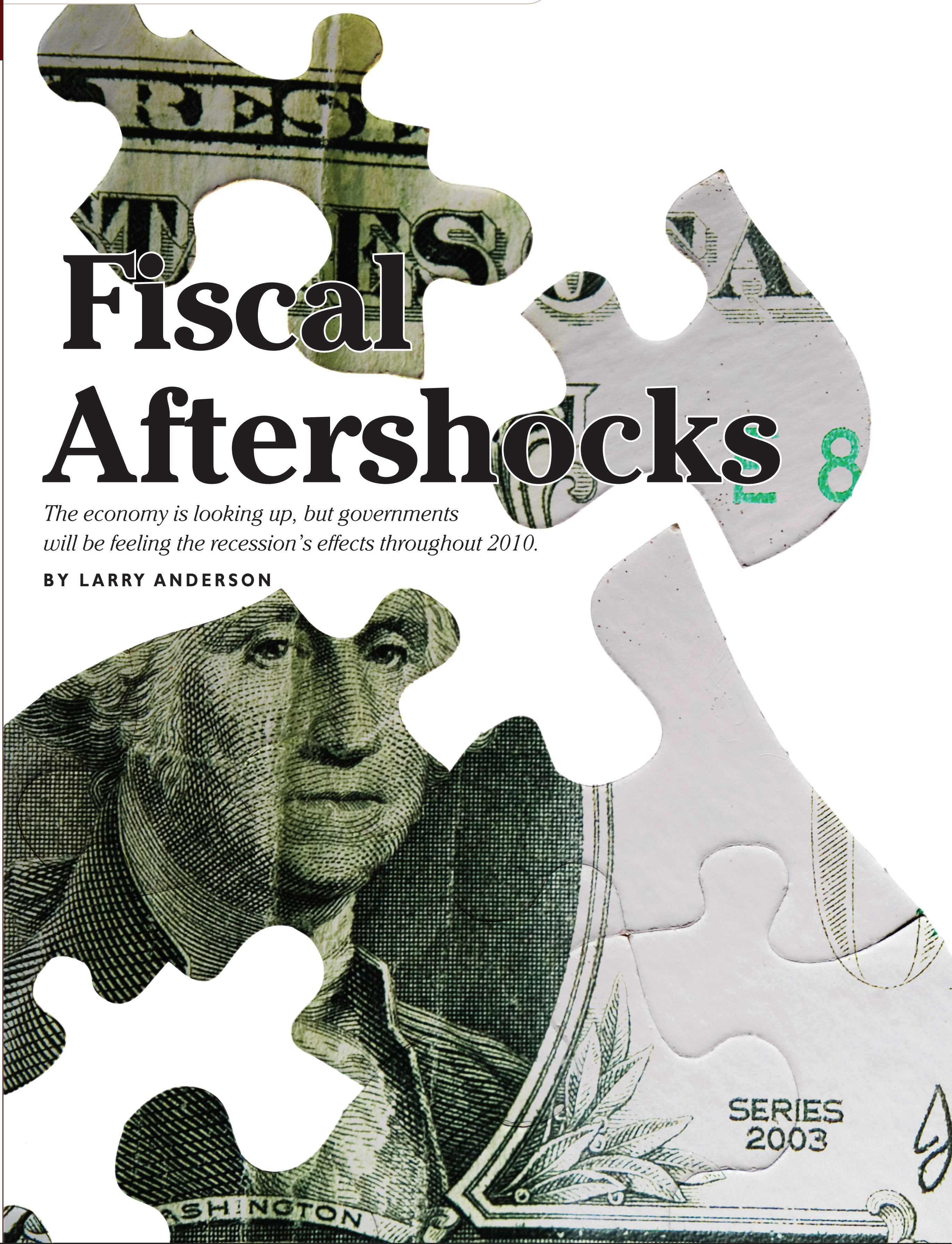
Fiscal Aftershocks

The economy is looking up, but governments will be feeling the recession's effects throughout 2010.

BY LARRY ANDERSON



Economic growth of 3.5 percent in the third quarter of 2009 may mark the end of the Great Recession, but state and local governments will likely feel ongoing negative effects throughout 2010 and beyond. Unemployment rates near double digits will continue through the next year, and governments will continue to endure the collateral effects of weak tax revenues, lower property values, slower consumer spending and other negative economic factors. But for the infusion of federal stimulus money, it would be a lot worse.

IHS Global Insight, a Waltham, Mass.-based economic forecasting company, predicts 2.2 percent growth in gross domestic product (GDP) in 2010 and 2.9 percent growth in 2011, both reflecting a turnaround in the U.S. economy, which shrunk 2.5 percent in 2009.

Even with more stimulus funds still in the pipeline and scheduled to be spent throughout 2010, state and local government growth will be barely existent (0.1 percent) in 2010, after a slight dip in 2009 (– 0.1 percent), according to IHS Global Insight. The firm forecasts state and local government growth to again become negative in 2011 (– 0.1 percent), suggesting a possible need for another round of federal stimulus funding in the future. "They will be looking for more help from the federal government, and there is greater risk unless there is further support [from the feds]," says Nigel Gault, chief U.S. economist, IHS Global Insight.

"Stimulus funding made a difference of a couple of percentage points [in overall GDP] in the second and third quarters this year, and the gradual phasing-in of funds continues to be a plus for growth through the third quarter next year," adds Gault. "A year in the future, the private sector will be in better shape to take the economy forward."

Gault also sees swings in the "inventory cycle" helping to boost growth in the next few months as companies gear up to build back inventory levels that declined during the recession. Fewer workers, as demonstrated by unemployment now above 10 percent nationally, are producing more, as reflected in soaring productivity rates for companies. But there are limits to how long companies can operate with fewer workers and aggressive cost-cutting.

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Historically, spikes in productivity have been a signal that the labor market is about to rebound, says Gault. Other hopeful signals about the jobless situation are increases in manufacturing overtime and temporary employment. "There are positive early indications, but it hasn't turned yet," says Gault. "There is a prospect of it turning in the next several months." He notes that unemployment rates will also benefit from hiring next year for the U.S. Census, which will involve more than a million workers at various times.

"The financial clouds are lifting," says Gault. "But it's not yet smooth sailing."

State budgets wrecked by recession

The dire effects of the recession are wrecking state budgets through the rest of the 2010 fiscal year and into the 2011 fiscal year, says Sujit CanagaRetna, Council of State Governments fiscal analyst. The intensity of the fallout continues to deplete state coffers as revenue intakes sputter and expenses escalate. State tax collections for the fiscal year 2009 plummeted by an average 9.2 percent, adjusted for inflation.

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"More alarming is that new budget gaps [have recently] opened in 18 states, with more states expected to join the list," says CanagaRetna. Cumulative budget shortfalls for the 2010 and 2011 fiscal years are forecast at $350 billion. "States are looking at a grim immediate future."

In preparing their budgets for the 2010 fiscal year, gaping budget holes prompted 41 states to reduce services, including restrictions on eligibility of low-income children and families for health insurance or reduction in access to health care services in 27 states. In addition, at least 24 states slashed medical, rehabilitative, home care or other services needed by low-income elderly or people with disabilities, or raised the cost of these services. Twenty-five states either cut or proposed cuts in K-12 and early education; 34 states cut funding to public colleges and universities; and 42 states shrank the size or work time of state government employees.

"Overall, the Great Recession and steep drop-off in state revenues will force state policymakers to try to shift voters' expectations about what services and programs government can provide," says CanagaRetna.

The National Governors Association State Economic Review also reflects the breadth of the fiscal problems.

Declining revenues at the end of fiscal 2009 made it more difficult for states to enact fiscal 2010 budgets. While in the middle of budget negotiations, a number of states were informed they would have less money available than previously forecast. In the end, eight states were unable to finalize their budget by July 1, the highest number in recent years. States are dealing with the lack of a budget agreement through such methods as issuing executive orders to keep the state running, passing temporary budgets, and giving IOUs to taxpayers, vendors and local governments.

Governments in states without a budget have proposed such solutions as additional program cuts, increasing sales or personal income tax rates and placing slot machines at race tracks to raise additional revenue. Even before the latest grim revenue projections, states realized that painful decisions would need to be made for fiscal 2010.

Assessing the impact on counties

In October 2009, the National Association of Counties (NACo) surveyed a sampling of 138 mid-sized to smaller counties in 34 states to assess the continuing impact of the economy. While media reports have focused on economic impacts on larger counties, the majority of counties are mid-sized or smaller. The NACo survey reveals a widespread impact of the downturn on counties of all sizes from several directions.

Here are some results from the survey:

- More than half – 56 percent – of the counties reported starting their fiscal years with up to a $10 million projected shortfall. Some 82 percent are anticipating shortfalls into the next fiscal year.
- Almost half – 47 percent – say the shortfall increased after the start of their fiscal year.
- Ninety-five percent of counties with additional shortfalls report those additional shortfalls are up to $10 million.
- Sixty-two percent are expecting to receive funds from the American Recovery and Reinvestment Act (ARRA) Transportation funding, and Community Development Block Grants are the most anticipated funds from ARRA.
- Thirty-five percent of counties anticipating ARRA funding had not received any as of the date of the survey.

The shortfalls in revenue included property taxes (52 percent of respondents), state or federal funding (50 percent) and sales taxes (46 percent). Counties reported responding to shortfalls by delaying purchases and repairs (60 percent of respondents), salary/pay freeze for employees (59 percent), delaying capital investments (54 percent), hiring freeze (49 percent) and using rainy day/reserve funds (44 percent).

Economy impacts cities' fiscal health

The fiscal condition of the nation's cities continued to weaken in 2009, according to a National League of Cities' survey of city finance officers. Survey results reflect the fallout from the national recession driven by declining housing values, restrictive credit markets, slowed consumer spending and rising unemployment:

- Nearly 9 in 10 (88 percent) of city finance officers report their cities are less able to meet fiscal needs in 2009 than in the previous year.
- Looking to the close of 2009, finance officers predict city revenues will decline (– 0.4 percent), while spending will increase (2.5 percent).
- City sales tax revenues (– 3.8 percent) and income tax revenues (– 1.3 percent) are predicted to decline by the end of 2009.
- To cover budget shortfalls and balance annual budgets, cities are instituting hiring freezes and laying off personnel, as well as delaying or canceling planned infrastructure projects.

- Ending balances, or "reserves," while still at high levels, decreased as cities used these balances to weather the effects of the downturn.

Construction market to increase in 2010

An optimistic outlook for the construction sector stems from an improvement in housing starts from extremely low levels and broader expansion for public works. The level of construction starts in 2010 is expected to climb 11 percent to $466.2 billion, following the 25 percent decline predicted for 2009, according to McGraw-Hill Construction, New York.

"The U.S. construction market in 2010 will be helped by growth for several sectors, following three straight years of decline that brought total construction activity down 39 percent from its mid-decade peak," says Robert A. Murray, vice president of economic affairs for McGraw-Hill Construction. "The benefits from the stimulus act will broaden in scope, lifting not just highway construction but also environmental public works and several institutional structure types."

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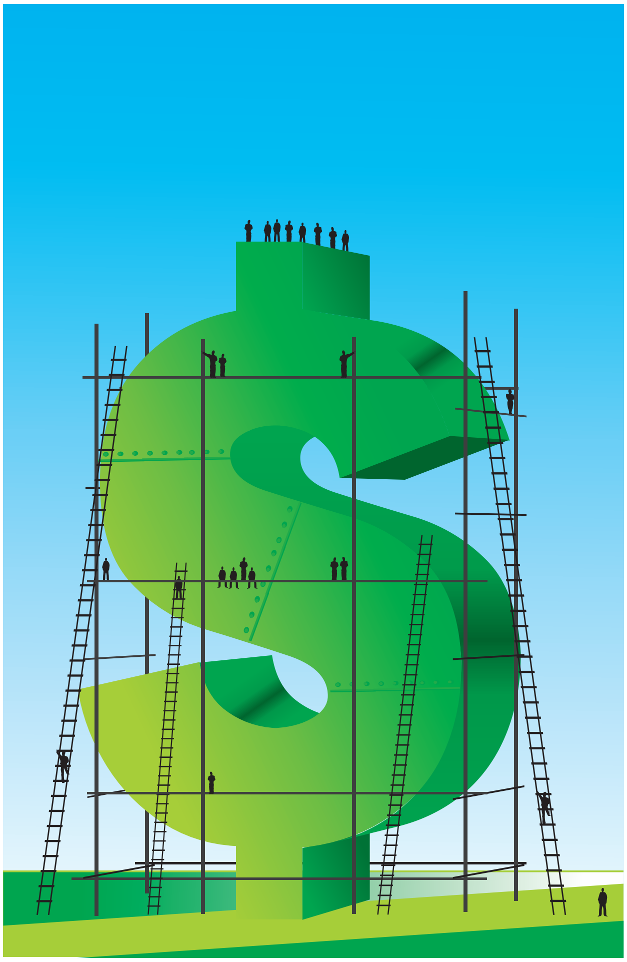
Highlights of the 2010 Construction Outlook from McGraw-Hill Construction include:

- Public works construction is expected to rise 14 percent, given more wide-ranging strength across all project types.
- Single-family housing next year will advance 32 percent in dollars and 30 percent in number of units.
- Multi-family housing will improve 16 percent in dollars and 14 percent in units, after steep reduction in 2008 and 2009.
- Commercial buildings will drop 4 percent in dollars, following a steep 43 percent drop in 2009. Weak employment will further depress occupancies.
- Institutional buildings will begin to stabilize after losing momentum in 2009. Square footage will retreat another 2 percent (after sliding 23 percent in 2009). The dollar amount of construction will edge up 1 percent.
- Manufacturing buildings will drop 14 percent in dollars and 3 percent in square feet, reflecting slack manufacturing capacity.



- Electric utility construction will slip 3 percent, further settling from a record high in 2008.

"The stimulus funds are meant to be just that, not the be-all-end-all answer to infrastructure financing," says Frank J. Giunta, senior vice president and managing director of Hill International, a construction consulting firm. "Both public and private sectors need to be innovative and rewrite the rules of project finance to address tremendous construction needs with minimal financing options."

A less optimistic view of the outlook for construction comes from FMI's Construction Outlook, which forecasts total construction will be down 13 percent in 2009 and 7 percent in 2010. FMI, a management consulting firm, expects residential construction to decline 1 percent in 2010 and nonresidential construction to decline 14 percent. Non-building construction will be the bright spot, increasing 4 percent in 2009 and again in 2010. "The economy may show some signs of improvement, but it is just the beginning of the downfall for nonresidential construction," says Heather Jones, a construction economist for FMI's Research Services Group.

About the author

Larry Anderson is the editor of Go Pro.