SPECIAL FX

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State and Local Government: What a Drag

The European debt crisis has thus far unfolded as a sovereign debt crisis. And the sovereign here is the national government. This is particularly true in Greece. However in the coming months, it may become clearer that local and regional governments in Europe, including those of Germany, Spain and Italy, also face serious fiscal challenges.

The similarities between Europe and the US, in terms of debt and deficit issues, are much greater than the different political, social and regulatory regimes may suggest. While investors are well acquainted with the US federal deficit, they may be only vaguely aware of the increasingly difficult strait of many US states and local governments. It is the latter to which we turn our attention.

The State of the Drag

On 1 July, 46 of the 50 US states will begin a new fiscal year. The cumulative deficit of the 50 states is about $127.5 bln. State and local government borrowing reached a record 22% of US GDP this year, up from about 15% in 2000. Their outstanding debt is about $2.2 trillion, a 57% increase since 2000.

US states and local governments did the same thing that governments around the world have done. There was a general reluctance to tax citizens to fund the various programs that were provided by the state and local governments. Governments responded not by slashing the programs, but by borrowing to fund them. Governments accumulated debts and lengthened maturities.

They seemingly gamed their way around rules, including at times, constitutional requirements for balanced budgets or fiscal responsibility. This left them particularly vulnerable to a decline in revenues. Each business cycle may be unique, but they are all periodic, even if difficult to predict. What appears sustainable in an upswing may not be on the downside. Until the business cycle is repealed, governments, like businesses, need to embrace this key fact.

State and local governments have cut spending and raised taxes. Roughly speaking, these cuts in the first quarter more than offset the increased expenditures at the federal level. Consequently, the government sector was only a small drag on Q1 GDP.

State and local government however shaved nearly 0.5% off of GDP, the largest drag since 1981. Conservative estimates warn that the drag from state and local governments will continue in the next fiscal year, and probably the one after that too.

Fiscal Reform Coming to a Town near You

State and local governments are addressing their fiscal straits by cutting services and increasing user-fees and taxes. State and local government tax and fee increases were nearly $24 bln in FY 2010. An estimated 40 states have cut spending by nearly $22 bln.

They are also reducing their workforce. State and local governments employ around 20 mln American workers. In the 12-month period through May, state and local governments laid off 190k employees. This same pace more or less is expected to continue over the next twelve months.

The need for civil service reform in Europe seems paitently obvious to many observers who followed the Greek tragedy. Civil service reform will have to come to the US as well. This is not a political claim—a normative discussion about what ought to be, it is simply a descriptive claim. Wages and benefits account for a full 50% of some state and local government budgets.

The average salary of state workers was about $47,230 in 2008. One study found that this was 5% higher than comparable private sector jobs. City and local governments paid an average salary of about $43,600, about 2% more than similar jobs in the private sector.

On top of this, the state and local government employees receive much more generous benefits. Most notably, businesses in the US have largely converted from defined benefits programs to defined contributions. Roughly 80% of private sector employees participate in defined contribution programs. Approximately 85% of state and local employees participate in defined benefit programs.

The primary reason businesses shifted was to save money. Defined benefits leave the employer responsible for making up pension shortfalls. This is part of the unfunded liabilities that employers, including governments, face, often due to the vagaries of the market place.

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Defined contribution programs effectively allow employers to shift the responsibility, and repercussions, of investment decisions to the employees. The employees, either directly or as a part of a matching employee-contribution program, select from a universe of funds that the employer makes available. If at retirement the 401k is short of necessary funds, the adjustment falls to the employee, not the employer.

As officials look for ways to put their state and local governments on more solid fiscal footing, it should not be surprising if there is a move to adopt defined contribution plans. Workers in the government sector tend to be organized better and may resist it more than the private sector, but in the face of necessity, principles have a way of being sacrificed. Perhaps it can be accepted in lieu of fewer job cuts.

The Feds

To be sure, these issues are not confined to US state and local governments, they apply to the federal government as well. One study found that federal employees earn higher salaries in eight of ten occupations in which there is a private sector equivalent. These include accountants, nurses, chemists, surveyors, cooks, clerks and janitors.

For occupations that exist in both the public and private sectors, federal employees earned about $67,700 in 2008. The average pay for the same occupations in the private sector is near $60,000. A recent press report found that a nurse in the Veteran's Administration earns on average about $57,000 a year. This is $4,500-$10,700 more than private sector nurses.

There are all kinds of mitigating factors, including seniority and age of the employee. Often the skills and complexity of the work, like an accountant, for example, may be different for a government employee than a private sector employee. Nevertheless, it does challenge the idea that government jobs are poorly compensated.

In addition to the wages, federal employees also receive a generous package of benefits. According to the Bureau of Economic Analysis, health care, pensions and other benefits are worth an average of almost $41,800 for federal employees, compared to only about $9,900 for private sector employees.

The US may not be alone in this regard. The London-based Policy Exchange found a similar situation in the UK. Public sector workers were better compensated, with more lucrative pension plans than the private sector. The median salary of government employees was 12% higher than the private sector average and the pension plans were 15% more generous.

Public sector employees, the study found, worked fewer hours and retired earlier than their private sector counterparts. Over the course of a career, private sector employees work 23% more hours, which is roughly equivalent to a little more than 9 years, than public sector employees. The new UK government has drawn attention to the discrepancy and may seek to address early on in its tenure.

Conclusion

Many investors and observers have focused on the fiscal policy of the US federal government. In Europe the focus, for the most part, has similarly been on the national level. This essay briefly sketches out what is happening on the state and local government level in the United States. It does not address the transfers of funds from the federal government to the states. Nor does it have anything to say about the merits or demerits of municipal bonds.

The essay does warn that the cutbacks by state and local governments will retard the US economic recovery for the next year or two. These cuts have blunted the impact of increased federal stimulus. Going forward, perhaps after the November Congressional elections, the increase in federal spending will also slow, reducing its offset of state and local budget cuts.

The US may face a greater fiscal drag than many observers suspect due to the impact of state and local government fiscal conditions. Investors would do well to consider the possible impact of similar fiscal conditions in European regions and cities.

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