

# Spending sputters trigger budget scramble

Fall in consumer spending, housing bubble undermine state budget plans

*How much worse can a worst-case get? That's the \$64,000 question in Columbus and other state capitals these days. And the fate of the jobs of state employees hangs on the answer.*

The Strickland administration is in a tough situation since it's hard to make contingency plans for public services when the worst-case situation is unknown. The governor is not alone: State officials and legislators across the nation are trying to react to an unraveling economy that is shredding the budget plans they put in place just months ago.

In Ohio, the jobs and the agencies OCSEA members work for are facing their most serious threat since 2001. Already, state departments and bureaus are being pressed to rein in spending and to draft plans for significant cuts.

In a horrible case of bad timing, the call for spending reductions in some state agencies, particularly the adult and juvenile prison systems, comes at the same time big emergency spending *increases* are desperately needed to guarantee basic security and safety.

Granted, there's a tendency every time there is a revenue crisis for the current one to be called "the worst," but there are several disturbing new devel-



*Leadership from the union listened to key cabinet members, including Office of Budget and Management Director Pari Sabety, last year during a budget briefing at OCSEA Headquarters. Since then, Ohio's state budget has declined and is facing large shortfalls.*

opments in the Ohio and U.S. economies that is causing major fears among political leaders and economist. Administration officials say the budget deficit could grow to \$1.9 billion.

Quick translation: The odds of major state employee attrition waves, layoffs and program cuts are high and growing fast.

## Unmanageable risks, unthinkable cuts

"Ohio's budget is at risk of going out of balance for a number of reasons. Some are controllable, but others are completely outside of state control, most notably the condition of the U.S. economy," wrote financial consultant Richard Sheridan in a recent issue of his *State Budgeting Matters* newsletter.

Sheridan cited cuts in federal and domestic spending (triggered by the cost of wars in Iraq and Afghanistan), rising energy and health care costs, the collapse of the housing market, and

disruptions in credit availability as the biggest uncontrollable problems being encountered.

States like California, New York and Florida were hit relatively early and have begun taking drastic measures. California Gov. Arnold Schwarzenegger, for example, has proposed closing state parks, eliminating indigent dental care and forcing major cuts in education spending. New York Gov. Eliot Spitzer has called for releasing thousands of felons and closing several prisons.

Now, Ohio's budget is showing major signs of suffering, too. It was one of six states that reported major drops in total revenues in their first quarter of Fiscal Year 2008 (July 1, 2007-Sept. 30, 2007), tumbling almost 1 percent compared to the same period a year ago. This

data, from last summer, was something of an early warning sign. By November, the gap had grown to 1.6 percent, but then fell back to 1.3 percent in December.

## Bubbles burst budgets

It's easy to see where the problems are in Ohio's budget. The state basically gets revenues from three sources: personal income taxes, business taxes and sales taxes. Business closures and growing unemployment levels are directly linked to fall offs in corporate and personal income tax revenues. Unemployment in Ohio has started climbing again and hit 6 percent in December, one of the highest rates in the nation.

As people's confidence in their personal financial situation has dropped, so have their purchases. Thus, state income



from sales tax has also taken a walloping.

The drop in state revenues is, however, the result rather than the cause of the underlying problems. The biggest issue eroding the states' and nation's finances is whether it can continue to be a consumer-driven economy. For better or worse, the willingness of people to buy cars, food, houses and other goods and retail services has buoyed the economy for more than a decade. It provided enough "oomph" to get us through the burst of the tech-stock bubble in 2000, the events of 9/11 and the surge in energy costs.

Despite little change in real income during the same period, consumer spending was made possible by growing real estate values that seemed to be only going up. Banks and mortgage companies made it easy - too easy, as we now know - for people to buy homes, watch their property values climb, and then borrow against that "paper" equity.

One measure is the ballooning of home equity lines of credit (HELOCs) that homeowners have used to make non-home purchases. In 1991, HELOCs represented about 1 percent of a family's disposable income. By 2006, it had jumped to 10 percent of disposable income. For the first time in history, millions of homeowners have been able to use their homes as collateral to borrow more than the property was worth.

This was like an influx of "free money" that seemed like it could go on forever. Unfortunately, the real estate bubble has turned out to be more akin to a pyramid scheme than a stairway to heaven.

Several major economists (e.g., Paul Krugman and Dean Baker) warned for years that the housing bubble was the final fuel for consumer spending and that its inevitable crash could rip apart the economy in unpredictable ways.

It appears they were correct.

### All eyes on DC

What happens to the economy, at least in the next year or two, depends largely on what happens in Washington. Ohio and other states are largely helpless in that they have to maintain a balanced budget. Although Ohio's Rainy Day Fund could be tapped and changes could be made to the tax code, those both require a political consensus that seems unlikely for now.

But the federal government has the ability to quickly delivering a short-term economic stimulus package aimed at least at leveling off consumer spending. This is a situation where the presidential political races will most likely help spur action.

As of late January, most proposals consisted of some form of tax-based rebate or credit that would be quickly offered to tax payers. Federal funding of off-the-shelf infrastructure projects is another possible, but less likely, stimulus.

But all that assumes that the worst is over when it comes to economic bad news, and that is far from a safe assumption. Many businesses have been slow to divulge the full extent of their housing-related losses and many retailers have been reluctant to disclose their fall off in sales.

Until more is known, any cuts and alterations in Ohio's state budget made over the next few months, unfortunately, must be seen as the beginning of a response by state officials - one that should be followed closely.



## What's in a bubble?

The term "bubble" currently being used to describe the housing investment situation, has been around for a long time. It was used in the late 1990s and early 2000 to describe the rapid growth in "dot-com" stocks and investments that crashed thereafter.

In recent history, it has also been used to describe oil investments in the 1980s and gold/silver investments in the 1970s.

Each of these cases has something in common. People and businesses made investments in areas where values appeared to be growing far faster than other parts of the economy.

Historians note that one of the oddest economic bubbles occurred in the 1600s in the Netherlands when there was widespread speculation on tulip bulbs. At one point, single tulips were selling at several times the average yearly income of the Dutch.

The U.S. housing bubble can be traced to price accelerations in the 1980s.

The increases were particularly sharp in major population centers on the East Coast and West Coast, plus Chicago, but eventually affected nearly every region and city after 2001.

As in other bubbles, unscrupulous middlemen played a key role.

Advisors and lenders touted real estate as a "sure thing" investment.

Some people who were better off as renters were lured into purchasing homes. Mortgage companies also made it easy for buyers to fudge their income and financial situation (the "sub-prime" mortgages).

Greed and wishful thinking have also been factors. Some buyers eagerly jumped on the bandwagon seeing it as an easy way to live beyond their means, thinking the worst that could happen is that they could break even or sell their property for a small gain.

The lesson, as always, is there is no free lunch. Nothing increases in value forever.



Pamphlet from the Dutch tulipomania, printed in 1637