ADVISOR PERSPECTIVES

The Sorry State of the States

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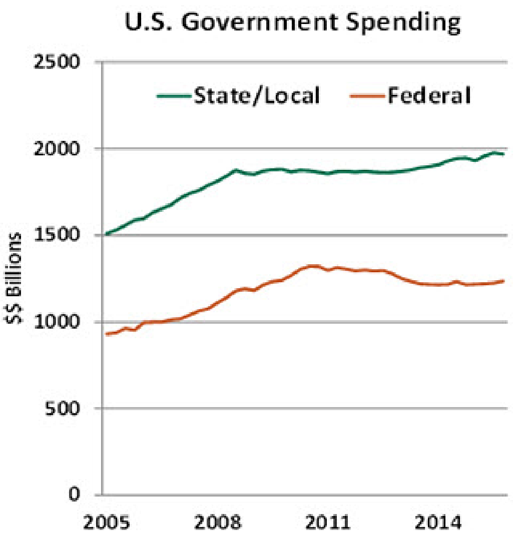
SUMMARY
- The Sorry State of the States
- Waiting for a Recovery of U.S. Exports
- Greece is Far From Out of Danger

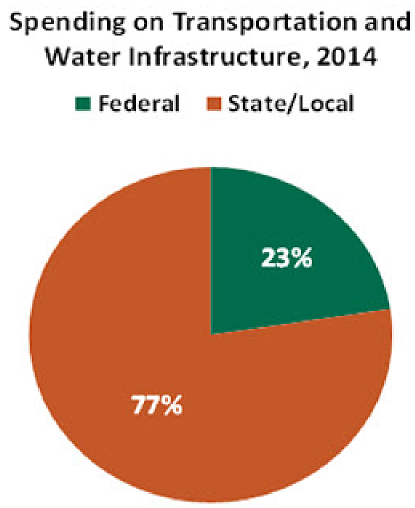
It was nice of the tax authorities to give us three extra days to file this year. Despite the additional time, I still finished at the last minute. Thankfully, I have 12 months before my next fiscal nightmare.

In a broader sense, though, we are all living through an ongoing fiscal nightmare. The budget news at the Federal level is troubling enough, as we discussed in February. But the finances of state and local governments in many parts of the country may be even more frightening.

This outcome is due to a combination of bad fortune, bad management and bad politics. Some citizens will try to avoid the worst of these problems by moving from place to place. But the nation will not be able to escape the damage that will be done to the overall economy if local budgets cannot return to health. Some radical thinking may be in order.

If you are like me, you pay much more attention to your Federal tax return. The amounts due to the IRS are considerably larger, and state returns typically take a fraction of the time to complete. But in terms of their contributions to national income, the activity of state and local governments is considerably larger. State and local governments employ more than 19 million workers, six times the Federal level.





Sources: Haver Analytics, CBO

The current contribution of local governments to gross domestic product (GDP) is substantial. But their contribution to future GDP may be even more significant, if more subtle. Investments in human and physical capital in our country are largely the province of governments below the Federal level. If these investments are not sufficient, our potential to grow will be compromised.

The state of physical infrastructure in the United States is abysmal. Monies appropriated to address the situation are not sufficient to keep pace with maintenance, much less break new ground. It isn't just roads and bridges that need attention; the electric grid, communications systems and water supplies are among the areas which must be modernized to keep the U.S. economy competitive.

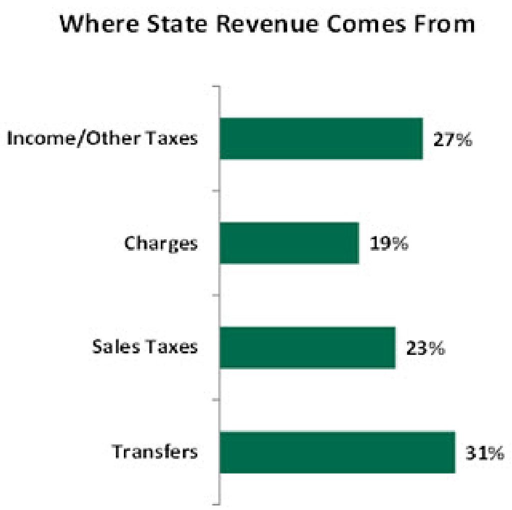
Living in a knowledge economy, the education of the workforce is a key differentiator. Achievement in many primary and secondary school systems is well below levels seen in other countries. Some of this shortfall is due to the challenged state of local finances. Further, states have traditionally provided considerable support to institutions of higher learning within their borders; funds for college have been significantly curtailed as state budgets have come under increasing pressure.

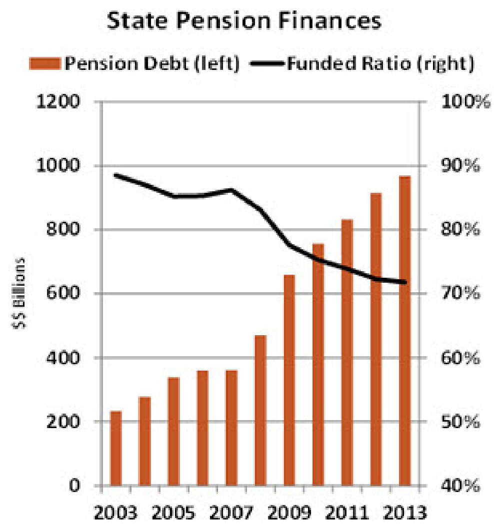
Economists have been puzzled by the diminished growth in U.S. worker productivity during the last decade. (At present, productivity appears to be at a near-standstill.) This has given rise to the theory of secular stagnation, and predictions in some quarters that American economic progress is near an end.

State and local governments are primarily responsible for our economic infrastructure.

In searching for potential root causes of the present stasis, the very modest level of investment in productive capacity is among the most likely. Because state and local governments bear the burden of financing these elements, the future competitiveness of the United States may rest on the fiscal shoulders of local treasuries.

States raise about two-thirds of their revenue from taxes and fees assessed on resident households and firms. The other third comes from transfer payments from the Federal government, a good portion of which is to match the Medicare and Medicaid spending done at the local level.





Sources: Urban Institute-Brookings, Pew Charitable Trusts

While Federal transfer payments have leveled, state revenues have improved in recent years as employment and consumption have recovered. A similar trend has been seen at the local level, where the recovery in house prices has helped property tax proceeds.

Unfortunately, the obligations of state and local governments have expanded much more rapidly since 2008. Low interest rates, deferred pension contributions and the aging of the public workforce have produced a national crisis in public retirement systems. A recent study from the Hoover Institution recently estimated that the total pension shortfall of state and local pension programs would be well over $3 trillion under conservative assumptions. This doesn't account for the liability presented by retiree health benefits accrued by public sector employees.

Rising pension obligations may be "crowding out" investments in future productivity.

Stated simply, then, challenging budget dynamics at the state and local level have consequences for national economic performance. Productive investment in human and physical capital is being limited by stress on local finances. This may ultimately limit growth in the economy, which will serve to compound the problem.

Raising taxes would not a successful strategy for dealing with this challenge. States compete with one another for the business base; firms facing higher tax burdens in one location can move to another. (Some governors have taken to making recruiting trips around the country to entice firms to relocate.) Statutory restrictions on budget deficits and pension modifications make these avenues difficult. Some new thinking is clearly needed.

In the post-crisis era, the American Recovery and Reconstruction Act included more than $50 billion to establish a State Fiscal Stabilization Fund (SFSF). This was viewed as a one-time effort, but it may hold promise as a vehicle through which targeted investments could be made in the national economic interest. The program could also promote national best practices for state budget dynamics, reducing the bookkeeping gimmickry that often attends that process.

So while most would like to limit thinking about fiscal policy to the yearly tax season, it might be beneficial if we kept the subject in mind continuously. Perhaps that would prompt the fresh thinking that state and local finances desperately need.

Trade Balancing

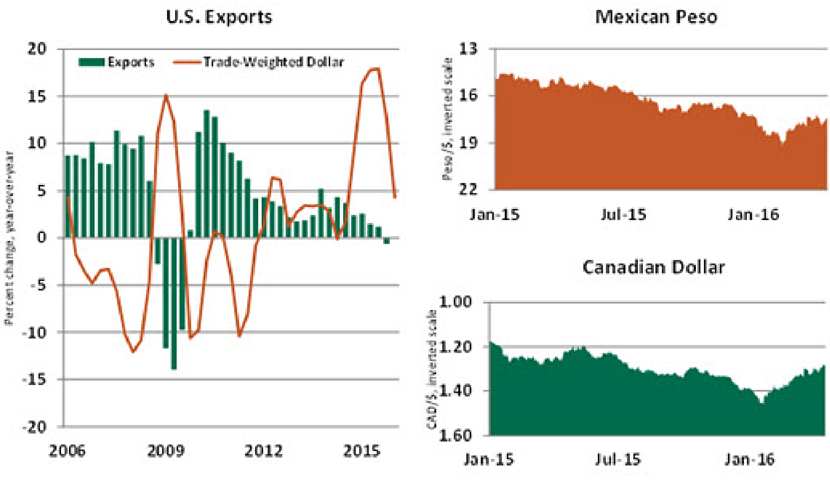
The year began with heightened concerns about the global economy. While issues remain, the sense of risk has clearly dissipated. While the primary expression of this relative calm has been seen in equity markets, U.S. exports may also be a beneficiary.

Real U.S. exports of goods and services in 2015 stood at $2.1 trillion. Over the last two decades, the share of exports has risen from the single digits to nearly 13% of U.S. real GDP. Canada (18.2%), Mexico (16.3%), China (7.3%), Japan (4.4%) and the United Kingdom (3.7%) are the top five destinations for U.S. exports.

Economic theory hypothesizes that a decline in income within a country translates into fewer imports, and a depreciation of a country’s currency also reduces imports. Both these outcomes were felt in 2015. There has also been a flight to safety among global investors that continues to this day.

The value of the greenback and the economic status of major trading partners of the United States present an explanation of the recent experience. The trade-weighted dollar’s 16% rally in 2015 is part of the reason for the weakness in U.S. export growth. A strong dollar is a welcome break for U.S. residents traveling abroad, and it increases U.S. imports of goods and services. But the other side of the story is that it weighs on exports, scales back economic growth and hits export-intensive sectors.

The dollar’s decline augurs positively for exports.



Source: Haver Analytics

In the last two months, however, the value of the U.S. dollar has moderated as international anxiety has declined. This may set the stage for better trade results in the quarters ahead.

Among the large importers of U.S. goods and services, China and Japan face pressing economic challenges. U.S. exports to China fell 6.0% in 2015, the first annual decline since 2009 and the largest in 16 years. Chinese authorities have succeeded in temporarily stabilizing economic and financial conditions. At the margin, Chinese imports from the United States could stage a minor recovery.

Exports to Japan fell in two out of the last three years. Although the Bank of Japan has taken unconventional steps to boost economic activity, a turnaround in business conditions is not assured. These uncertain prospects suggest a murky trajectory for Japanese imports, at best.

The Mexican peso and Canadian dollar fell 16% and 14%, respectively, last year. Mexico’s economic growth improved slightly in 2015; it appears that the hit to the currency took a toll on imports. There was a marked deceleration in economic activity in Canada during 2015.

The economic outlook for both Mexico and Canada is positive, stable oil prices are likely in 2016, and both currencies have strengthened in the first four months of the year. These considerations imply that exports to these economies (about a third of total U.S. exports) could move up.

Given the recent decline of the dollar, tailwinds from exports could be the surprise factor in this year's growth picture, if America's trading partners are successful in maintaining a stable economic momentum.

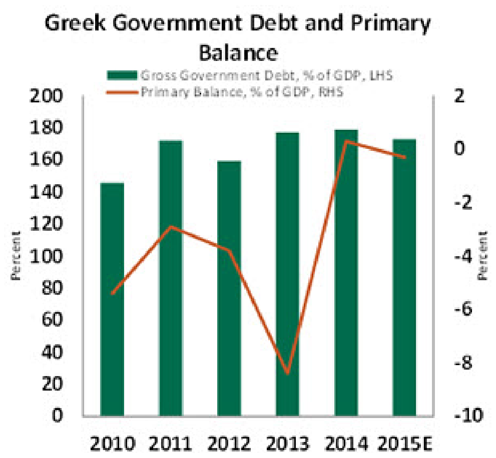
More Greek Drama Ahead?

You would be forgiven for thinking that Greece's problems have shifted from its financial woes to the ongoing migration crisis. And you would be right; but lurking in the background the Greek fiscal situation is still a subject of deep controversy, and one that could boil over again later in 2016.

Greece has some sizeable debt repayments due in the months ahead.

The latest review of the 2015 bailout program (crucial for further aid tranches to be released) has dragged on for months. The reason is two-fold. First, European creditors and the International Monetary Fund (IMF) disagree about the targets set for Greece over the coming years. In the Memorandum of Understanding outlining the parameters of the deal, Greece agreed to reach a primary surplus (government revenue minus expenditure before debt interest payments) of 3.5% of GDP by 2018. The IMF believes this target is unrealistic, imposing too much austerity on the Greeks.

Second, the Greek government is reluctant to make more cuts to pension payments. The bailout terms envisage pension savings amounting to 1% of GDP this year. But extremely high unemployment (particularly among the youth) means many households rely on pension payments as a primary income source. While this is clearly not sustainable, it does make cutting back politically difficult.



Sources: Wall Street Journal, Oxford Economics

The IMF considers Greek debt levels highly unsustainable and is pushing for debt relief, believing the measures needed to get Greece back on track go well beyond those suggested by the Europeans. The IMF's involvement in the program could hinge on this point, and it has insinuated that it could walk away from the deal.

But Europe has no appetite for additional lending to Greece and has explicitly said there will be no further reductions to debt. Private-sector debtholders were forced to accept haircuts on their holdings several years ago. But holders in the "official sector" (which includes banks, governments and the European Central Bank) are reluctant to write-down their holdings because of the potential impacts on budgets and capital.

These hold ups are starting to cause concern. Greece owes €5.5 billion in debt repayments in June and €5.7 billion in July. If the seemingly large differences in opinion between Europe and the IMF cannot be bridged before then, the Brexit referendum may not be the only uncomfortable issue Europe has to deal with this summer.

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