employees in many jurisdictions.[3]

State and local governments also will have to address the burgeoning costs of retiree health benefits. Estimates of these costs are subject to substantially greater uncertainty than are those for pension liabilities, largely because of the difficulty inherent in projecting overall health-care costs decades into the future. In addition, retiree health plans generally do not have the same degree of explicit protection as do pensions and thus may be more subject to change. With these uncertainties in mind, the prospective costs of providing retiree health benefits – though certainly consequential – appear to be somewhat smaller than unfunded pension liabilities. For example, one recent estimate suggests that state governments have a collective liability of almost $600 billion for retiree health benefits.[4]

Not all of the longer-term issues facing state and local fiscal authorities involve closing budget gaps. For example, in light of the recent experience, an important question is whether

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[2] See Alicia H. Munnell, Richard W. Kopcke, Jean-Pierre Aubry, and Laura Quinby (2010), *Valuing Liabilities in State and Local Plans* (Chestnut Hill, Mass.: Center for Retirement Research at Boston College, June); and Robert Novy-Marx and Joshua D. Rauh (forthcoming), "Public Pension Promises: How Big Are They and What Are They Worth?" *Journal of Finance*.

[3] See Jeffrey R. Brown and David W. Wilcox (2009), "Discounting State and Local Pension Liabilities," *American Economic Review*, vol. 99 (May), pp. 538–42. It should be noted that *future* pension accruals generally seem to be accorded a lower level of protection.

[4] See Pew Center on the States (2010), *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform* (Washington: PCS, February).

anything can be done to reduce the sensitivity of state and local budgets to the business cycle. As the past couple of years have shown, the balanced-budget rules under which most states operate can force sharp cuts in services and increases in taxes during recessions, which is just the time when many people in the state are economically most vulnerable. Moreover, the instability in funding streams and tax rates associated with the business cycle can impede planning by both the public and the private sectors.

By and large, the evidence suggests that balanced-budget rules provide valuable fiscal discipline for states, and I do not advocate eliminating them.[5] However, even with these rules in place, the question remains whether the effects of the business cycle on state budgets can be mitigated in the future. One strategy used by many governments is to build up a rainy day fund during good economic times. Measured as a percent of general fund expenditures, the aggregate reserve-fund balances for all state governments stood at a record 11-1/2 percent at the end of fiscal 2006. These comparatively high reserve-fund balances have lessened the severity of spending cuts or tax increases in many states during the past couple of years. However, given the depth of the recession, even these historically high balances proved insufficient to fully buffer the budgets of most states. Thus, governments may wish to revisit their criteria for accumulating and using fiscal reserves. Building an adequate reserve fund during good times may not be politically popular, but doing so can pay off during bad times as well as lessen the tendency to overspend when times are good.

In principle, some smoothing of expenditures over good and bad times could also take place through the capital budget. In particular, maintaining or even increasing the pace of construction spending when the economy is weak could add valuable infrastructure and provide local jobs; it may even allow a government to get more “bang for the buck” because of increased competition among private contractors when demand is slack. Voters and policymakers may understandably be reluctant to approve new bond issues and take on additional costs for debt payments in a period of fiscal and economic stress, but they might be less reluctant if governments were to accumulate larger rainy day funds and assign a higher priority to tapping them for infrastructure purposes in times of economic weakness.

Another development that has compounded the difficulties faced by many state governments is that their revenues – always sensitive to economic conditions – appear to have become even more tied to the economy over time. One reason for this greater sensitivity is that capital income, which tends to vary substantially more than wage and salary income, has become an increasingly important source of state personal income taxes.[6] Also, sales taxes may have become more cyclical because of an increasing tendency to exempt certain necessities, for which demand is relatively more stable. As state legislatures review their tax systems, they may wish to consider steps to enhance the cyclical stability of their revenue streams. Of course, many considerations enter into tax policy, including the fairness of the code, the support it provides for economic growth and development, and the level of administrative and compliance costs.

Budget balance and budget stability are important fiscal issues. In the long run, though, the most important fiscal issue is whether the structure and composition of the government budget best serves the public interest. Certainly, most people would support the goal of fostering healthy economic growth. Government can contribute to this objective in a number of ways. One critical means is by ensuring an adequate investment in human capital – that is, in the knowledge and skills of our people. No economy can succeed without a high-quality

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5 See, for example, James M. Poterba (1995), “Balanced Budget Rules and Fiscal Policy: Evidence from the States,” *National Tax Journal*, vol. 48 (3), pp. 329–36.

6 See Richard Mattoon and Leslie McGranahan (2008), “Revenue Bubbles and Structural Deficits: What’s a State to Do?” Working Paper No. 2008–15 (Chicago: Federal Reserve Bank of Chicago, July); and David L. Sjoquist and Sally Wallace (2003), “Capital Gains: Its Recent, Varied, and Growing (?) Impact on State Revenues,” *State Tax Notes*, August 18.

workforce, particularly in an age of globalization and technical change. Cost-effective K-12 and post-secondary schooling are crucial to building a better workforce, but they are only part of the story. Research increasingly has shown the benefits of early childhood education and efforts to promote the lifelong acquisition of skills for both individuals and the economy as a whole. The payoffs of early childhood programs can be especially high.[7] For instance, preschool programs for disadvantaged children have been shown to increase high school graduation rates.[8] Because high school graduates have higher earnings, pay more taxes, and are less likely to use public health programs, investing in such programs can pay off even from the narrow perspective of state budgets; of course, the returns to the overall economy and to the individuals themselves are much greater.

Additionally, in a dynamic economy in which job requirements are evolving more rapidly than ever, individuals already in the workforce need opportunities to improve their skills throughout their lives. There are many ways to provide such opportunities. For example, community colleges and vocational schools train and retrain workers, often in close collaboration with private employers, and in many cases they perform this function at a relatively low cost. Although helping workers acquire up-to-date skills is always important, it is especially critical now, when long spells of unemployment are threatening the longer-term employability and productivity of many.

Conclusion

Tonight I have highlighted some of the fiscal challenges faced by elected officials, both in New York and in other regions. In the past few years, the weak economy has significantly reduced government revenues, which in turn has forced governments to make difficult decisions on spending and taxes. An improving economy should help, but state and local finances will remain under pressure for some time. Moreover, states and localities are facing difficult longer-run issues related to pension and health-related expenses for their retired employees. These challenges are daunting indeed, but meeting them will be essential to ensuring that our resilient and dynamic economy delivers rising living standards to the citizens of New York and to our nation as a whole.

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[7] For example, see the work of the Human Capital Research Collaborative, a joint project of the University of Minnesota and the Federal Reserve Bank of Minneapolis.

[8] See, for example, Henry M. Levin, Clive Belfield, Peter Muennig, Cecilia Rouse, Barbara Wolfe, and Nathan Tefft (2007), “The Public Returns to Public Educational Investments in African American Males,” *Economics of Education Review*, vol. 26, pp. 700–09.