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The Setting for Municipal Finances in the 1990s

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Under the Eaves

THE SETTING FOR MUNICIPAL FINANCES IN THE 1990s

Dr. Roy Bahl

The prospects for financing municipal governments are more than ever interwoven with the fiscal health and the fiscal attitude of state governments. State aid, state financial assumption, mandates and the division of revenue authority are all the center of any present day discussion about the fiscal position of city governments. So, even though the focus of this forum is cities, I have chosen to comment on the public financing position of the state and local government sector. I think that three issues are relevant. The first is to understand what happened to state and local government finances in the last decade; the second is to speculate about whether there are some lessons that might be learned from this experience; and the third is to identify the likely major influences that will shape the financial health of state and local governments during the 1990s.

Editor's Note

This guest "Eaves" was written by Dr. Roy Bahl, who is the Director of the Policy Research Center and a Professor of Economics at Georgia State University. Dr. Bahl presented his thoughts at both the League's Forum on the Future of Municipal Finance and Taxation and at the League's Annual Conference. We have had enough requests for copies of his comments, we thought you might enjoy them.

Dr. Bahl's comments will soon appear as a chapter in one of a series of books the League is publishing in conjunction with the National League of Cities. That series is based on the works produced by the League's *Challenge of a New Century* forum series. Publication of those works is made possible through the generous support of the Cleveland firm of Calfee, Halter & Griswold. Order forms for the individual volumes and the entire series should be available toward the end of the year.

"Eaves" will return in its usual format in the next issue of the *Cities and Villages.*

What Was Different About The 1980s?

The state and local government sector stopped growing in the 1980s, as indicated by a nearly 2-point decline in the experience share of GNP. For every dollar of personal income increase in the 1970s, state and local governments spent 24 cents. This marginal rate fell to 15 cents during the 1980-1988 period. Part of this slower growth is due to the fiscally conservative mood of the post-proposition 13 decade, part of it is due to a fear that higher taxes will scare off industry, and part of it is due to less elastic tax structures (flatter income tax rate structures, lags in property assessment, the growth in service consumption and the continued failure to include most services in the sales tax base).

A second trend is decentralization of financial responsibility to the state and local government sector. Federal aid has dropped from 25 to 17 percent of total revenues, from $456 in 1980 to $381 in 1989 real per capita terms. In addition, the value of deductibility of federal taxes has been eroded with the elimination of sales tax deductibility and the reduction in the federal marginal rates. The results of all this is that the tax price, the proportion of each dollar of expenditures that must be financed from local sources, has increased. A higher tax price increases the accountability of state and local government officials to their constituencies, because local citizens are asked to pay for a greater proportion of each budget dollar expended.

Third, the shift toward increased dominance of state government in the state and local government financing system slowed and perhaps stopped in the 1980s. In part this was due to a passing through to local governments of the cuts imposed by the federal government, and in part it was due to the hesitance of states to increase taxes in order to finance higher levels of state aid. The local property tax actually increased in importance as a revenue source in the 1980s, after a long period of decline.

Fourth, state and local governments changed their revenue raising strategies, and they altered the way they allocated their resources in the 1980s. Rather than broad-based taxes, most states looked to taxes that would be targeted on only a selected set of potential payers (selective sales taxes), on beneficiary and user charges, and on magic (lotteries, amnesties, accelerated revenue payments, temporary borrowing). States seemed unwilling to make a "permanent" commitment to alter their basic financing structure. On the expenditure side, the share of the budget spent on education went down in every state and the absolute amount spent fell by 1.4 cents per dollar of personal income earned. The health, welfare and highways shares were also down. Those expenditure categories which took an increasing share of resources were interest, judicial and corrections, and medical assistance.

Fifth, there was less emphasis on redistribution in the 1980s. Social service spending was down, state income tax structures were less progressive, and federal grants were not equalizing in their distribution across states.

To sum up, there was a shift in responsibility for financing services from the federal to the state and local government sector, and to a lesser extent from the state to the local government sector. The entire sector stopped growing in the 1980s and it began to disinvest in social services and in general to move away from redistributive fiscal policies. As the sector has become more self-sufficient and its politicians more fiscally accountable to their constituents, there seems to have been a shift to smaller government, and to more of an economic development focus in fiscal strategy.

What Are The Lessons From The 1980s?

As the 1980s drew to a close, many states found themselves in fiscal trouble. Part of this is no doubt due to recession of the early 1990s, but in some states, part of the problem is due to poor fiscal planning. It is arguably true that the big problems in New York, Massachusetts, California and Virginia would have occurred to some degree even without a recession. In virtually every state in fiscal trouble, local governments have also been hurt by the combination of the recession, the cuts from the statehouse, and in some cases fiscal mismanagement. The question I raise here is whether some of these problems could have been avoided by better fiscal planning, and I suggest three lessons that might be learned from the experience of the last decade.

Lesson #1: Don't squander windfalls, they come along too infrequently. The

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big spender states (New York is the prime example) had a golden opportunity to use the unexpectedly strong economic growth of the 1980s to bring their public sectors into line with the rest of the country, to remove some of the debt overhang, deal with unfunded persion liability, reduce taxes, etc. Many states, however, seemed to take the view that this economic growth was permanent and spent without considerations of how the newly expanded expenditure base would be carried when the growth stopped. A recent analysis by the Philadelphia Federal Reserve showed that those states with the highest rates of spending in the 1980s had the biggest deficit problems as the 1990s began.

Lesson #2: There is a revenue *and* an expenditure side to the budget. State and local governments should undertake long-term fiscal planning, i.e., revenue and expenditure forecasting. Most expenditure commitments carry long-term implications that can be foreseen. Some examples are the O&M implications of capital spending, debt servicing, negotiated compensation rates with public employees, and compliance with federal mandates. The right question to have asked in the 1980s was the level of the tax rate that would be required to carry these expenditures into the 1990s, under varying assumptions about the performance of the economy.

Lesson #3: There is a state *and* a local government sector. The leadership for comprehensive fiscal planning must come at the state government level, but this does not mean that only the finances of the state government are important. State aid programs, shared expenditure responsibilities, mandates and a plethora of regulations on the local tax base tie the two sectors together in an inextricable way. Yet the crisis of 1990-1991 saw states such as Massachusetts and Connecticut try to solve part of their fiscal problem by offloading onto the local governments. The lesson is that long-term fiscal planning by state governments should include a clear vision of the role that local governments will play and how this role will be financed. In fact, many states are taking steps in this direction. Some examples are new local taxing initiatives in Arizona and South Carolina, revision of the state aid program in Wisconsin, state assumption of expenditure responsibility in New Jersey, and a revision of mandates in Florida and California.

What Do the 1990s Hold?

Good fiscal planning, the underlying theme of the above discussion, also requires some anticipation about the major events that will shape the fiscal future of a state. The next decade will be a period when external events and federal policies will have a major impact on what state and local governments are able to do with their budgets. The following are what I see to be some of the major issues.

1. Federal Policy. There likely will be more of a decline in federal grants, and the value of deductibility of state and local taxes could be further eroded as the federal government continues to search for a way out of its deficit problem. This will increase the tax price of local expenditures and make it tougher for local and state officials to sell tax increases. The problem will be compounded by continued federal encroachment on state tax bases, e.g., excise taxes and possibly even a national sales tax.
2. Regional Shifts. There probably was a premature celebration in Northern newspapers about the end of the Sunbelt shift. The basic causes of the movement of the 1970s — a lower cost of doing business, access to markets, better weather — are still with us. Moreover, the global economy may make the Sunbelt states more attractive than ever. While in the Sunbelt cities are still "new," their air transportation services are now better than in the 1970s, business services are well developed, housing prices and office rental rates are relatively low, and the culture and amenity package has developed substantially. The game in the 1990s will be one of attracting new activities rather than bidding firms away from other locations. The implication is that we may be reentering a period when states will once again compete fiercely with one another for jobs and new industry, and industrial policy considerations will dominate fiscal decisions to an even greater extent than in the past decade.
3. Changing Population Structure. The changing composition of the US population will have important consequences for the state and local government fisc. On the revenue side, there will be a slower growth in the working age population. This also means that there will be fewer family-forming units, those that purchase the big ticket consumer items. The growing retirement age population will also force reconsideration of some revenue issues, including the proper tax treatment of retirement income, and property tax relief that is age-rather than means-tested. Also, revenue decisions will be increasingly influenced by older Americans, who may be less sympathetic to a larger government sector. On the expenditure side, there will be an increase in the number of elderly, implying a demand for a different package of public services. By the end of the decade the school-age population will be on the decline. There is every prospect that expenditures for crime and corrections will be heavy. The 1990s will be a period of substantial adjustment (and perhaps costly adjustment) in state and local government budgets.
4. Changing Economic Structure. The structure of jobs and income is changing in all states, and tax systems will have to catch up. Most states have traditional tax structures that focus on commodity consumption, earned personal income, incorporated companies, and real property. But income in the 1990s is going to be heavily derived from capital sources and transfer payments, consumption is heavily in services, partnerships, play a major role in service production, and much wealth is held in the form of intangibles. State tax structures are going to have to look to these new bases if they are to be adequately revenue-productive and equitable in the way they distribute the tax burden.
5. The Poor. The 1990s will be a decade when state and local governments will begin to reinvest in the poor. The problems, and their costs to society, are staggering: drug abuse, crime, teenage pregnancy, high school dropouts, black male unemployment, low birthweight, homelessness, and welfare dependency are among the ignored problems of the 1980s. State and local governments will come up against a big fiscal ticket during the next decade when they attempt to face up to those problems. C&V