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POLITICS

State Budget Woes A Drag On Growth, And Will Get Worse

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New Jersey Governor Chris Christie, pictured speaking last Sunday outside the state's Cape May Court House, declared a "fiscal emergency".... [View Enlarged Image](#)

in fiscal 2011 to help states deal with a spike in Medicaid spending due to economic woes.

The House included more state aid in its \$150 billion stimulus bill that narrowly passed in December. But Senate Democrats left it out of their jobs bill that could come up for a vote in two weeks.

Runaway Train

Whether or not additional federal aid allows states more time to make their fiscal adjustment, the only light at the end of the tunnel appears to be a runaway train of unfunded pension obligations.

State and local government employee benefit packages are 70% more generous than in the private sector, according to a report by Chris Edwards, director of tax policy studies at the libertarian Cato Institute.

"The benefits are extremely generous, they are substantially underfunded and there appears to be a giant tax bill coming down the road," said Edwards.

Take Pennsylvania Gov. Ed Rendell who last week proposed a \$29 billion budget, penciling in \$2.8 billion in federal stimulus funds, including \$800 million not yet approved by Congress.

But the state will have to go cold turkey on stimulus come fiscal 2012, and in fiscal 2013, pension costs are set to soar by \$2.4 billion, driving the state's projected deficit to \$5.6 billion.

"A fiscal tsunami is coming at us, and I believe that we must act now to mitigate its impact," Rendell said.

States Hiking Taxes

So as an early step, he wants to raise an extra \$2.3 billion in taxes over two years by broadening the sales-tax base to include services and closing business tax loopholes.

As Washington works to rev up the economy and spur hiring with yet another dose of stimulus, state and local governments are busily applying the fiscal brakes.

Tax hikes, spending cuts and layoffs top the agenda as states continue to wrestle with severe budget crises that largely can't be deferred by borrowing.

State and local government deficit cuts will be a drag on growth equal to 0.6%-0.7% of GDP from mid-2009 to mid-2010, estimate Goldman Sachs economists. They expect the drag to persist in the coming fiscal year (which starts in July for most states) and warn it "is apt to intensify if federal stimulus winds down" in calendar 2011, as scheduled.

The liberal Center on Budget and Policy Priorities estimates a cumulative state budget gap of \$142 billion in fiscal 2011 — after \$38 billion in remaining federal stimulus aid for states. That fiscal tightening could reduce GDP by 0.9% and cost the economy 900,000 jobs, CBPP estimates.

The White House budget proposed spending an additional \$25 billion

Chris Christie, the new GOP governor of New Jersey, declared a "fiscal emergency" Thursday to close a \$2.2 billion current-year budget gap by freezing and cutting spending. The state's expected fiscal 2011 deficit is \$11 billion.

But many states, like Pennsylvania, are raising taxes instead. In just the past couple of weeks:

- Oregon voters approved a two-year, \$733 million hike in income and business taxes.
- Arizona's legislature approved a ballot measure seeking a 1-cent sales-tax increase to raise \$1 billion over three years.
- Washington state lawmakers voted to make it easier to pass tax hikes by suspending a requirement for a two-thirds majority.
- Colorado lawmakers voted to raise about \$140 million by reversing tax exemptions on a range of items including candy and soft drinks, energy used in manufacturing, downloaded software and online retail purchases. Online retailers who don't collect the taxes voluntarily would face a fine unless they instruct customers to pay the tax.
- A Virginia Senate panel passed a so-called "Amazon bill" that would raise \$17 million by requiring online retailers to collect state sales taxes.

These and other proposed tax hikes would come on top of revenue increases of \$23.9 billion in the current budget year by 29 states, according to the National Governors Association.

Jon Shure, deputy director of the State Fiscal Project at CBPP, notes that while some states may have erred by not setting aside enough to meet their retiree obligations, the immediate "crisis they face is because of an unprecedented drop-off in revenues."

Tax revenue swelled in California and many other states during the housing and construction boom. Politicians used those short-lived windfall revenues to increase public spending rather than save for a rainy day.

CBPP cites research by economists like Mark Zandi of Moody's Economy.com, an adviser to John McCain's campaign, to press the economic case for further state aid. Zandi estimates that \$1 of general state aid raises growth by \$1.41.

Recent estimates by the Congressional Budget Office suggest a smaller bang for the buck, with \$1 raising growth by a range of 40 cents to \$1.10. Still, CBO said such aid "would probably have a significant effect on output and employment."

The Education Department in November estimated that stimulus funds had helped preserve 327,000 education jobs.

State government employment has fallen by 44,000 in the past 12 months. Local governments have shed 128,000 workers. That's after adding 56,000 and 89,000 jobs, respectively, from January 2008 to January 2009 as private employers shed 4.6 million jobs.

Although the Senate is narrowly tailoring its jobs bill to win bipartisan support, further aid to states could come up in future legislation.

"I don't think there will just be one vehicle that moves," White House press secretary Robert Gibbs told reporters on Friday.

Freezing wages, requiring employees to chip in a greater share of pension contributions and moving new employees to defined contribution plans, all make sense to address budget shortfalls, Edwards said.

Even some on the left are starting to warn that spiraling pension expenses will affect public services.

San Francisco Mayor Gavin Newsom told a business conference last week that the city's pension costs have grown from \$384 million a decade ago to \$890 million and are set to hit \$1.4 billion in three years.

"We simply can't afford our social service investments if we can't curtail the growth of our pension system," Newsom said.