

# FRAGILE RECOVERY

BY CHRISTOPHER THORNBURG

**T**he National Bureau of Economic Research tells us the recession ended in June 2009, but you wouldn't know it by looking at state budgets. They're worse, not better.

California, New York and Texas alone face a combined \$60 billion budget gap over the next two fiscal years. The public bond markets that up until now have been happy to continue to fund states and local economies are showing the first signs of reluctance. Rates have started to rise.

The reason for this growing crisis is two-fold. First, most states failed to enact long-term solutions when the budget gaps first formed at the start of the downturn, instead relying on delay tactics such as one-time revenues and accounting tricks. Although some may call this a dodge, kicking the can down the road a bit isn't necessarily a bad thing. Moving budget problems to better times when revenues are growing spreads out the pain and limits the fiscal sting of higher taxes and reduced spending during the worst part of the economic crisis.

This leads directly to the second reason the problems have grown worse. Those hoped-for better times of growing revenues have not materialized. Although state revenues have started to grow, the pace has been tepid at best. This reflects, in turn, the overall weakness of the current recovery. To put this in perspective, after the last two deep recessions in 1974 and 1982 came to an end, the economy averaged 6.7 percent growth over the five quarters that followed. During the current recovery, the economy has averaged 2.8 percent growth—leaving the economy operating at a level far below its economic potential.

*Christopher Thornburg, Ph.D., is an economist and founding principal of Beacon Economics. Learn more at [www.beaconecon.com](http://www.beaconecon.com).*

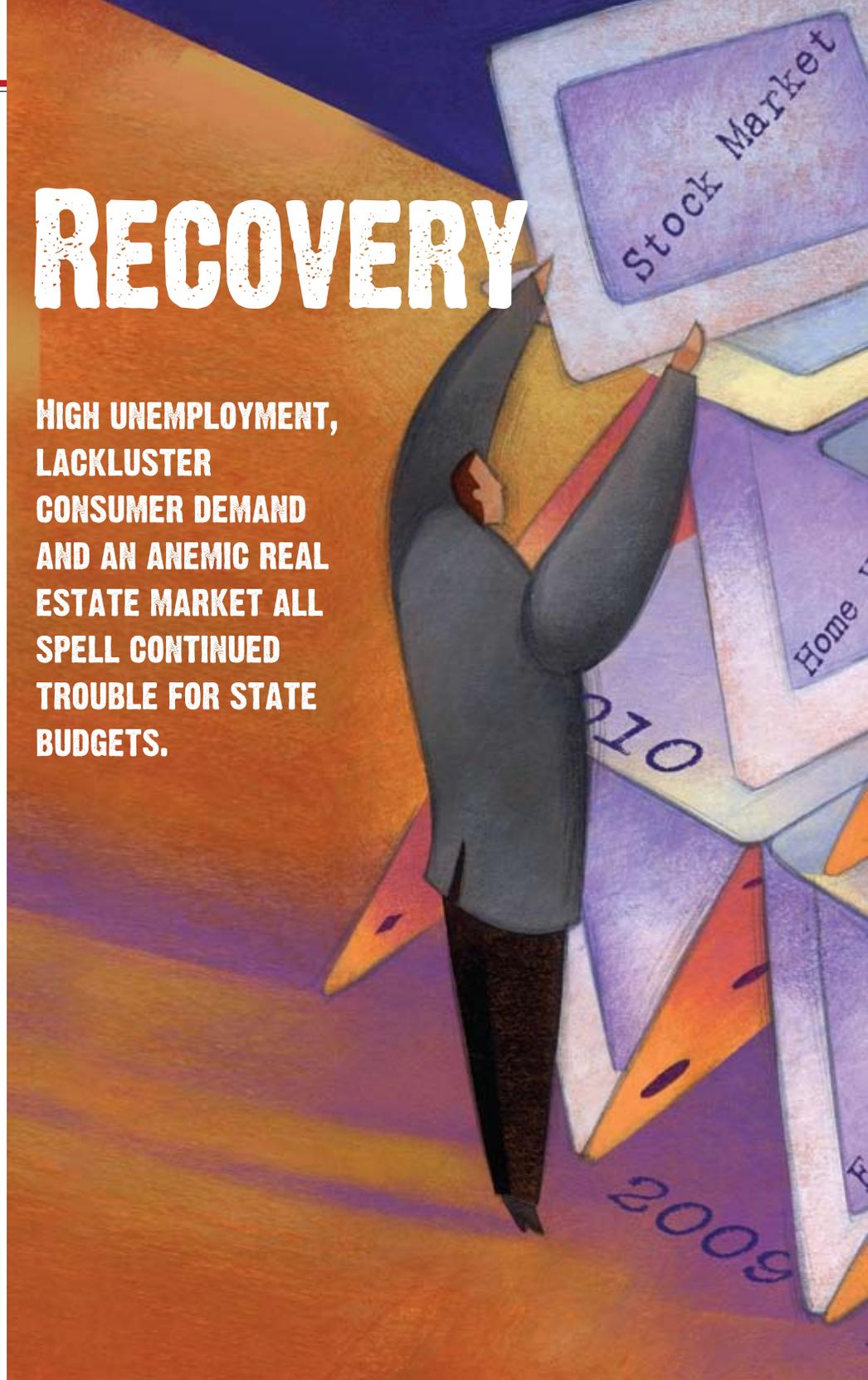
**HIGH UNEMPLOYMENT,  
LACKLUSTER  
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ESTATE MARKET ALL  
SPELL CONTINUED  
TROUBLE FOR STATE  
BUDGETS.**

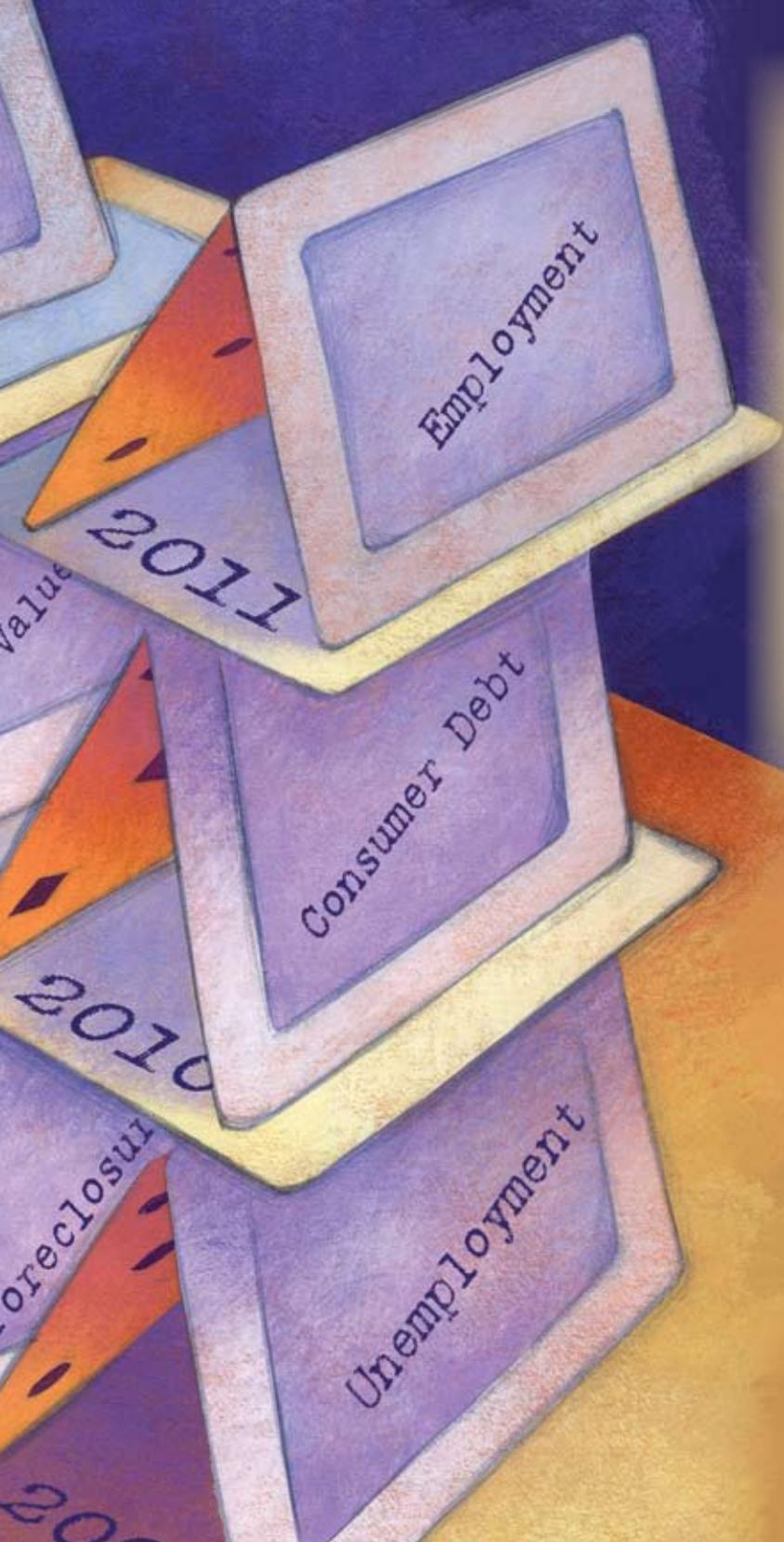
## CHALLENGES TO GROWTH

When considering contributions to growth at the national level based on where the money is being spent, the growth gaps are clear. Government spending, the trade gap and business spending are right on track to match past recoveries. Residential real estate and consumer spending are

responsible for the growth gap.

The reasons behind the lack of consumer spending also are clear, as are the implications for state budgets. During past recoveries there has been a sharp acceleration in consumer spending as households “caught up,” buying cars and furniture and other luxuries that were put on hold during the downturn. That isn't





## CONTRIBUTIONS TO ECONOMIC GROWTH

by source of demand

	Current Recovery	Past Average*
<b>GDP Growth</b>	2.90%	6.67%
<b>Personal consumption</b>	<b>1.39</b>	<b>3.69</b>
Goods	0.99	2.18
Services	0.40	1.52
<b>Gross private investment</b>	<b>2.27</b>	<b>3.94</b>
Nonresidential	0.59	0.69
Residential	-0.06	1.13
Change in inventories	1.74	2.13
<b>Net exports</b>	<b>-1.01</b>	<b>-1.30</b>
Exports	1.40	0.27
Imports	-2.41	-1.57
<b>Government</b>	<b>0.27</b>	<b>0.34</b>
Federal	0.41	0.19
State and local	-0.14	0.15

Source: Bureau of Economic Analysis  
\* Past Average from 1974 and 1982 Recessions

*Government spending, the trade gap and business spending are right on track to match past recoveries. Residential real estate and consumer spending are responsible for the growth gap.*

happening this time, however, because the recent recession came at the end of a period of unsustainable consumer spending.

The rapid rise of asset values in the United States that occurred between 1996 and 2007—of which housing was a portion—convinced Americans that saving was no longer a necessary part of planning for the

future. At the start of the recent downturn, Americans were saving barely 1 percent of their incomes, substantially less than the 6 percent to 7 percent that was the historic average, and much smaller than the 8 percent to 9 percent that many economists think necessary. Most of the current decline in consumer spending has been little more than

a return to something closer to a sustainable level.

The news gets worse: The current lower level of spending is still too high. While savings rates are up to 5 percent of income, overall spending is still running at about 83 percent of income, compared to a more sustainable level of 80 percent.

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## **BOTTOM FOR REAL ESTATE**

As for residential real estate, the nation is still saddled with 2 million to 3 million excess homes, while foreclosures remain at record levels. Yet, despite weak demand and excess supply, the market has found a steady bottom. This is largely because falling prices and interest rates have put affordability at record high levels throughout most of the nation. Nevertheless, only a growth in families looking for homes and an increase in homeowner equity will put the market back on a truly firm path of growth. Both will take years to build up without an enormous change in immigration policy or some inflationary boost.

Behind these basic headwinds to the recovery, another fundamental problem is blowing. When American consumers began their spending binge at the start of the last decade, the increased demand did not stimulate extra growth in our economy. Instead the fiscal benefits went to the rest

of the world in the form of a rapidly widening trade deficit. For the U.S. economy to fully rebalance itself, this trade gap must largely disappear—meaning fewer imports and more exports.

Unfortunately we seem to be moving in the wrong direction. The trade gap, which had reached a record level in 2007 before closing substantially during the downturn, has started to widen again. In other words, some of the positive effect of the weak growth in aggregate demand isn't staying within our nation's borders. Instead it is again helping the world economy. With these fundamental weaknesses, it should hardly be a surprise that the job market is recovering so slowly and that unemployment remains high.

As a result, the primary sources of revenue at the state and local levels—property, income and sales taxes—have grown slowly and those tough budget decisions that have been put off are coming home to roost. With

anemic growth projected to continue, it seems unlikely that this scenario will change much in the near future.

## **SOME HOPE**

There are, however, a couple of rays of light on the horizon.

Despite the weak labor market, those who have jobs are working more hours, and their incomes are starting to rise—albeit at a slow pace. The rebound in the financial markets should give states a nice boost on taxes collected on capital gains—at least when the hefty losses incurred in 2008 and 2009 are fully written off. Corporate profits also have been growing at a steady pace. These trends will likely continue, but not fast enough to provide instant relief.

What does it all add up to?

States may very well have to accept that now is the time to finally make the tough decisions about spending and taxes they have avoided so deftly up until now. 