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UA36I/29 Gary Ransdell - Fed. Reserve Board - Challenges for the Economy & State Governments

St. Louis Federal Reserve Board

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At the Southern Legislative Conference 64th Annual Meeting, Charleston, South Carolina.
This document is not an official transcript. The text is selectively drawn from the original and summarized. Full text:http://www.federalreserve.gov/newsevents/speech/bernanke20100802a.htm

Today, the financial crisis appears to be mostly behind us, and the economy seems to have stabilized and is expanding again. But we have a considerable way to go to achieve a full recovery. The recession has also battered the budgets of state and local governments, primarily because tax revenues have declined sharply. Today, I will touch on current economic and financial conditions and then turn to challenges--fiscal and otherwise--facing state governments.

The Economic Outlook

The U.S. economy stabilized in the middle of last year and is now expanding at a moderate pace. While the support to economic activity from stimulative fiscal policies and firms' restocking of their inventories will diminish over time, rising demand from households and businesses should help sustain growth. In the household sector, growth in real consumer spending seems likely to pick up in coming quarters. In the business sector, investment in equipment and software has been increasing rapidly. At the same time, rising U.S. exports have helped foster growth in the U.S. manufacturing sector.

To be sure, notable restraints on the recovery persist. The housing market has remained weak. Similarly, poor economic fundamentals and tight credit are holding back investment in nonresidential structures. The slow recovery in the labor market and the attendant uncertainty about job prospects are weighing on household confidence and spending.

Private payrolls expanded at an average of about 100,000 per month during the first half of this year, an improvement but still a pace insufficient to reduce the unemployment rate materially. Financial conditions--though much improved since the depth of the financial crisis--have become somewhat less supportive of economic growth in recent months. Notably, concerns about the ability of Greece and a number of other euro-area countries to manage their sizable budget deficits and high levels of public debt roiled global financial markets.

European leaders put in place a number of strong measures, including an assistance package for Greece and backstop financing for euro-area countries. And, recently, European banking supervisors released the results of comprehensive stress tests of their banks. On net, these measures appear to have reduced concerns in financial markets about European prospects.

The state of the U.S. banking system has also improved significantly. Loss rates on most types of loans seem to be peaking, and, in the aggregate, bank capital ratios have risen to new highs. However, many banks continue to have a large volume of troubled loans, and bank lending standards remain tight. With credit demand weak and with banks writing down problem credits, bank loans outstanding have continued to decline. Small businesses have been particularly hard hit by restrictive lending standards. At the Federal Reserve, we have been working to facilitate the flow of funds to creditworthy small businesses. We will continue to monitor bank lending and to seek feedback from banks and borrowers.

Inflation has been low, with consumer prices rising at an average annual rate of about 1 percent in the first half of this year, and we anticipate it will remain subdued over the next couple of years. Slack in labor and product markets has damped wage and price pressures, and rapid productivity increases have helped firms control their production costs. Meanwhile, measures of expected inflation generally have remained stable.

Fiscal Challenges for State Governments

Cuts in state and local programs and employment are also weighing on economic activity. Sales tax revenues have declined with household and business spending, and income tax revenues have been hit by drops in wages and salaries, capital gains, and corporate profits. In contrast, property tax revenues collected by local governments generally held up well through the beginning of this year, although reappraisals of the values of homes and commercial properties may affect those collections in the future.

Medicaid spending is another source of pressure on state budgets. With revenues down and Medicaid spending up, other categories of spending by state governments have been tightly squeezed. Some states have also raised taxes, but the weak economy has made it difficult to find significant new revenues. Assistance from the federal government, especially through the fiscal stimulus package, has eased, but certainly not eliminated, the budget difficulties faced by states. Although states and localities will continue to receive significant aid this year, that source of help will be winding down next year.

On a more positive note, state and local tax revenues seem set to increase as economic activity expands. And improvements in the job market should gradually ease some of the demands on Medicaid and other social services. Moreover, the municipal bond market has remained reasonably receptive this year to most borrowers.

All that being said, with economic conditions still far from normal, state budgets will probably remain under substantial pressure for a while. A question for the longer run is whether the vulnerability of state budgets to business-cycle downturns can be ameliorated. I do not advocate changing the balanced-budget rules followed by 49 of the 50 states; they provide important discipline and are a key reason that states have not built up long-term debt burdens comparable to those of many national governments. However, as is the case today, these rules may force significant state cutbacks in bad economic times when services are most needed. Moreover, many government programs--in areas such as education or health care, for example--are likely to be most effective when funding sources are stable and predictable, allowing for longer-term planning.

Many states deal with revenue fluctuations by building up reserve--or "rainy day"--funds during good economic times. These high reserve-fund balances were helpful in lessening the severity of spending cuts or tax increases in many states. Nevertheless, given the depth of the recent recession, even these historically high reserve-fund balances proved insufficient. Thus, state governments may wish to revisit their criteria for accumulating fiscal reserves.

In principle, some smoothing of state government expenditures over time could take place through the capital budget. Maintaining or even increasing the pace of infrastructure construction when the economy is weak fosters economic development and provides local jobs, and it may even allow the state to get more bang for the buck because of increased competition among private contractors when demand is slack. However, 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.

Beyond balanced-budget rules, state government finances also fluctuate because of the increasing sensitivity of their revenues to changes in economic conditions. As state legislatures review their tax systems, they may wish to consider revenue stability along with other critical features of the tax code such as fairness, support for economic growth, and administrative costs.

Of course, healthy economic growth can ease state and local fiscal problems--and federal fiscal problems, for that matter. A basic economic principle is that growth requires investment. Investment includes physical investment such as infrastructure development; surely, adequate transportation networks and the like are necessary for economic growth. But for sustained economic development, investment in people--in their knowledge and skills--is even more important. No economy can succeed without a high-quality workforce, particularly in an age of globalization and technical change. I think this is a lesson that the South, as a region, has learned quite well. Doubtless, investment in education and training has been a key source of the remarkable economic gains that the South has achieved over the past 50 years or so.

In light of this experience, your efforts to improve education and workforce skills will continue. As you do that, please keep in mind that formal K-12 and post-secondary education, as important as they are, do not alone build better workforces. Research increasingly has shown the importance for both individuals and the economy as a whole of both early childhood education as well as efforts to promote the lifelong acquisition of skills. Though creating opportunities for workers to retrain is always important, it is especially critical now, when the high rate of long-term unemployment threatens the longer-term employability and productivity of many.

Healthy local economies will also be necessary if state governments are to successfully confront some difficult, longer-term fiscal issues. As you know, with the retirement of state employees that are part of the baby-boom generation and the continued rise in health-care costs, states' retiree pension and health-care obligations will become even more difficult to meet in coming years. Indeed, some estimates suggest that, on average, states would need to more than double their typical annual pension contributions over the next decade to avoid collectively exhausting their pension funds during the next couple of decades. This daunting problem has no easy solution; in particular, proposals that include modifications of benefits schedules must take into account that accrued pension benefits of state and local workers in many jurisdictions are accorded strong legal protection, including, in some states, constitutional protection.

In addition to pensions, states will have to address the burgeoning cost of retiree health benefits. Estimates of these liabilities are subject to significant uncertainty, largely because we have little basis on which to project health-care costs decades into the future. However, one recent estimate suggests that state governments have a collective liability of almost $600 billion for retiree health benefits. These benefits have traditionally been funded on a pay-as-you-go basis and therefore could entail a substantial fiscal burden in coming years as large numbers of state workers retire.

The demographic and health-care trends faced by state governments present severe challenges for federal fiscal policymakers as well. Long-term projections of the federal government's budget show a structural budget gap that is both large relative to the size of the economy and increasing over time. To steer clear of sudden, sharp, and disruptive shifts in spending programs and tax policies, and to retain the confidence of the public and financial markets, federal policymakers need to develop a credible plan to restore fiscal sustainability.

The states have the opportunity to serve as role models for effective long-term fiscal planning. Given the size of long-term obligations and the importance of meeting commitments to employees and the public, I don't think these problems can be solved simply through across-the-board cuts in existing state programs. Instead, states should intensively review the effectiveness of all of their programs and be

willing to make significant changes to deliver necessary services at lower cost. This willingness to look for new solutions seems especially important in the case of health programs, where costs are growing the most quickly.

Conclusion

These are daunting challenges indeed, but I believe we can find constructive ways to meet them, and I suspect that many of these solutions will be found at the state level.

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