Fiscal Stimulus versus Economic Base Development

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The fiscal environment of state and local government is continuing the rapid deterioration that began in 2007. Nearly all forecasts seem to imply that this deterioration will continue until (at least) the third or fourth quarter of 2009 and states may continue to struggle into 2011. Tax revenues are down, and the National Governors' Association estimates combined 2009 and 2010 budget deficits of perhaps $200 billion. Housing sales and prices are still skidding because of the recession, Medicaid is being cut in some states, some states are stopping road construction, there is a good chance of significant cuts in public education budgets, and the obvious solutions to these problems (using up rainy day funds, travel cutbacks, marginal spending cuts) have all been exhausted. Further, in the long run, the Government Accountability Office is forecasting the combined federal, state, and local deficit to be 20% of GDP by 2040 under current trends. The parts of the Obama stimulus plan that provide increased funding for unemployment benefits and food stamps will quickly help, but much of the other federal stimulus plans will likely begin to go into effect in the second quarter of 2009. However, it will take some time for these expenditures to be felt. To the extent that states are in fiscal danger, local governments will be in additional fiscal straits because the state, under hard budget constraints, will not be able to help its local governments deal with their problems.

In addition to the federal stimulus (which is not a subject of these White Papers), the expenditure and tax policies of state and local governments also have impacts on economic growth. There is some literature that suggests that these sub-national fiscal policies have a stronger impact (per dollar) on real GDP than those of the federal government. Note that most of the local budget problems come from the slowdown in the revenue generation that occurs because of the recession. It is also clear that the typical state and local response to a change in economic activity tends to accentuate the business cycle, making downturns and upturns more extreme. Because of hard budget constraints, local governments have a choice of either cutting expenditures or raising taxes during recessions. Both exacerbate the declines in the business cycle However, nearly all of the economics literature finds that cutting expenditures hurts more than raising taxes in terms of fiscal stimulus.[1] Unfortunately, local governments have far less

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[1] See, for example, Peter Orzag and Joseph Stiglitz, Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?

autonomy to undertake these actions, because of state limitations, huge political risks of raising taxes at the local level, and mobility of both labor and capital especially within a local region. Because of these constraints, a powerful argument can be made for additional federal aid.

One of the areas in which local governments can act is that of economic development, which, once it occurs, will generate jobs and tax revenues. Both at the state and at local levels, fiscal economic development incentives are statistically significant, i.e., they significantly differ from zero. Despite this, at the state level, they seem to have little effect on development decisions. However, these incentives do become powerful at the local level, after a developer has decided to move to a particular region.. In particular, they may be more important during a recession because the private sector might be more sensitive to the impacts of the incentives because its profit margins may be less.

It is important for local government managers to remember other factors besides fiscal incentives when they attempt to attract local businesses. For example, local community assets (including infrastructure, work force capabilities, and educational structure), difficulties of getting project approvals, maintaining credit worthiness in the municipal bond market (which is currently in a very bad situation—yields on municipal bonds are now comparable to treasury yields, despite the tax exempt status of municipal debt), and the tendency to engage in a race to the bottom by cutting taxes and expenditures all effect the ability to attract new economic development. Finally, chasing private sector development that has little chance of locating in the jurisdiction or which generates a very small (or negative) return to the jurisdiction's investment is a waste of time and resources.

Economic base development must be considered more of a long-run phenomenon, involving careful planning, multiple analyses of many variables, and minimal expectations of quick payoff. This is in distinction to state and local fiscal stimulus, which is likely to have fare more immediate effects. Perhaps the most important outcome of the economic downturn for the public (and non-profit) sector might be what those who study private sector innovation are forecasting—"an unmitigated positive effect on

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http://www.cbpp.org/10-30-01sfp.htm. Note that Orzag has been recently named to head President-Elect Obama's Office of Management and Budgeting and Stiglitz is a Nobel Laureate in economics. For a more technical analysis, see Iryna Ivaschenko. (2004), Will the State and Local Budget Crises Hinder Economic Growth? In Matin Muhleisen and Christopher Towe (eds.) *U. S. Fiscal Policies and Priorities for Long-Run Sustainability.* Washington D.C.: International Monetary Fund. 48-54.

innovation." This becomes the time when public sector management has the opportunity to engage in reforms that might be difficult to accomplish in other times.