Bank Financial Group

Special Report

October 27, 2010

TD Economics
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THE NIFTY-FIFTY NO MORE: AN INDEPTH LOOK AT STATE FISCAL FINANCES

Executive Summary

With the US economic recovery just over a year old, financial market participants have turned their attention to areas in the economy which have yet to reflect this rebound. State government finances are one such area that remains in poor repair, with Illinois, New Jersey, Rhode Island, Nevada and Connecticut topping our ugly duckling list. In spite of dramatic spending cuts and evidence that revenue growth is starting to improve, large budget gaps are expected to persist for another 3-to-4 more years. Ongoing fiscal restraint at the state level is expected to shave roughly 0.2 percentage points off national real GDP growth each year through 2012, after which the negative economic impact should lessen. However, budget gaps are largely a cyclical phenomenon. As long as the economy continues to expand and create private sector jobs – even at a meagre pace – budgets will automatically self correct with time.

This doesn't mean that all of the financial woes among state governments will be resolved. There is a distinction between near-term (cyclical) challenges and long-term (structural) issues. Attempts to immediately address annual budget gaps have come at a severe long-term cost for a number of states – particularly Illinois, Kentucky, Rhode Island, Massachusetts and Connecticut. The future has been traded off for the present, as large funding shortfalls have emerged in pension and health care plans. Once cyclical budget gaps cease to be a problem, a number of states must still need to engage in tax and retiree plan reforms to address long-term funding gaps.

There are no easy solutions and time is of the essence. One study indicated that more than half of state pension funds could run out of money by 2028. Those in dire need according to our TD State Vulnerability Indexes within the report should take a two prong approach to addressing shortfalls. First, states must limit the risk of large and enduring budget gaps from re-emerging during another economic downturn – which will inevitably happen since business cycles are not defined solely by expansions. Persistent budget gaps from the 2001 recession and the 2008-09 recessions left many states with insufficient funds to put towards their long-term liabilities. And, under-contributing to pension liabilities is particularly dangerous because such plans tend to have constitutional and contractual barriers that hamstring governments from making reforms within existing plans. Once government funding falls behind the eight ball, catch-up becomes exceedingly difficult and leads to tougher, more economically detrimental choices. Second, even if cyclical budget fluctuations are mitigated, a number of states still need to directly target future expenditure obligations within pension plans by some combination of reform within states taxes and existing pension plans – though success in the latter will be difficult.

To go about the first task, once budget gaps cease to be a problem, some states need to take a more critical look at how, and the degree to which, they finance reserve funds. Caps could be raised to at least 15% of general expenditures to provide adequate fiscal cushion. To finance these amidst other pressing needs, contributions to rainy day funds could be included directly into budget expenditures (rather than being by-products of unexpected surpluses or overshoots on revenue targets). However, this may only offer a partial solution should another recession befall the US that severely cripples state revenues. To guard against this risk, some states should revisit their tax revenue composition. Some tax revenue streams are more sensitive to business cycles and are also more distortionary to investment and saving behaviour. For instance, for every one percentage point decline in employment, we find that corporate tax revenues fall by 3 percentage points, income tax revenues fall by 2.6 percentage points, and sales tax revenues fall by 1.7 percentage points. States with a tax base more skewed to the former two tax measures generally saw larger declines in revenues during the recession, and this placed added pressure to cut

expenditures on long-term liabilities in order to fund budget shortfalls. In addition, given the slow recovery in job growth, sales tax revenues have bounced back with more vigour in the early stages of the economic recovery. Some states (like Illinois) should also look at whether they have unused tax capacity relative to competing neighboring states via lower tax rates and lower tax-takes relative to incomes.

Aside from tax measures, a number of states – particularly Illinois, Kansas, Oklahoma, Rhode Island and Connecticut – need to directly tackle pension obligations. Most pension reform measures across America have focused on developing lower cost tiered plans for new hires, in order to skirt around legislation and contractual barriers for existing plans. This is a necessary condition to contain costs, but likely not a sufficient condition for those states with pension plans in dire straits. A logical first step is to put in place some sort of binding funding requirement, as some states, like Illinois, habitually under contribute. However, as we have already noted, addressing costs within existing plans is no simple matter, as legal barriers make it difficult to directly target these costs by increasing contribution rates, raising retirement qualifying years, or modifying future inflation adjustment payouts. Still, some states like New Jersey and Rhode Island are taking steps in this direction, although labor unions are unlikely to accept any changes without a fight. Riskier strategies may include moving to defined contribution plans, rather than defined benefit plans. But, even here, union resistance is strong for new hires, let alone existing plan members. In the report, we wade through the pros and cons of various options for cost containment but ultimately the solutions boil down to some degree of tax and plan reforms. And, the economic costs could hinder growth and leave a state less competitive relative to its neigbors. Nonetheless, the piper must be paid, and difficult budget financing choices will continue to exist long after cyclical budget gaps are closed.

Craig Alexander
SVP & Chief Economist
416-982-8064
mailto:craig.alexander@td.com

Beata Caranci
AVP & Deputy Chief Economist
416-982-8067
mailto:beata.caranci@td.com

Christos Shiamptanis
Economist
416-982-2556
mailto: christos.shiamptanis@td.com

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