States and the Financial Condition of Cities

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The fiscal problem of large cities was as prominent a policy issue in the 1960s and 1970s as it was a forgotten issue in the 1980s. Is this because the problems were solved, because other problems have become more pressing, because the problems have become “hidden,” or simply because cities are weakly represented in congress and in state legislatures?

Many thought that the fiscal problems of central cities and the celebrated city-suburban disparities were due to, or at least exacerbated by, state government fiscal policies. Have state governments assumed more of the financing responsibility for cities in the 1980s, or have they passed along the reduction in federal subsidy to their local governments?

These are the two questions to be addressed in this paper: What is the financial condition of cities, and whether state governments have used their new, more powerful role in the federal system to strengthen the financial hand of cities. A third section of the paper speculates about the policy options in the 1990s and the factors that will put some bounds on these options.

The Financial Condition of Cities

There have been few newspaper headlines in recent years about dire financial situations facing big city governments. Certainly there has been no great re-emergence of a federal concern—the direct urban aid programs have long since disappeared with little discussion of their revival, General Revenue Sharing died a very quiet death, and retrenchment in federal assistance to the state and local government sector is in full bloom. Yet there are indicators of fiscal trouble that are reminiscent of the last decade: the NIA deficit of the state-local sector is growing, the National League of Cities reports that revenue growth in over half of all large cities will not keep up with inflation, and the list of distressed cities in the 1980s has many of the same names as in the 1970s.

Are cities in a sound fiscal position or not? One might boil the discussion on this issue down to three hypotheses: (a) The national economy improved and cities simply outgrew their problems; (b) Cities have learned to live with their revenue constraints; and (c) Cities have deferred their problems and a day of reckoning is coming. The right answer here is important because the first two hypotheses suggest no need for a special policy response—local governments have found a way to deal with their problems. The third hypothesis suggests that many city governments cannot find their own way out of these fiscal problems and that a special state or federal policy response may be necessary.

City Economies

The 1970s were a rough time for cities, and especially those in the north came to the 1980s in a precarious position. The average per capita income of their residents fell—in many cases from above to below the national average—as higher income families and jobs migrated out. The share of national population (and therefore consumer markets) fell and many cities suffered absolute declines in employment. There was a changing mix of employment away from the traditional manufacturing base to services. The latter turned out to be a mixed bag of high paying, white collar professional jobs in high growth sectors of the economy and low paying, semi-skilled jobs that were sensitive to the business cycle.

With this recent history, and with the recession of the early 1980s about to set in, how could city economies have performed strongly in the 1980s? Have cities shared heavily enough in the benefits of the post-1981 recovery to outgrow their fiscal gaps? Some answers are in the work of Garnick, who has charted the employment growth in the 1970s and 1980s by region and by metropolitan area. Some of his findings about employment patterns the 1980s might be summarized as follows:

- MSA core counties grew at a rate about 30 percent less than did the rest of the country. Even this represented some improvement, however, because they had grown 70 percent more slowly in the previous decade.
- Many core counties, particularly in the north, experienced no employment growth or even absolute decline in some places.
The strongest growth in central county employment has been in the Southeast, Far West, and parts of New England. An analysis of the 10 largest city-county governments yields about the same results. Growth has been stronger in the 1980s than the 1970s, but below the national average rates.  

The conclusion one might reach here is that the story that cities outgrew their fiscal problems is an unlikely one.

Better Financial Management

A view held by some is that the problems of the 1970s were as much bad financial management as anything. The New York City debacle was taken as a lesson of what can happen if a city does not live within its financial means, Propositions 13 and 2 1/2 were taken as a sign that voters would not tolerate high taxes, and a wave of fiscal conservatism swept the country and became a fashionable label for politicians. The result of all of this is that cities have learned to live within their financial means, hence fiscal deficit problems have not been common.

There is more than a grain of truth in this story. For one thing, cities had to become more self-sufficient because of the pull-back of federal assistance. Whereas in 1977, direct federal aid to the 15 largest cities was equivalent to 34 percent of the amount raised from own sources, in 1987 the ratio had fallen to below 10 percent. As will be discussed below, state governments did not step in to fill this gap. Cities had little choice but to become more responsible.

To the extent fiscal conservatism is part of the explanation for the apparently better fiscal health of cities, there should be some evidence of retrenchment or at least a slowing rate of growth in the expenditures of large local governments. The data indicate this to be the case, at least to the mid-1980s. When personal income growth slowed and federal assistance was reduced in the early 1980s, expenditure growth slowed and taxes were increased. During this period, the retrenchment was greatest for local governments.

There has been a change in this pattern since the mid-1980s. As the recovery has continued, local governments have expanded parts of their operation. The number of employees of state and local governments has begun to increase after a long period of retrenchment. The average compensation rates of these employees also have been increasing, especially in larger cities, and a catch-up with the private sector has again occurred.

What one might conclude from this is that conservative budgeting and fiscal planning is part of the answer as to why fiscal crises have been the order of the day in the 1980s. Cities seem to have done a better job of expanding and contracting their budgets depending on the performance of their economies. Still, since 1984, there is evidence of a resurgence of growth—perhaps evidence of backsliding or perhaps a signal that some deferred public service needs and public employee compensation disparities had to be addressed.

The Deferral Thesis

The problem with the fiscal responsibility argument is that while it may lead to balanced budgets and fiscal health in the traditional sense, it may not lead to healthier cities. Cities may balance their budgets simply by deferring their expenditures on certain activities to later years and allowing those public services to deteriorate.

The most often cited example of this is spending for infrastructure. There was a slower rate of capital expenditure growth in the 1980s, and though some of this is surely attributable to the completion of the interstate highway system, many would argue that it also reflects a neglect of the development of the capital stock. Another example is in the area of public employment. The cutbacks in the late 1970s and early 1980s may be no more than deferrals, because after 1984, public employment levels began to increase again.

In other areas, one cannot easily see hard evidence of deferral, but there are glaring inadequacies in the quality of certain public services and obvious unmet needs. Urban education, the plight of the poor in inner cities and the growing underclass, and the homeless are examples. On the one hand, these public service needs may not be best met by using local resources, but they are evidence that balanced budget or no, some cities are not healthy.

Some interesting support for this argument comes from the empirical work of Dearborn, and Ladd and Yinger. Dearborn traces the financial condition of cities using measures of liquidity, deficit position and cash balances. Though there is some evidence of chronic fiscal imbalance among a small group of cities, he generally sees a stronger financial position in the mid-1980s than in the 1970s. Ladd and Yinger on the other hand look at distress in a much broader way than just the budget and point to a
much longer list of distressed cities, including some of those whose budgetary balance seems relatively sound by the Dearborn criteria.

The deferral thesis is clearly part of the story about why cities do not seem to be in as much financial trouble in the 1980s.

**THE ROLE OF STATE GOVERNMENTS**

There has been a pronounced shift in the balance of fiscal responsibility in the federal system in the last decade. The Carter Administration shifted the balance of power toward the state government level by beginning the phaseout of the direct urban aid programs (CETA, anti-recession fiscal assistance, and local public works). The Reagan Administration took this a step further by shifting responsibility for public financing from the federal to the state-local level. Critics of the Reagan plan saw it as a thinly disguised way to offload a portion of the federal deficit.

Whether shifting balance or offloading, the federal government passed its responsibility down in three ways: reductions in federal grants to state and local governments, elimination of deductibility for general sales taxes, and a reduction in the value of deductibility of state and local taxes. The result of these actions was to increase the tax price at the state and local level.

The question we might pose about the new role of state governments in the 1980s is this: when the federal government cut back its subsidy to the state and local government sector, did the state governments follow suit and offload their losses onto the local governments? There is some evidence that they did. The patterns described in Table 1 indicate the following:

- The state government share of direct state and local government expenditures increased through the 1970s but has fallen in the 1980s.
- The state government share of taxes raised increased from 54 percent in 1972 to 64 percent in 1981, but had fallen to 62.5 percent by 1987.
- State aid to local governments has fallen. It is lower than in the early 1980s whether viewed as a percent of state government expenditures or as a percent of local government expenditures.

These statistics would seem to indicate a trend toward fiscal decentralization. To investigate this hypothesis, we have defined a shift toward local government as a 1 percent or greater swing in the share of total state and local government revenues raised, or direct expenditures made, at the local level. By this measure, 17 states decentralized their revenue structures and 11 decentralized their expenditure structure between 1977 and 1987. What this suggests is that states have reacted in a very different way to the reduction in the federal subsidy and to the financial situation of their local governments.

**TABLE 1**

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A reasonable proposition is that some cities will face serious fiscal problems in the next few years. In the worst case, their economies have grown slowly, federal assistance has been cut back and states have not stepped in to fill the gap. These cities have avoided default by compensating for revenue inadequacy with some combination of raising taxes and postponing or cancelling public expenditure programs. For this class of cities, some form of special subsidy program will have to be part of the federal agenda in the 1990s. The questions are how to identify such cities, what form should this subsidy program take, and how will the responsibility for financing the subsidy be divided between the federal and state governments. The lessons we learned from the 1970s about this were that one could not devise a targeted assistance program unless he directly addressed the issue of how all other local governments would be treated, and that the success of any assistance program was very much dependent on the economic and political setting in which it was carried out.

For the state and local sector as a whole, the setting for dealing with the financial problems of cities has changed. Consider the following:

- The tax price has been driven up by a combination of the removal of sales tax deductibility, the reduction in federal marginal personal income tax rates, and reductions in federal aid. Faced with a higher price for state and local government services, consumer-voters will likely demand less. In other words, raising taxes to finance better urban services is going to be a harder sell now than it was before.
- The state and local government sector has moved from a sizeable surplus to a deficit position in the past two years. This means that accumulated surpluses from the long recovery period have been drawn upon extensively.
- The reduced value of the federal offset heightens the new competitive federalism because tax rate differentials among states now more nearly reflect tax burden differentials. This will increase the degree to which industrial policy will drive state fiscal decisions in the 1990s, and pro-city fiscal programs may suffer.

What are the ways out for cities in fiscal trouble, i.e., the ailing cities in the Ladd-Yinger story? Direct federal assistance to local governments would not seem to be in the cards, at least not in the form it took in the 1970s. However, an increased amount of direct aid to people (vs. places) does seem likely and can address some of the serious problems that cities in particular must face in the next decade. These include poverty and the underclass, AIDS, homelessness and drug abuse.

An increased state government responsibility for urban services would seem the most likely source of an increased subsidy for local governments. The state government tax base is more productive and the local property tax is the most unpopular of the state and local government revenue sources. The fiscal position of most states is strong and state governments may also see it as reasonable to take on responsibility for problems that are not local in nature, e.g., homelessness, drug abuse, AIDS, and many aspects of the poverty problem. Against the scenario of a greater state government involvement are the now higher tax price that will dampen the state government's political ability to raise the level of taxes, and suburban-rural dominated state legislatures that may balk at programs that would transfer major amounts of state resources to central cities.

Can local governments do more to help themselves? The answer, of course, is that they can. But there is a great variation in the financial health of cities and those in the most trouble are probably the least able to help themselves. Moreover, the property tax has been made even more unpopular with those who itemize deductions for federal income tax purposes because of the reduced value of deductibility. On the positive side, the 1980s saw a great growth in the use of user charges and the next 10 years could see an even greater growth. This is partly because benefit charges of all kinds are now popular and seem to fit the mood of voters, and partly because the increased price of general taxes now makes user charges a "better buy" than before. It also is true that local governments may be in the best position to retrench on the expenditure side, by reducing employment where it has increased beyond needed levels and by keeping the rate of growth in compensation of public employees on a par with that in the private sector.

Conclusions

One gets the feeling of having been through this discussion before—in the 1960s and 1970s. Cities were adjusting to a new economic role (a smaller, poorer and blacker population), there were substantial and growing fiscal disparities between cities and suburbs, and neighborhood environmental conditions in cities were deteriorating. The policy discussion centered around how the state governments had not properly come to the assistance of cities and there were calls for mandated pass-throughs and
direct federal-local aid programs, and there was much discussion about how urban governments might better help their own situations (metropolitan government and regional tax base sharing were the hot reform topics). The big difference this time around is the size of the federal deficit and the fact that the federal government does not seem to be part of the discussion.

FOOTNOTES


8The National Conference of State Legislatures reports that most states finished fiscal 1989 in a strong position and that Rainy Day Funds held by states at the end of that year were equivalent to about 4.5 percent of their general fund expenditures. “State Budget Actions in 1989,” Legislative Finance Paper #69, Denver: National Conference of State Legislatures, Martha A. Fabricious, Steven Gold and Korina L. Eckl, September 1989, p. 53.

9The National Governors Association/National Association of State and Budget Officers reports that compensation increases “... provided in most states attest to the fact that state budgets are in a period of relative surplus and provide a stark contrast to the early 1980s when employee compensation increases were very limited.” Marcia A. Howard, Fiscal Survey of the States, National Governors Association and National Association of State Budget Officers, September 1989, p. 9.


FISCAL STRESS: THE CREDIT MARKET VIEW

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INTRODUCTION

The objective of this paper is to compare indicators of fiscal stress as they are employed by municipal analysts in credit evaluations and by academic researchers examining systemic causes of central city decline. This is difficult because the analytical activities performed by rating agencies, municipal