

*Dan Hamilton*

*June 25, 2010*

Forty-six states face budget shortfalls of \$112 billion for the fiscal year ending next June. While there are political difficulties in closing these gaps there are also constitutional mandates for doing so. If and when they close these gaps, it is likely that some of it will be constricted expenditures and this will filter down to local government budgets as well. State and local governments will try to implement the expenditure cuts without losing staff, but we expect at least some staff losses.

State and local government expenditures are sixty-percent of the Government portion of Gross Domestic Product. While Q1 2010 Federal government spending rose by an annualized inflation-adjusted rate of \$3 billion, State and local government spending fell by \$15 billion. We expect these kinds of State and local government spending declines to occur in each remaining quarter of 2010.

These government sector activities will impact the economy. The staff cuts will keep job growth relatively low and delay the return of a strong labor market. The expenditure declines will filter into GDP, more than offsetting any future positive contributions from Federal expenditure.

Some might propose that the Federal expenditure level should be boosted via payments to allow State government operations to continue without cuts. However, this would setup a problem where State operations would have an incentive to be rewarded with larger budgetary requirements (without necessarily implying any estimated efficiencies or benefits) in order to get more Federal money.

I reiterate our position that Government stimulus should be: Investment Tax Credits and expenditures on public good infrastructure that boosts household and establishment productivities. Private investment expenditures boost current and future GDP while infrastructure greases the machinery of commerce. In the 1950s key infrastructure included roads/docks/bridges, etc., and these remain important today. However, we should also think about public wireless internet systems and other improvements designed for the high-tech economy.