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Roy W. Bahl

Georgia State University, rbahl@gsu.edu

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Recession, Inflation, And The State/Local Fisc

BY ROY W. BAHL
Professor of Economics and
Director, Metropolitan Studies Program
The Maxwell School
Syracuse University

"... state and local governments are fast approaching a fiscal dilemma of major dimensions and one which certainly will result in the cutting out of some on-going programs, the elimination of some sub-functions, and the postponement of capital expenditures."

If today's mixture of high rates of inflation and unemployment leaves federal policy-makers in a quandary about proper macroeconomic reform actions, it leaves state and local government fiscal planners in a situation of not even being able to identify the probable budgetary effects of a continued poor performance of the economy. This paper is an attempt to flesh out some of those budgetary effects in a context of assessing the current and possible future performance of state and local government finances over the next few years.

At the outset, it would seem worth highlighting those features of the current inflation/recession dilemma which are particularly important to the state/local government fisc. Three would stand out: 1) the prospects of a continued level of inflation, with prices projected to rise between 7 and 10 percent next year; 2) a continuing growth in unemployment toward a projected level of 9 percent by next year, and decline in value added by more than 10 percent of potential output, and 3) marked changes in relative prices, with labor costs possibly rising faster than the average cost of materials and supplies.

Presuming continued slack in the economy and present trends in the price level, these three factors will exert a major effect on the financial viability of state and local governments over the next two-to-three year period.

In a context of projecting the probable consequences of rising prices and unemployment on state/local finances, three concrete propositions might be offered. *First,* the inflation/recession combination stimulates expenditures to a far greater extent than revenues and, therefore, produces a growing fiscal gap. *Second,* the fiscal position of local governments is harmed more than that of state governments. *Third,* the overall level of services delivered, particularly in central cities, will deteriorate even in the face of rapidly rising expenditure levels.

In a context of these impressions about the future of the state/local fisc, two of the currently proposed solutions to the dilemma—public employment cutbacks and general revenue sharing—are considered in a final section.

It should be emphasized at the outset that the view taken here is that under anticipated levels of price and unemployment increases, inflation effects on state/local finances will tend to dominate recession effects. The reasoning is straightforward—increases in unemployment will principally affect the marginally employed who may not make a major contribution to the tax base in any case.

Their expenditure requirements, however, do not diminish as their income declines—indeed, these requirements may increase. Inflation, on the other hand, exerts effects of major proportions, particularly on the expenditure/cost side.

Revenue vs. expenditure effects—State and local governments depend on three major tax revenue sources—property taxes (37 percent), sales taxes (34 percent), and income taxes (19 percent). In terms of the potential effect of continued inflation/recession on the yield of each, one can speculate about the relative size of the stimulative

effects of inflation and the dampening effects of recession, drawing, where possible, from the scant research existing in this area.

The property tax is the least responsive of the major taxes. Particularly in many older central cities where taxable new construction is becoming less frequent and where reassessments are infrequent and drastically understate property value increments, property taxes remain relatively constant during an inflation. (It should be noted that this effect varies, depending on the nature of the tax rate limit—nominal or real—and the extent to which "real" tax limits have been reached.)

High mortgage rates, which have markedly reduced construction activity, have reinforced this dampening effect on property tax revenue growth, particularly in suburban areas. Recession, on the other hand, also would have little effect on property tax receipts since job layoffs have not yet resulted in massive plant shutdowns and assessments respond to neither the creation of excess plant capacity nor changes in the employment status of homeowners.

Sales taxes do respond significantly to increases in the price level; however, it is interesting to note a differentially higher rate of growth of expenditures on non-taxable than on taxable items. For example, expenditures on housing, food, and shelter rose by a greater percent because of price increases, than did the overall CPI. While there are comparability problems with these indexes, the results suggest that inflation might induce consumers to shift a greater proportion of their budget expenditures toward non-taxable items and, therefore, exert a dampening effect on sales tax revenues.

The effects of recession on the sales tax base will be felt as consumers postpone purchases, particularly of durable goods, but a combination of rising product prices and the limits on how much consumption a person can postpone or forego suggests continued increase in sales tax revenues.

Finally, income taxes will rise during inflation in income tax states, particularly where progressive rate structures are used, i.e., where tax receipts respond more than proportionately to families moving to higher rate brackets. By 1974, only nine states did not have a personal income tax, but rate structures differ and capture this inflation bonus to varying degrees.

This stimulative effect on income tax revenues will be dampened considerably by declining personal incomes as the recession proceeds, but the net decline will be tempered because many of the now unemployed are frequently in the lower tax brackets while employed.

The conclusion, then, is that inflation exerts a positive effect on state/local government revenues and, though this growth is somewhat dampened by the current recession, it is not likely to be offset given current forecasts of the rate of unemployment or the decline in real GNP.

The major budgetary problem of the projected inflation/recession pattern is on the expenditure side. On one hand, neither changes in the price level nor changes in the unemployment rate are likely to reduce resident requirements for public services.

On the other hand, price level increases are markedly raising the public sector cost of providing even a constant quality package of public services. The cost of materials has certainly risen, but public employee labor costs, responding to a rising cost-of-living and a favorable bargaining position, have risen even faster.

The budgetary effects of these price level changes have been of major proportions. For example, Greytak, *et al.*, in a very detailed study of New York City finances found that over the 1965-1972 period, 43 percent of the city government expenditure increase could be attributed to inflation. (David Greytak, Richard Gustely and Robert J. Dinkelmeyer, "The Effects of Inflation on Local Government Expenditures," *National Tax Journal*, December, 1974, Vol. XXVII, No. 4.)

In a comparative study, Gustely has estimated that the percent of labor cost expenditure increase due to inflation ranges between 36 and 52 percent among the nation's ten largest cities. (Richard D. Gustely, "A Comparison of Changes in City Government Labor Costs Among the Ten Largest U.S. Cities: 1966-1971," Working Paper No. 11, The Maxwell School, Metropolitan Studies Program, Syracuse University, Syracuse, N.Y., 1973.)

Quite apart from the wage and material price pressures on expenditure level are the fixed commitments, i.e., the committed present and future retirement system payments which in many cases automatically respond to price level increases, to increases in health insurance rates which raise government costs, etc.

In sum, the situation is likely to be one of expenditures continuing to grow rapidly with price level increases and continued pressure for compensation increments. On the other hand, revenues will respond to inflation, but this response will be constrained by either assessment practices which aren't amenable to capturing rapid change in the property tax base, flat rate state income tax structures, or the offsetting effects of some combination of rising unemployment and declining personal incomes.

In any case, the result is clear: state and local governments are fast approaching a fiscal dilemma of major dimensions and one which certainly will result in the cutting out of some on-going programs, the elimination of some sub-functions, and the postponement of capital expenditures.

State vs. local effects—Our second proposition is that the current pattern of inflation/recession will affect local governments, particularly core city governments, far more adversely than it will affect state governments. On the revenue side, the state government tax mix, which includes sales, income, and excise taxes, is far more amenable to capturing the effects of inflation than is the primary local government revenue source, the property tax. In general, the structure of local revenues tends to be unresponsive to income or price level growth, i.e., 54 percent is raised from property taxes and 21 percent from various charges and licenses.

On the expenditure side, the problem also would seem more severe for local than state governments. According to one estimate (Greytak, *et al., op. cit.*), the price of labor inputs has been raised by ten percent more, because of inflation, than has the price of non-labor inputs. Since payroll costs represent about 62 percent of local government expenditures as compared to about 50 percent for state governments, the inflation effect on local governments is clearly greater. (Roy W. Bahl, David Greytak, Alan K. Campbell and Michael Wasylenko, "Intergovernmental and Functional Aspects of Public Employment Trends in the United States," *Public Administration Review*, Volume XXXII, 1972, No. 6.)

Moreover, the labor proportion of total expenditures is growing faster for local than for state governments. Because of the nature of local government systems for delivering these services—highly labor intensive—there would seem little room for substituting capital for labor and thereby reducing this effect.

The inflation/unemployment combination probably hits central cities in metropolitan areas hardest of all. These governments typically rely most heavily on the property tax, have the most stagnant property tax bases, and provide the most labor intensive package of services. Moreover, since many of the newly unemployed are central city residents, recession effects may result in a greater drain on city budgets to provide increases in welfare-related services.

Service level effects—A third effect of inflation/recession which might be questioned is how public service levels are apt to be changed. It seems probable that rising prices and unemployment will act in concert to drive service levels down and to drive costs up. First, note that particularly in the labor intensive local public sector, marginal changes in expenditures are more apt to bring about increases in service levels if more employees are provided than if higher wage rates result.

Indeed, if we examine the short run and consider that marginal changes in the wage rates are not likely to stimulate increased productivity, we may conclude that service levels will respond positively to *only* increases in the number of employees.

Now consider the service level effects of inflation. First, there is the obvious effect of rising prices: the prices of government labor and non-labor inputs rise thereby raising expenditures, but not service levels. Second, there is an indirect effect—city finance officers seeing higher wage rates and having scarce revenues to allocate will react by hiring fewer new employees, or reducing employment.

Empirical studies have shown that a one percent higher wage rate for state and local government employees tends to be associated with an employment reduction of from 0.1 to 0.6 percent. (R. G. Ehrenberg, "The Demand for State and Local Government Employees," *The American Economic Review*, Volume LXIII, No. 3, June 1973. Note that since the employment level declines by a smaller percentage than the wage rate rises, the total labor bill will increase.)

The effects of rising unemployment and lagging economic activity are less dramatic, but have the same effect. To the extent recession exerts a constraining effect on the local government budget—by reducing either local tax collections or the inflow of external aids—it forces a more severe trade-off between higher wages vs. more employees. For example, faced with a given level of collectively bargained wage rates and supplements, the tighter the budget, the fewer the new employees added.

Therefore, the combined effects of inflation/recession most likely will be lower service levels at higher costs.

The solutions—The proposed solutions to the problem—how to maintain a viable state/local fisc in a period of rising prices and unemployment—are many and generally ineffective. By far the worst is the laying off of public employees, an action which recently has been taken by many large cities. While there is clearly much fat in public employment roles, those laid off (or not employed because of a hiring freeze) tend in large to be involved in direct delivery services.

Hence, an immediate effect is the lowering of service levels, particularly in cities where there already are serious public servicing problems, i.e., the numbers laid off will be greater in cities where the budget squeeze is tightest. If a part of the decline of American central cities may be attributed to this low public service provision, the suburban flight will be further stimulated by city public employment cuts.

The employment reduction solution may be faulted also on grounds that it is a solution for only one government. For example, if in a period of high unemployment a city worker is laid off, the result may be simply a switch from a city payroll cost which is borne mostly by city residents to a transfer payment cost which is borne by all levels of government. Only, under the transfer payment income, he no longer works.

Since the net gain in all of this to taxpayers is the difference between the employee's city pay rate and his transfer payment, minus the loss of the value of services he performed while working, it would seem that federal assistance programs would do well to focus on a public employment maintenance program.

A second set of proposed solutions to the immediate problems has to do with federal and state assistance programs. These are subject to the critiques that they are too small to even begin to offset the enormous cost increases associated with inflation, and/or that they cannot deal properly with the service level issue raised above.

Proper solutions are always difficult to construct, even more difficult to implement, and seemingly never politically feasible. But, what is called for here are a reform in intergovernmental relations which lifts the state/local financing burden from the local property tax, and the creation of a state level mechanism to control government costs so as to ensure that increased revenues will produce some service level increase.

The first of these goals might be accomplished by direct state financial assumption of major local functions, e.g., education. The second could result from the centralization of collective bargaining at the state level, and the creation of a set of realistic and enforceable compensation guidelines. □