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1992

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Recommended Citation
Bahl, Roy, Jorge Martinez-Vazquez, and David L. Sjoquist. "City Finances and the National Economy." Publius 22, no. 3 (1992): 49–66. http://www.jstor.org/stable/3330251.

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City Finances and the National Economy

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AUTHORS' NOTE: We would like to thank James Murphy and Drew Warwick for their research assistance.

Abstract:

City governments were better prepared to face the 1990-1992 recession than were state governments, and they adjusted their budgets with relatively less fanfare. The absence of widespread bankruptcy notwithstanding, the fiscal position of cities has deteriorated and some of the necessary adjustments were painful. Services were reduced as real per capita expenditure growth declined, taxes were increased, and the entire local government sector remained in deficit during the past six years. The problem has not been softened by federal or state policies; in fact, the flow of both federal and State aid slowed markedly during the late 1980s. A combination of economic and social forces suggests that many of the nation's older cities will not outgrow this fiscal stress and their budgetary well-being will be more dependent on state and federal policies.

In the recession of 1973-1975 and its aftermath, city financial problems occupied center stage in the national press and received federal attention. Nearly twenty years later, the U.S. economy has come to another recession, but city fiscal problems seem to be getting less attention than the problems raised by state budgetary shortfalls. The popular press has been full of discussions about state government deficits: $3.6 billion in New York, $700 million in Maryland, $500 million in Illinois, $950 million in Washington, and, by some accounts, $10 billion in California. The financial crisis facing cities is much less visible in the popular press, the policy debate in Congress, and in the statehouses. Even the Bridgeport, Connecticut bankruptcy in 1991 (brought on by a declining economic base with the recession dealing the final blow to the city's budget) and Chelsea, Massachusetts being placed in receivership (the result of chronic fiscal troubles and political infighting) were not enough to prompt a new concern about the condition of city finances. Not until the riots in Los Angeles did a proposal for major federal assistance for central cities come under serious consideration.

What explains this apparent lack of interest in local government finances? The reason may be that the fiscal condition of cities is not thought to be weak. Perhaps the political and economic importance of cities has diminished to a point where they have become the forgotten piece of our intergovernmental system. Certainly, the problem would not seem to be that state and local governments are an unimportant sector of the economy. They account for 60 percent of all government expenditures, and 40 percent of all taxes collected. City governments raise about one-third of all local government taxes and make 20 percent of all state and local government expenditures in order to deliver essential services.

The lack of policy concern about city finances may reflect one or both of the following hypotheses. First, cities may have taken a more conservative budgetary stance during the economic expansion of the 1980s; hence, they came to the recession of the 1990s with enough cushion to withstand the downturn. Moreover, cities may have adjusted to the recession more effectively than states. As a result, city finances may not appear as hard-pressed by the recession, even though the fiscal position of cities may be as precarious as that of the states. Second, state governments and the federal government may have

buoyed up city finances with increased aid. Because of this support, cities may have been spared from severe fiscal crises during the recession.

In order to explore these hypotheses, particularly the first hypothesis, it is necessary first to assess the fiscal condition of local governments. Given that there is no agreed-upon measure of fiscal stress, we consider three commonly used measures. Thus, in the next section, we review measures of fiscal health and then take up the question of what is known about the current financial condition of local governments in general, and of cities in particular. We then turn to the hypotheses discussed above, based on an analysis of how cities coped with the recession. This analysis is based on a review of the literature, anecdotal evidence about the experience in specific cities, and data for a sample of large cities. A concluding section considers the findings in light of the economic and policy outlook for the 1990s.

Measuring the Financial Health of Local Governments[1]

There is no single, unambiguous measure of fiscal health. Under certain circumstances, high taxes can be as good or as bad as low taxes, high debt burdens and low cash balances can be warranted, and deficits are not always a sign of fiscal irresponsibility. However, some cities do fare worse than others in raising enough revenue to finance government services, and for purposes of public policy, it is necessary to try to measure this stress.[2] All such measures are, in some way, subjective and controversial.

This conceptual problem notwithstanding, analysts have tried to describe the financial position of local governments in at least three ways: comparative empirical analysis, time series studies of the aggregate sector surplus, and survey studies of perceptions of fiscal health.

Comparative Analysis

Comparative analysis may focus solely on the financial condition of cities by examining their year-end budgetary outcomes and their fund balances. This is the approach taken by Philip Dearborn in his studies of the financial statements of cities.[3] The National League of Cities (NLC) surveys the budgetary position of cities with questionnaires. The most recent analysis, based on NLC's survey of about 500 cities, shows that the growth rates in per capita nominal revenues and expenditures in 1991 were down from the previous year, and that per capita revenues in fifty-six large cities had actually declined.[4]

Comparative analysis may also focus on the relationship between financial and economic conditions, as is done by the rating agencies in their rankings of credit risk.[5] The rating agencies do not regularly report on trends in their ratings for classes of local governments, so one cannot easily use these data to

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[1] Throughout this article we draw from and update our earlier work. especially Roy Bahl, Jorge Martinez-Vazquez, and David L. Sjoquist, “Local Governments and the Current Recession," 1991 Proceedings of the National Tax Association-Tax Institute of America (Columbus, Ohio: NTA-TIA, 1992).

[2] 2Forexample, some states measure “overburden" in city finances for purposes of distributing state aid; the federal government identifies areas for targeting special assistance; and the courts are interested in measuring fiscal inequities in school finance cases.

[3] Philip Dearborn, "Fiscal Conditions in Large American Cities, 1971-84," Urban Change and Poverty, eds. Michael G. H. McGeary and Laurence E. Lynn, Jr. (Washington, D.C.: National Academy Press, 1988).

[4] Michael A. Pagano, City Fiscal Conditions in 1991 (Washington, D.C.: National League of Cities, 1991), p. 5.

[5] Standard and Poor's, Standard and Poor's Municipal Finance Criteria (New York, S&P, 1989) and Moody's Investor Service, Moody's on Municipals (New York: Moody's, 1989).

examine changes in fiscal conditions during the business cycle. Statements by rating agency officials at the time of the Bridgeport collapse, however, indicated that city finances had weakened. St. Louis, Detroit, and Yonkers all carried Standard and Poor's lowest investment-grade rating, and Philadelphia was rated in a junk-bond category. About 15 percent of all municipalities rated by Moody's carried the same BAA credit grade as Bridgeport.[6]

There is also a substantial academic literature that compares the financial and economic conditions of local governments using a variety of measures.[7] Most of these studies take a similar approach. Cities, or other local governmental units, are compared along a spectrum of measurable factors, and the outliers are identified as "distressed," "strained," having a debt burden or tax effort that is inordinately high, and the like.

The problem with the comparative approach is that it is subjective. Whether a particular measure indicates fiscal strength or weakness often depends on the interpretation given, and irrespective of interpretation, different analysts give different weights to the importance of various measures and define cutoff values for "distress" in different and arbitrary ways.

There was a rash of studies of fiscal distress in the 1970s and early 1980s. A review of these analyses finds a rough consensus that most of the fiscally troubled cities are located in the East and the industrial Midwest.[8] Few comparative studies have focused on the changing fiscal condition of cities in the 1980s. Helen Ladd and John Yinger are an exception. Their estimated "index of fiscal health" for seventy-one cities declined on average between 1972 and 1982.[9] Recall that the U.S. was emerging from a recession at the end of this period. Between 1982 and 1986, a period of slow but positive growth, the index worsened for twenty-three cities and improved for forty-eight. Ladd and Yinger conclude that the average improvement in city health in the 1980s was modest, and that the "average city" was in worse fiscal shape in 1986 than it was in 1972. Cities in the poorest fiscal shape in the 1970s remained in the poorest shape in the 1980s. There are no comparative studies that use this approach to measure urban fiscal distress during the 1990-1992 recession.

The NIPA Surplus

A second possibility for gauging the fiscal health of local governments is to study movements in the National Income and Product Account (NIPA) general surplus (exclusive of social insurance funds) in the state and local government sector. This measure, available on a quarterly basis, is the difference between total revenues, exclusive of borrowing, and total expenditures. Changes in this surplus/deficit over time are often used to indicate changes in the overall fiscal condition in the sector.

There are two major problems with this approach. First, it can be argued that the surplus does not necessarily measure fiscal "health." A surplus is an excess of revenues over expenditures, but if the surplus is a result of expenditures that are too low, then it may be less an indicator of fiscal health than

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[6] As reported in The *New York Times*, 1991.
[7] Helen F. Ladd and John Yinger, *America's Ailing Cities: Fiscal Health and the Design of Urban Policy* (Baltimore, Md.: Johns Hopkins University Press, 1989); Katherine L. Bradbury, "Fiscal Distress in Large U.S. Cities," *New England Economic Review* (January/February 1982): 33-44; and Roy Bahl, *Financing State and Local Government in the 1980s* (New York: Oxford University Press, 1984).
[8] Bahl, ibid., Ch. 3.
[9] Ladd and Yinger, *America's Ailing Cities*.

of inadequate public service levels. Moreover, the aggregate sector surplus is a measure that combines surpluses in some places with deficits in others. It is not regularly disaggregated by individual local government units, and so it hides wide variations in fiscal health among local governments. Who would argue, for example, that we can learn much from a measure that offsets a deficit in Newark with a surplus in Minneapolis?

Many economists have tracked and tried to explain the movements in this sector surplus, and have generally found it to be cyclical.[10] The size of the surplus/deficit has not changed much over time when measured in terms of the total size of state and local government budgets.[11] Deficits were fairly small in absolute amounts during the recession of the early 1980s, but increased significantly during 1984 and 1985. However, by the end of 1986, the state and local government sector was in deficit. These deficits have continued to increase and reached $35 billion for 1991 (4.6 percent of total state and local government expenditures).[12]

Unfortunately, measuring the change in the aggregate local government surplus in 1990 and 1991 is not possible because of a lag in the availability of data.[13] Although NIPA data are available with a lag of only a few months, the state and local sector has not been disaggregated in this series since 1988. That disaggregation shows that most of the deficit in recent years has been lodged in state government (77 percent in 1988).[14] The local government general surplus, net of social insurance funds, declined after 1985 and turned negative in 1987 and 1988. Because no data beyond 1988 are available, it is not possible to report directly on the finances of the local government sector during the recession. It is necessary to make an estimate.

In an earlier study, we relied on the systematic, historic relationship between the budgetary position of the local government sector and that of the combined state and local government sector to make suchanestimate.[15] In particular, annual values for 1959-1988 were used to estimate the relationship between the local government sector general surplus (exclusive of social insurance funds) and the surplus for the state and local government sector. Using this regression equation, we estimated that the local government sector would have a general government deficit of $13.3 billion by 1991, up from an actual amount of $4.9 billion in 1988. By this model, the local government deficit increased dramatically in absolute terms.

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[10] U.S. Congress, House, Budget Committee, *Hearings on the State and Local Government Sector*, 102ndCong., 1st sess., 1991,p. 274. Edward Gramlich's testimony on state and local government finance attributed much of the growth in the aggregate state and local government sector surplus to "the large effects and explosive growth of health costs and related influences on the transfer systems of state and local governments."

[11] Ibid. and Roy Bahl and William Duncombe, "State and Local Government Finance: Was There a Structural Break in the Reagan Years?" *Growth and Change* 19 (Fall 1988): 30-48.

[12] Most recent data(first quarter of 1992) show the sector deficit to have declined to $26.6 billion (from $46.9 billion in the fourth quarter of 1990), i.e., from 6.5 percent to 3.5 percent of total state and local government expenditures in fifteen months.

[13] It will be 1994 before one is able to use census of government data to determine *ex post* how the 1990-1992 recession affected individual local governments.

[14] Donald Peters, "Receipts and Expenditures of State Governments and of Local Governments: Revised and Updated Estimates, 1985-1988," *Survey of Current Business* 69 (October 1989): 24-27.

[15] Bahl, Martinez-Vazquez, and Sjoquist, "Local Governments and the Current Recession."

Although use of the surplus to measure fiscal stress is not without its problems, the observed growing deficit and reduced asset position do suggest that local governments have been cutting sharply into their fund balances in order to make ends meet. This suggests that their financial position deteriorated in the years prior to the recession.

Comparative Surveys

The third approach to measuring fiscal health is simply to ask local officials about their perceptions as to whether their local fiscal position is more or less healthy than in the previous period, and to document their perceptions. Such surveys have the advantage of drawing on the opinions of those closest to the problem. The disadvantage of this approach is its subjectivity. Most local financial officials have a propensity to cry wolf, and the surveyor must find a way to compare various local officials' perceptions of distress and health.

Still, a serious concern about fiscal condition on the part of local finance officials is probably reasonable evidence that the fiscal house is not in order. In last year's survey by NLC,[16] about 75 percent of the cities reported that they were less able to meet their financial obligations in 1991 than in 1990. Furthermore, the percentage of cities reporting that expenditures exceeded revenues increased from 32.3 percent in 1989 to 45.5 percent in 1990 to 60.9 percent in 1991. In a similar study, the National Association of Counties reported that four of every ten populous counties in the nation were facing a budgetary shortfall in 1991, and more than 70 percent of New York, Maryland, and California counties were showing a deficit.[17]

All of this taken together suggests that the local sector has not escaped the recession, and that some of the most distressed cities of the 1970s did not improve their relative position during the strong economy of the 1980s.

The Fiscal Performance of Cities in the 1980s

It would not be unreasonable to argue that cities, better than states, learned the lessons of fiscal responsibility during the recessions of the mid-1970s and early 1980s.[18] As a result, cities were less apt to overspend in the 1980s and more able to cope with the recession in 1990-1992. This is in contrast to the high rate of growth in spending by many of the hardest-pressed states in the 1980s.

To measure this effect, we have constructed a simple index of surplus [$S = (R - E)/R \times 100$], where R represents total revenues, including state and federal aid but not borrowing, and E represents total general expenditures. The estimates of this surplus for sixteen large cities are reported for several years in Table 1. (These cities are not the largest cities, nor are they a representative sample of cities. They were chosen to reflect a geographic distribution of larger central cities. In fact, it is possible that they are unique, but the implications we draw from the sample seem to fit with the picture drawn from more aggregated data.) For example, the value of 7.4 for Atlanta in 1989 means that revenues were adequate to cover all expenditures, and provided an excess equivalent to 7.4 percent of revenues. In Houston, the

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[16] Pagano, *City Fiscal Conditions in 1991*.
[17] "40% of Biggest Counties in U.S. Face Budget Shortfalls," *The Los Angeles Times*, 29 August 1991, p.A37.
[18] George E. Peterson, "Urban Policy and the Cyclical Behavior of Cities," *Reagan and the Cities*, eds. George E. Peterson and Carol W. Lewis (Washington, D.C.: Urban Institute Press, 1986), pp. 11-36.

value of -10.4 may be interpreted as a deficit in revenues equivalent to 10.4 percent of total revenues. Presumably, this deficit was covered by some combination of borrowing, deferred payments to creditors, a transfer from some special fund, or a subvention from the state or federal government.

It is useful to track this measure of the surplus over a period of years to understand how the fiscal position of cities has changed. The years before 1975 were generally considered an expansion period for cities.[19] Budgets grew, and there had not been an experience with a major economic contraction in the political lives of most city leaders. Note that in 1969, fully half of the cities in this sample were in a “deficit" position. This number had tailed off dramatically by 1977, largely because of a substantial influx of federal assistance. By 1985, with the national economic expansion of the 1980s still under way, only St. Louis in this sample showed a revenue shortfall. Most cities had revenues well in excess of expenditures, and over half had a cushion in excess of 10 percent. The reason for this improved fiscal position was largely on the expenditure side of the budget. As may be seen in Table 2, the real rate of growth in per capita total expenditures in almost every city in the sample slowed dramatically in the late 1970s and 1980s. Between 1977 and 1985, ten of the sixteen cities had a growth in per capita real expenditures that was slower than that in per capita real GNP. This slowdown in expenditures occurred even though most cities did increase revenue mobilization in the late 1970s and early 1980s (see Table 3). Apparently, city governments were not willing to replace fully the revenue losses from federal and state aid reductions with tax hikes. This finding is consistent with the hypothesis that cities adjusted, even as their capacity to deliver services diminished.

By 1989, this favorable condition had deteriorated, and half of the sixteen large cities reviewed here were in deficit (Table 1). Three others had surpluses amounting to less than 5 percent of total expenditures. Part of the differences in the outcomes of these cities, particularly with regard to state aid, may be the result of mandates.[20] Fourteen states (e.g., California and Massachusetts) have provided state funding to finance programs mandated by the state; however, differences of opinion exist about the financial impact of mandates. Fourteen states (e.g., California and Massachusetts) have provided state funding to finance programs mandated by the state; however, differences of opinion exist about the financial impact of mandates. For example, former New York mayor Ed Koch claimed that federal and state mandates would cost New York $6.25 billion over four years.[21] On the other hand, a survey of government officials in New York suggested that local governments are not burdened by mandates.[22] Michael Pagano uses a similar measure on a sample of 525 cities for 1991.[23] His "imbalance index" shows that 26.5 percent of all cities estimated that expenditures would outpace revenues by more than 5 percent. More than twice as many cities expected severe imbalance than was the case in the previous year. Clearly, cities were feeling financial pressure in the year before the recession.

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[19] George E. Peterson, “Finance," *The Urban Predicament*, eds. William Gorham and Nathan Glazer (Washington, D.C.: Urban Institute Press, 1976), Ch. 2; Helen F. Ladd, “Big City Finances," working paper (Cambridge, Mass.: Lincoln Institute of Land Policy, 1989).
[20] For a discussion, see U.S. Advisory Commission on Intergovernmental Relations, *Mandates: Cases in State-Local Relations* (Washington, D.C.: ACIR, 1990) and Michael Fix and Daphne A. Kenyon, eds., *Coping with Mandates: What Are the Alternatives?* (Washington, D.C.: Urban Institute Press, 1990).
[21] Edward I. Koch, "The Mandate Millstone," *The Public Interest* 61 (Fall 1980): 42-57.
[22] U.S. Advisory Commission on Intergovernmental Relations, *Mandates: Cases in State-Local Relations*, p. 15
[23] Pagano, *City Fiscal Conditions in 1991.*

Table 1*

Surplus as a Percent of Total Revenues: Selected Years for Sixteen Large Cities

City	1958	1964	1969	1975	1977	1985	1989	1990
Atlanta	-2.1	-12.9	-12.7	7.0	1.5	1.6	7.4	14.4
Baltimore	-2.7	1.1	-9.1	7.3	-1.8	11.8	14.2	9.7
Boston	-1.2	-6.9	-9.4	-8.1	3.2	13.9	6.4	6.5
Chicago	-21.7	11.1	-9.6	8.9	4.7	8.0	-3.2	5.5
Dallas	.32.7	-12.2	-7.9	-10.1	8.8	12.6	-13.3	3.3
Denver	4.4	4.6	-10.3	3.2	1.0	8.8	-6.0	3.0
Detroit	5.7	--	12.9	9.4	23.0	17.8	-1.0	3.9
Houston	6.3	-2.4	-1.2	6.0	5.0	12.8	-10.4	-7.0
Los Angeles	1.1	12.2	15.6	9.9	21.1	16.9	10.0	8.3
Minneapolis	7.7	11.0	8.9	-19.8	-4.9	20.7	-3.8	-6.4
New Orleans	5.5	-5.6	-2.7	7.8	7.9	2.4	-8.4	-4.4
Philadelphia	-0.1	-5.3	-5.1	-3.8	9.5	7.2	4.5	0.3
St. Louis	-6.3	1.7	3.1	9.5	8.7	-20.8	2.9	-3.1
San Francisco	5.7	14.4	11.0	9.8	13.0	22.6	22.8	19.5
Seattle	-13.9	10.6	18.7	-5.4	9.2	14.6	-4.4	13.3
Washington, D.C.	-3.6	-0.4	-9.6	-30.6	2.0	1.5	2.6	-1.5

SOURCE: U.S. Bureau of the Census, *City Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years).

*The relative surplus position is computed as the ratio of the difference between total revenues (own revenues plus state and federal aid) and general expenditures, to total revenues, expressed as a percent.

Table 2

Average Annual Percent Change in Per Capita Real Total Expenditures: Selected Years for Sixteen Large Cities

City	1958-1964	1964-1969	1969-1975	1975-1977	1977-1985	1985-1989	1989-1990
Atlanta	-3.61	10.00	*5.69*	-1.10	1.78	2.46	2.36
Baltimore	2.63	10.50	3.59	2.61	-4.84	-0.60	3.62
Boston	3.68	4.97	4.03	-2.17	-3.42	4.94	1.92
Chicago	-1.83	7.15	2.07	1.78	-0.07	2.80	1.95
Dallas	-7.58	4.76	4.05	-6.99	1.29	4.70	-14.70
Denver	-0.78	8.51	3.80	3.73	0.30	2.34	-1.76
Detroit	1.08	3.73	6.72	-0.95	1.70	3.37	-8.56
Houston	-3.97	4.00	2.11	*5.64*	1.77	2.91	*-5.52*
Los Angeles	-0.57	5.24	1.86	-3.51	0.65	3.07	*5.99*
Minneapolis	0.84	2.79	10.13	1.63	3.54	6.01	-3.87
New Orleans	-2.84	*5.56*	4.40	1.14	4.13	-0.02	-3.50
Philadelphia	2.28	6.17	4.11	1.43	0.51	1.61	2.49
St. Louis	3.71	3.04	6.00	2.81	4.66	-6.50	2.78
San Francisco	4.02	11.15	1.36	2.12	0.28	-0.83	9.61
Seattle	-2.57	*4.59*	7.61	1.98	-1.05	*4.55*	-11.40
Washington, D.C.	6.88	8.93	11.10	-6.50	2.25	2.29	*5.96*
Real Per Capita GNP	2.64	3.03	0.73	3.75	1.49	2.29	-0.10

SOURCE: U.S. Bureau of the Census, City Government Finances (Washington, D.C.: U.S. Government Printing Office, various years).

Table 3

Average Annual Percentage Change in Per Capita Real Revenues from Own Sources: Selected Years in Sixteen Large Cities

City	1958-1964	1964-1969	1969-1975	1975-1977	1977-1985	1985-1989	1989-1990
Atlanta	-3.03	7.83	5.95	-0.95	5.64	-0.61	4.26
Baltimore	0.78	5.41	0.55	-3.20	0.79	1.03	0.88
Boston	1.55	4.21	3.60	2.32	-5.42	4.68	3.39
Chicago	3.88	-0.30	3.71	-2.78	1.22	1.63	9.98
Dallas	-4.76	5.67	1.44	1.24	1.78	1.49	-0.41
Denver	-0.50	6.71	5.61	0.84	3.84	-2.00	5.98
Detroit	0.00	0.00	2.05	0.99	0.93	-1.71	4.13
Houston	-5.65	4.34	1.08	5.54	3.68	-2.59	1.26
Los Angeles	1.27	5.54	-1.04	1.53	1.23	2.89	5.22
Minneapolis	1.08	-26.81	3.05	1.83	10.74	-2.89	2.49
New Orleans	-1.85	6.76	1.07	-1.15	6.19	-0.91	-0.69
Philadelphia	0.81	3.67	1.63	8.44	1.79	0.88	-2.10
St. Louis	3.84	3.97	2.82	2.37	2.06	1.00	-2.64
San Francisco	5.37	7.20	1.76	0.14	2.24	1.70	2.95
Seattle	1.83	0.70	5.29	4.16	2.25	2.03	6.69
Washington, D.C.	5.30	4.59	1.22	9.31	4.66	2.85	-2.09
Real Per Capita GNP	2.64	3.03	0.73	3.75	1.49	2.29	-0.10

SOURCE: U.S. Bureau of the Census, *City Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years).

Other evidence reported above suggests that cities were under stress in the late 1980s:

- The aggregate surplus for the entire local government sector turned negative.
- Comparative analysis indicated that cities suffered a decline in their fiscal condition in the 1980s, and that the same cities were at the low end of the distribution in the 1990s as were at the low end in the 1980s.
- NLC's survey of local officials indicated that local governments were hit hard by the recession and federal mandates, and are now facing serious financial difficulties.

Even with this deterioration, complete collapse as in the case of Bridgeport remained the exception. One might conclude that cities are survivors in periods of fiscal adversity, or at least they have become so since the mid-1970s. Thomas Dorsey examined the bond rating experiences of twenty cities whose fiscal condition worsened (according to the Ladd-Yinger analysis) during 1972-1982.[24] He found that the ratings declined in ten cities. Of the five cities that showed up worst on the Ladd-Yinger index,[25] the ratings were lowered in only three. Fiscal capacity in some of these cities declined by as much as 30 percent, but the bond ratings remained intact. The conclusion he draws from this result is that cities shifted resources to protect fund balances and service their debt.

The conclusion here is that there is some merit to the argument that cities were better prepared to face the recession than states, partly because cities did not overspend to the same extent as some states in the 1980s, and partly because they were willing and able to make the adjustments necessary to avoid the most severe consequences. Fiscal stress is not the same as urban distress; the onset of a period of fiscal stress does not necessarily imply that the quality of life has been reduced. However, reduced expenditures made in order to bring budgets into balance mean reduced services, and thus it does not necessarily follow that living conditions in the cities did not deteriorate. Anecdotal evidence suggests that city services have been cut back and infrastructure investment expenditures have been postponed.

Although local governments in general, and cities in particular, appeared to take a more conservative fiscal stance from the late 1970s to the mid-1980s, there is evidence that local governments did expand their budgets more rapidly in the last part of the 1980s. For example, Bahl, Martinez-Vazquez, and Sjoquist, using the historic relationship between local government expenditures and a set of explanatory variables, found that expenditures grew much faster in the latter part of the 1980s.[26] Thus, it may actually be the case that some local governments entered the recession in a weaker position than available data might suggest. There is evidence that some cities (e.g., Philadelphia) entered the recession in a weak financial condition.

Although much is imperfect about all of this evidence, it seems to indicate that there was a general deterioration in the financial condition of the state and local sector, and of cities, as the recession approached. The following generalizations might be drawn from this evidence about the fiscal health of local governments during the pre-recession period:

- Cities that were financially distressed in the 1970s remained so in the 1980s.

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[24] Thomas A. Dorsey, “Fiscal Stress: The Credit Market View," *1989 Proceedings of the National Tax Association-Tax Institute of America* (Columbus, Ohio: NTA-TIA, 1990), pp. 85-89.
[25] "Ladd and Yinger, *America's Ailing Cities*.
[26] Bahl, Martinez-Vazquez, and Sjoquist, "*Local Governments and the Current Recession*."

- The local government sector moved to a deficit position in 1985, and by our projections, has remained in deficit through the recession.
- By the late 1980s, cities were in a weaker budgetary position and their access to state and federal aid was markedly less.
- City economies may not have been hit harder by the recession than suburbs, but fiscal disparities did not narrow.
- Cities showed an ability to adjust their budgets to match their resource base in the 1980s.
- There was much variation among cities in fiscal performance and budgetary condition in the 1980s

Many cities have had budget problems, but not of the magnitude of Los Angeles, Philadelphia, or New York. At the end of 1991, Philadelphia was on the edge of insolvency; it had just $36 million in reserves, enough to cover ten days of routine expenditures. In October 1991, the city failed to pay nearly $87 million it owed the city employees' pension fund. It had an operating deficit of more than$200 million, with an expectation that it could double in the near future, despite major increases in taxes over the past ten years. According to the National Association of Counties, Philadelphia ranked in the worst shape of any of the large counties in the United States.

A state financial oversight board was appointed in 1991 and required the city to develop a five-year plan to bring the city's budget into balance. The outgoing administration of Mayor Wilson Goode left the task of developing the five-year plan to the new administration of Mayor Edward Rendell, which took office in January 1992. Mayor Rendell submitted his plan, and the oversight board is raising about $475 million in loans to cover the city's deficit.

While Philadelphia may have been the fiscal problem child, other major cities also experienced substantial fiscal difficulties. New York City's fiscal woes were reported widely, but New York City's budget has turned around. The mayor announced a $515 million budget surplus for FY 1992.[27] Los Angeles also had major fiscal difficulties, including a budget shortfall of nearly $60 million by late 1991, and a very serious problem balancing its budget in the spring of 1992.

How Cities Coped with the Recession

How have local governments, and especially cities, dealt with the fiscal problems caused by the recession? Most local governments are restricted to balancing their budgets annually (i.e., they normally cannot run deficits in their operating budgets). In the most simple terms, there are three available responses to a fiscal difficulty: the government can plead for more assistance, raise additional revenue, or reduce expenditures. (Governments also use gimmicks to get around the balanced budget constraint, but usually these can only be employed for a short time.) It might be argued that the federal and state governments increased assistance to local governments to bail them out of the worst of the recession. To investigate this hypothesis, we have constructed Table 4, which shows the ratio of state and federal aid to total revenues of the city. If the hypothesis is true, it would be consistent with an increasing ratio of aid to revenues. The evidence suggests that the hypothesis is false (i.e., cities became less dependent on federal and state aid in the 1980s). Only one city in the sample (Boston) showed a higher value of the ratio in 1989 than in 1977.

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[27] "NYC Mayor Withdraws Tax Package," *State Tax Notes*, vol. 2, no. 22, 1 June 1992, p. 755.

Of course, there are a multitude of ways of raising revenue or cutting expenditures. As noted above, published data on revenue and expenditure patterns are not yet available for the recession years. Thus, in this section, we rely primarily on anecdotal evidence from newspapers and reports of individual governments.

Table 1 shows that early in the recession some cities made adjustments in their budgets. Between 1989 and 1990, nine of the sixteen cities had an increase in the surplus measure, and only five (compared to eight in 1989) had negative surpluses. Table 2 shows that the rate of growth in real per capita expenditures dropped significantly between 1989 and 1990 as compared to the 1985-1989 period.

Turning to specific changes, we first discuss state aid. In 1990, per capita state aid to local governments, exclusive of aid to education and welfare expenditures, averaged $177, and ranged from $33 in West Virginia to $497 in Alaska. Until recently, however, cities have not pleaded for additional funds from state governments; local governments have been far more inclined to ask for authority to use new revenue sources and for relief from mandates. Comparing the last two columns of Table 4, we see that aid as a percentage of revenues increased between 1990 and 1992 for six of the sixteen cities. In most of these cases, the increase in the percentage was the result of a change in non-aid revenue.

Generally, state government actions during the recession appear to have had a negative effect on local government fiscal conditions.[28] In 1991, fifteen states took legislative action to reduce aid to local governments. For example, New York cut revenue sharing by $343 million, including a 25 percent cut for New York City. Georgia cut aid to cities by at least $40 million. Governor Jim Edgar of Illinois proposed that the state keep the $237 million share of a temporary income tax surcharge that was to go to municipalities, but was overturned by the House. Boston lost $85 million in state aid during 1989-1991.

Steven Gold reports that forty states earmark some tax source for local aid.[29] Thus, as the recession cut into state revenue from these taxes, state aid to local governments was cut automatically. State aid to local governments is cyclical. We regressed state aid as a share of state expenditures against the unemployment rate lagged one year and obtained a negative and significant coefficient on the unemployment rate. Thus, as the economy slows and the unemployment rate increases, state aid as a share of expenditures falls.[30] Despite this cyclical nature of state aid, for 1959-1988 the variation in the ratio of state aid to state expenditures is small. The highest and lowest values of the ratio differ by only 15 percent. Furthermore, the state aid share of state expenditures declined during the 1980s. Ladd fmds that the elasticity of total state aid with respect to state own-source revenue is less than one.[31]

Why do states not try to help local governments during recessionary periods? The most basic answer is that during recessions, states try to balance their own budgets; local government aid is of sufficiently low priority that it gets cut more than revenues decline. This is seen in the discussion below concerning state

[28] Steven D. Gold, *State Policies Affecting Cities and Counties in 1991* (Albany, N.Y.: Nelson A. Rockefeller Institute of Government, n.d.) and Steven D. Gold and Sarah Ritchie, “State Policies Affecting Cities and Counties," *Public Budgeting and Finance* 11 (Summer 1991): 33-46.

[29] Gold, ibid.

[30] See also Steven D. Gold and Brenda M. Erickson, “State Aid to Local Governments in the 1980s," *State and Local Government Review* 9 (Winter 1989): 11-22.

[31] Ladd, “*Big City Finances*.”

Table 4

Aid as a Percent of Total Revenues: Selected Years for Sixteen Large Cities*

City	**1958**	**1964**	**1%9**	**1975**	**1977**	**1985**	**1989**	**1990**
Atlanta	19.7	7.9	16.8	30.4	26.1	20.3	21.6	24.4
Baltimore	33.0	42.1	49.5	64.2	65.0	52.0	50.2	48.5
Boston	25.5	30.5	31.4	33.9	35.3	51.3	47.5	46.6
Chicago	14.9	12.7	25.0	31.3	34.5	29.9	24.8	24.8
Dallas	2.2	2.5	2.1	14.2	15.8	16.1	4.0	4.7
Denver	34.5	33.6	29.3	31.1	33.2	19.2	21.0	21.9
Detroit	26.4	-	27.8	42.5	49.2	49.0	48.8	44.4
Houston	3.1	4.9	3.9	16.0	15.3	9.6	8.3	4.4
Los Angeles	13.4	14.1	16.2	24.8	27.1	19.6	13.6	12.5
Minneapolis	12.1	14.0	29.4	37.7	45.2	29.0	34.6	28.2
New Orleans	21.9	16.9	14.5	37.1	39.9	25.6	19.4	19.7
Philadelphia	7.3	10.6	20.7	32.3	32.6	23.6	23.7	23.6
St. Louis	4.6	8.2	8.5	28.9	28.9	23.0	15.6	14.5
San Francisco	25.7	27.2	36.9	34.5	39.2	36.9	30.4	31.6
Seattle	18.0	16.2	36.8	28.1	35.4	21.0	15.1	14.8
Washington, D.C.	18.7	27.9	35.8	48.4	46.7	35.5	30.3	32.0

SOURCE: U.S. Bureau of the Census, *City Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years).

*Aid includes both state and federal government transfers. Total revenues include aid and own-source revenues.

actions taken during the past two years that affected local governments. More extensive analysis of state aid does not reveal much about the motivation of state governments.[32]

On the other hand, nearly twenty states (including California, Pennsylvania, Arkansas, and Utah) allowed increased local access to new or expanded revenue measures. With respect to the property tax, five states liberalized limitations, while four added restrictions. Much of the increase in local governments' ability to use new or expanded revenue sources, however, will have to be used to finance new mandated services, especially for environmental programs, and for state programs that were shifted to local governments. For example, California shifted responsibility for $2.2 billion in programs for mental health, indigent health care, and social services to county governments, but also gave the counties new tax revenue in the form of new sales tax and vehicle registration fees. Philadelphia was given permission for a 1 percent add-on to the state sales tax.

State changes in 1991 compared to 1990 were generally more harmful to local governments. In 1990, fewer states cut aid programs or shifted services to local governments. Thus, it appears that as states fell into their fiscal crisis in 1991, they spread part of the problem to local governments. The state actions in 1991 were not monumental changes, but reflect a change from actions taken in previous years. For example, one estimate is that state aid to cities increased by 5.6 percent in 1989- 1990, but by only 2.1 percent in 1990-1991,[33]less than the inflation rate.

Federal aid to state and local governments did not increase in the past year, and until the Los Angeles riots, there was little discussion of increased aid to cities. Pagano shows that per capita federal and state aid to cities increased from $92 to $100 between 1989 and 1991, slightly more than the rate of inflation.[34] The rate of growth in state and federal aid in 1990-1991 was less than half that of the previous year, suggesting that the "bail-out" argument is not a strong one. In the aftermath of the riots, the Congress began to discuss aid to central cities. The proposal discussed by House Democrats would allocate an additional $9 billion to existing programs. This is much smaller than the $35 billion urged by NLC,[35] but much larger than the federal financial assistance to cities that Congress passed by early summer 1992 (a $1.1 billion emergency urban aid program). Half of the aid package is for 360,000 summer jobs for disadvantaged teenagers, and $100 million is targeted to the nation's seventy-five largest cities, with the remainder distributed to states. The program also allows for loans and emergency grants to help rebuild the Los Angeles neighborhoods damaged in the riots that followed the Rodney King verdict.

The recession has led to other proposals for aid to local governments. For example, Senators Paul S. Sarbanes (D-MD) and James R. Sasser (D-TN) introduced three bills "designed to end the recession."[36] The first bill would provide $20 billion (half to local governments) for education, infrastructure, and the prevention of employee layoffs in critical areas. The second bill would provide $10 billion in interest-free loans for the same purposes, while the third bill would waive the matching requirements for several federal public works programs.

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[32] Ibid.
[33] Pagano, *City Fiscal Conditions in 1991*, p. 17.
[34] Ibid, p. 13.
[35] Democrats Working on $9 Billion Urban Aid Package, Foley Says," *Tax Notes*, 1 June 1992, p. 1172.
[36] *The Congressional Record*, 27 February 1992, p. S2580

The second approach to bringing local government budgets into balance is to raise taxes and fees. Although several local governments increased tax rates in the past two years, Pagano estimates that most cities had a lower rate of growth in tax revenues in 1991 than in 1990.[37] Los Angeles considered a budget for 1991-1992 that called for $77 million in new taxes and $100 million in expenditure cuts.[38] Prince George's County in suburban Washington, D.C. increased taxes by $40 million. Atlanta, however, did not raise taxes to balance its latest budget. Philadelphia even resorted to the use of volunteers to help clean up public buildings. The more common action was to reduce expenditures. Officials from Prince George's County reported reducing their work force by 25 percent, reducing salaries by 3.8 percent, and cutting the capital program dramatically. Reducing the work force directly or through a freeze on hiring appears, based on newspaper accounts, to have been a common local action. For example, in late 1991, Los Angeles laid off 1,200 workers.[39] Washington, D.C. proposed a cut of 6,000 employees.[40] New York City, in June of 1991, after initially suggesting that 15,000 workers would have to be let go, announced a layoff of 10,000 workers.[41] Part of Philadelphia's five-year plan to balance its budget calls for a substantial reduction in employee retirement and other benefits. The plan also calls for eliminating all city funding of the art museum.

There are examples from all over the country of cities coping with the recession by cutting services, capital spending, and maintenance of infrastructure. For example, using NIPA data from the Survey of Current Business, we find that from the end of 1989 through the fourth quarter of 1990, state and local government expenditures on structures increased in real terms.[42] But between the fourth quarter of 1990 and the end of 1991, expenditures on structures fell almost as much as they had increased in the previous two years. In the first quarter of 1992,they rebounded to their 1990 level. State and local government spending on durables has been essentially flat for the past nine quarters. Other examples of cuts in services include:

- The Los Angeles schools proposed a shorter classroom year, the elimination of the afternoon playground program, and a cut in basic repairs to schools.[43]
- Washington, D.C. area governments froze salaries, cut assistance to poor families, and delayed payments to retirement plans.4[44]
- San Diego reduced mental health expenditures.
- Philadelphia failed to pay most of its contribution to the city employees' pension fund.[45]

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[37] Pagano, *City Fiscal Conditions in 1991*, p. 17.

[38] Bradley Proposes $77-Million Tax Hike, Budget Cuts," *The Los Angeles Times*, 13 April 1991, p.A1.

[39] "Hiring Freeze Stiffened in Bid to Slash L.A. Deficit," The Los Angeles Times, 27 November 1991, p. B1.

[40] "Report Urges Cutting 6,000 D.C. Employees," *The Washington Post*, 17 November 1990, p. Al.

[41] "New York City Lays Off 10,000 Workers," *The Los Angeles Times*, 29 June 1991, p. A16

[42] "Estimates of County and Metropolitan Area Personal Income, *"Survey of Current Business* 72 (April 1992): 81-104, Table 3.8B.

[43] "School District Ponders Shorter Classroom Year," *The Los Angeles Times*, 15 May 1992, p. Bl; "After School Care Squeezed by L.A.'s Belt-Tightening," *The Los Angeles Times*, 27 April 1992, p. Bl; and "Board Agrees on Hiring Cuts, Expansion of Brea Landfill," *The Los Angeles Times*, 29 February 1992, p. B1.

[44] P.G. Council Restores Wage Freeze," *The Washington Post*, 1 April 1992, p. A1; "What Welfare Cuts?" *The Washington Post*, 16 July 1991, p. A18; and "$5 Million a Week and Counting," *The Washington Post*, 3 July 1991, p. A18.

[45] "Pension Fund Gets a Short Check," *The Philadelphia Inquirer*, 2 October 1991, p. B1.

Policy and the Outlook for the 1990s

Nevertheless, cities are fiscal survivors. They have absorbed the 1990-1992 recession; an increased share of the impoverished; the continued loss of manufacturing jobs and population; reductions in federal aid; and now the fiscal and social burdens of AIDS and drugs. Yet with a few exceptions, city bankruptcies and fiscal troubles have dominated neither the news nor congressional and state legislative debate. The fiscal strategy that brought them through these crises has been one of adjustment, namely, retrenchment, tax increases, and program expansion only if it was within their fiscal means. This does not necessarily mean that all is well with cities. They have managed their fiscal affairs, but serious social problems remain, and restrictive budgets make it more difficult for cities to deal with these problems.

A combination of economic and social forces and government policy seems to have assigned cities a new role for the 1990s. Cities are centers of activity for producing and selling services and finance and providing central office employment. They draw many suburban residents to work and shop, but they also have become the designated residence of the poor and the disenfranchised. Any vision about the future of urban America must take these new roles into account.

Three factors would seem to shape the fiscal prospects of cities, at least for the remainder of this decade. The first is the growth in the national economy and how cities will share in this growth. By all accounts, the U.S. is out of the recession; however, forecasters say that the recovery will be anemic. Longer-term projections do not suggest that the 1990s will be a period of substantial growth. Thus, expectations are that macroeconomic conditions will reflect relatively stable prices and a slow growth in output. On average, this probably translates into a slower growth in city revenues from own sources.

A second factor influencing city finances is federal policy. The federal budget deficit makes it unlikely that any new major aid program will be put in place, at least before 1996. The recession has led to some recent proposals for aid, though one obstacle to passage of these initiatives is that cities appear to have weathered the recession.

Finally, there is the question of whether state aid will increase in the 1990s. One determinant is the growth in state economies. State revenues are also captives of the growth in the national economy, and a slower growing U.S. economy in the early 1990s does not bode well. The other issue is whether assistance to cities will claim a greater share of the state aid pie. Certainly, the representation of cities in state legislatures will not increase in the 1990s. Another issue is school financing, and there has been a long-term trend toward greater state government participation in this area. This has been driven by state efforts to improve school performance and by court cases, or the threat of legal actions, focused on inequalities in school financing.[46] State aid for education will likely expand as a share of state and local education expenditures, and cities could benefit from this trend.

State aid for non-education programs will likely recover after states have solved their own fiscal problems. However, the shift of responsibilities from the federal government to state governments,

[46] Roy Bahl, David L. Sjoquist, and Loren W. Williams, "School Finance Reform and Impact on Property Taxes," *1990 Proceedings of the National Tax Association-Tax Institute of America* (Columbus, Ohio: NTA-TIA, 1991), pp. 163-171.

and the other pressures on state budgets from such programs as health care and criminal justice, will undoubtedly limit the growth of state aid. There is a trend for state governments to shift responsibility for services to local governments, especially through mandates, and provide new or expanded revenue sources. Although this is more likely to occur during recessions ,the pattern of the 1980s suggests that it will continue during the recovery, but at a slower rate. Concern about public infrastructure, however, is likely to be an exception.

A final question is whether cities can do more to help themselves. Although most cities do not have the resources to cover their budgetary needs, they can strengthen their financial position in significant ways. At the top of the list is realizing their comparative advantage as a seller of services to the metropolitan area, and developing both a set of quality services (traffic control, protection, and the like) and an imaginative set of user charges for these services.