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STATE AND LOCAL FINANCES

Some Jurisdictions Confronted by Short- and Long-Term Problems

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SUMMARY

As the Nation begins to debate health care reform, welfare reform, and other major policy initiatives in which state and local governments are expected to play a key role, questions persist concerning the financial condition of these governments. At the request of Majority Leader Gephardt, we looked at the short- and long-term financial conditions of states, cities, and counties, using measures we developed for these purposes and data collected by the U.S. Bureau of the Census. We also did field work in selected states and localities.

We found that from 1985 to 1991, state and local governments faced myriad spending and revenue pressures. Most categories of programs were growing but certain programs grew more rapidly, such as Medicaid at the state level and public safety at the county level. The spending growth reflected not only some factors beyond the control of state and local officials, but also their choices to expand services. While at the period's outset revenues were helped by economic growth, the growth slowed and a recession set in.

In response, jurisdictions acted to control program growth, cut services, and raise revenues. State and local governments instituted spending cuts that affected a variety of programs, government payrolls, and capital projects. Revenue actions ranged from increasing fees to raising taxes. But spending continued to outpace revenues, bringing year-end budget surpluses down. Without such "budget cushions," jurisdictions had less flexibility for funding services, and some jurisdictions incurred budget deficits.

These trends may improve as the economy improves or priorities change. But many cities with high poverty levels and low incomes face a more fundamental long-term problem. These jurisdictions have less capacity to finance their police, fire, and other services at average levels because of their relatively low tax bases. In fact, several large cities and counties face not only a short-term problem of budget deficits but also a long-term deterioration in the level of services they can afford to provide--hence such jurisdictions may have the most difficulty in overcoming their financial problems and meeting the service needs of their residents.

On a broad scale, the decline in state and local budget surpluses could exacerbate the federal deficit's effects on the economy, and if so, could cause reduced long-term growth in the economy. In our view, the trends and differences in state and local financial conditions argue strongly that they be made a part of the major reform deliberations now underway.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on the financial condition of state and local governments.[1]

As the 103rd Congress and the Administration consider health care reform, welfare reform, and other major policy initiatives that will require the participation of state and local governments, questions continue to be raised concerning the financial conditions of state and local governments. Reports of financial distress in several jurisdictions continue, raising concerns about the ability of at least some state and local governments to effectively carry out their existing responsibilities and take on new ones.

Majority Leader Gephardt asked that we look at the financial conditions of states, cities, and counties in both the short- and long-term. To do this, we developed measures for these purposes and used data collected by the U.S. Bureau of the Census. We supplemented these analyses with visits to selected states and localities that represented a variety of economic and financial circumstances.

In summary, we believe the financial stress on state and local governments has generally resulted in tight budgets across jurisdictions. In our work on the short-term financial condition of states and local governments we found several significant trends. Over the 1985 to 1991 period, spending pressures and constraints on raising revenues created a budget squeeze at all three levels of government. Jurisdictions we visited responded to these pressures with such actions as cutting program growth, raising additional revenues, or managing existing resources differently. In addition, overall budgetary surpluses declined at all three levels, contributing to a reduced flexibility for undertaking major new investment and responding to new policy initiatives or short-term emergencies. Nationwide, the declining state and local budget surpluses could compound the federal deficit's effects on the economy. That is, these declining surpluses combined with the large federal deficit could impede long-term growth nationwide.

In our work on longer term financial condition, we found that large disparities exist among states and large cities in the levels of services they can afford to finance, given average levels of taxation. This reflects differences in underlying economic factors, such as income levels and poverty rates. At the city

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[1]State and Local Finances: Some Jurisdictions Confronted by Short- and Long-Term Problems (GAO/HRD-94-1, Oct. 6, 1993).

level, these disparities have grown over the past two decades. Further, some large cities and counties had relatively weak capacities to finance services and also had operating deficits. These cities may find it increasingly difficult to overcome their budget deficits and meet the service needs of their residents.

In our view, these trends and differences in state and local conditions argue strongly that they be made an integral part of the reform deliberations now underway.

REVENUE AND SPENDING PRESSURES INCREASED AT ALL THREE LEVELS

Over the 1985 to 1991 period, state and local governments faced a challenge in responding to varied spending and revenue pressures. On the spending side, while almost all categories of programs were growing, some programs were growing especially rapidly, such as Medicaid at the state level, environment and housing at the city level, and public safety at the county level.

For example, state health care spending grew at an average annual rate of 7.6 percent from 1985 to 1991. Medical vendor payments, a close proxy for Medicaid, grew even faster at 9.5 percent over the same time period. The high growth rates for health care spending were especially important because health care formed a large share of state spending. Nationwide, total state health expenditures comprised, on average, 21 percent of general expenditures in 1991.

This growth in spending partly reflected officials' choices favoring some new or expanded services and programs, but it also reflected factors beyond the immediate control of state and local officials, such as rising health care costs or regional economic problems. While at the beginning of the period, revenue growth was enhanced by robust economic growth, later it was dampened by slowing economic growth and a recession. Between 1985 and 1988, real growth in Gross Domestic Product (GDP) was relatively strong, averaging 3.3 percent a year. Beginning in 1989, though, economic growth slowed significantly. The real annual change in the nation's GDP dropped to 2.5 percent in 1989 and continued declining to a recessionary low of negative 1.2 percent in 1991. In many cases, revenue projections based on previous years' growth did not materialize.

In addition, jurisdictions faced declines in some types of federal aid and voter reluctance to increase taxes. Federal grants for capital projects and other general operations--excluding entitlement programs for individuals, such as Medicaid--declined from 1985 to 1991. Moreover, with state and local taxes plus other "own-source" receipts (as a percent of gross national product) approaching a 25-year high in the mid-1980s (see fig. 1), voters in many jurisdictions also showed a reluctance to increase taxes.

Limitations on revenue-raising were enacted in several states, adding to the growing list of states with such restrictions.

STATE AND LOCAL RESPONSES

This difficult situation led jurisdictions at all levels, including those jurisdictions in stronger financial positions, to reevaluate their spending priorities and undertake actions to control program growth, cut some services, and increase revenues. Our analysis of national data and visits to 13 state and local governments underscored that jurisdictions, including those in stronger financial positions, undertook actions to alleviate budget pressures. Many of the actions involved managing existing financial resources through measures such as tapping into contingency reserves, shifting monies from one budget fund to another, and restructuring debt. However, other actions involved efforts to raise revenues and control spending.

On the revenue side, the jurisdictions we visited undertook a variety of measures. These included actions to increase property, sales, and gas tax receipts and increase fees and charges. A notable example of the revenue actions occurred in Connecticut, which became the 41st state to enact a broad-based personal income tax. In addition, Tennessee imposed a one year, 1/2-percent sales tax increase in 1993. State officials indicated that the resulting 6 percent tax rate combined with optional local sales taxes made Tennessee's sales tax among the highest in the country.

State and local governments also instituted spending cuts that affected a variety of programs, government payrolls, and capital projects. For example, Connecticut cut funding to programs at the local level, including reducing the state's reimbursement rate to towns for General Assistance programs. California's budget cutting included health and welfare programs. Locally, Nashville-Davidson, Tennessee, officials reported reductions in nonmandated school health programs, which affected services to rural areas. Tight budget conditions in Fresno County, California, have reportedly resulted in overcrowded conditions in juvenile detention centers. Several localities we visited also laid off employees and took other personnel actions, such as pay and hiring freezes, salary reductions, and employee furloughs. Some local officials reported that staff reductions have affected the level and quality of services. In fact, Detroit officials reported that as a result of Health Department layoffs, city-run health clinics turned away many uninsured patients.

We note that some of the actions officials described to us may simply postpone rather than eliminate costs. For example, several jurisdictions reduced or deferred capital spending--actions which may add to long-term capital costs. Officials in Nashville-Davidson told us that leaks in school buildings have become common since improvements have been deferred. Off-budget transactions,

such as California's off-budget "loans" to education districts, may understate long-term program costs. Finally, in California and Colorado, officials told us of reductions in contributions to employee pension plans, a strategy which could result in increased liabilities for the future.

REDUCED SHORT-TERM FLEXIBILITY

In spite of these budget adjustment actions, spending continued to grow faster than revenues over the 1985 to 1991 period, bringing year-end budget surpluses down. For each of the three levels of government, operating surpluses (excluding retirement and other insurance trust funds and direct capital spending) fell from a peak of about 6 to 9 percent of expenditures in the mid-1980s to between 1 and 3 percent by 1991 (see fig. 2).[2]

With lower surpluses to carry forward as "budget cushions," jurisdictions experienced a reduced flexibility for increasing the funding of existing services or undertaking major new spending initiatives. However, other indicators of budgetary condition did not show similar deterioration. Cash and security holdings available to each of the three levels of government generally rose slightly or remained relatively constant over the 1985 to 1991 period. Furthermore, between 1985 and 1991, levels of both short-term and long-term governmental debt outstanding were generally stable or decreasing. Finally, for the states, largest cities, and largest counties, the number of bond rating increases and decreases were roughly the same, suggesting that the financial markets did not perceive a substantial deterioration in the condition of these governments.

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[2]Our measure of operating surplus or deficit is not the same as the general fund balance reported in individual jurisdictions' budget or financial reports. Our measure uses Census data and concepts, which define a governmental entity as the parent government plus its dependent agencies and enterprises such as water utilities and airports, and which standardize the financial transactions of governments into comparable categories. We exclude only insurance trust funds (except annual contributions to such accounts) and capital accounts in order to better reflect the current costs of state and local government transactions. Being more inclusive, our measure facilitates comparisons across jurisdictions. Such comparisons are problematic using general fund concepts, because general funds vary widely in the percentage of governmental spending covered--for example, from 21 to 74 percent at the state level, according to the Congressional Research Service. A 1991 survey publication of the National Governors' Association and National Association of State Budget Officers reports that states' general funds account for only about half of total state spending.

However, many jurisdictions--including New Jersey, Detroit, Los Angeles County, and others widely reported on by the media--experienced significant changes. Many incurred budget deficits, and some also experienced decreases in their levels of cash and security holdings and increases in their short- and long-term debt. Of the 50 states, 56 large cities, and 77 large counties we analyzed, 8 states (16 percent), 16 cities (29 percent) and 27 counties (35 percent) experienced deficits when averaged over the 3-year period between 1989 and 1991. We note that in most of these jurisdictions, however, the deficits were under 5 percent of expenditures. Moreover, the jurisdictions that experienced operating deficits were economically diverse, including both wealthier and poorer ones. A variety of factors, including a jurisdiction's policy choices, can affect its short-term budget condition.

LONGER TERM PROBLEMS IN CAPACITIES TO FINANCE SERVICES

These budget trends may improve in the short-term as the economy improves, or as elected officials adjust their spending and taxing priorities. However, despite such budgetary improvements, many poorer jurisdictions--that is, those with relatively high poverty levels and low incomes--face a more fundamental, longer-term problem. These jurisdictions have less capacity to finance their police, fire, and other services at average levels because of their relatively low tax bases. The best example of this is seen in the older central cities that have experienced industrial base deterioration and middle-class flight to the suburbs, leaving high concentrations of people in poverty or with low personal incomes.

In this regard, we found a significant trend affecting large cities. Over the past two decades, the poorer cities experienced a deterioration in the levels of basic services they could afford while the better-off cities improved. Residents of the poorer jurisdictions, who can least afford it, would have had to shoulder higher tax burdens than residents of better-off cities to finance city services at comparable levels (see fig. 3). If the weakest cities had wanted to levy average tax burdens and finance services at average levels, they would have needed additional outside funds equal to an estimated 36 percent of their own tax revenues.

The improved status of the strongest cities was generally associated with a large growth in per capita income accompanied by a small rise in needs for public services. However, the weakest cities experienced low growth in per capita income compared to needs (see fig. 4).

While the gap among the nation's largest cities widened in terms of the services they could afford to provide, the gap between the nation's strongest and weakest states narrowed. Examining the various factors that affect capacities provides further insight into changes in disparities. Although the taxable resources for

the weakest states remained stable, their poverty rates decreased during the years we studied.

We observed regional patterns in state capacity (see fig. 5). Specifically, the Plains and Southeast states experienced the greatest improvement in their fiscal capacities. The Plains states improved from 8 to 1 percentage points below the national average. Meanwhile, Southeast states improved from 17 to 6 percentage points below average. None of the regions experienced significant declines in capacities.

SOME CITIES HAVE SHORT- AND LONG-TERM PROBLEMS

Our study identified five large cities that faced not only a short-term problem of budget deficits, but also a long-term deterioration in the public services they can afford to provide. Such jurisdictions may have the most difficulty in overcoming their financial problems and meeting the service needs of their residents. Similarly, we identified four large counties that faced the same short- and long-term problems.

We note, though, considering all of the state, city, and county jurisdictions that we studied, there was not a strong relationship between a jurisdiction's fiscal capacity to finance services and its budgetary condition. At the city level, there was a weak relationship--city differences in fiscal strength explained only about 9 percent of differences in budget surpluses or deficits--while at the state and county levels, there was no statistically significant relationship. In other words, poorer and better-off jurisdictions generally managed their financial resources with similar results in terms of their surpluses or deficits, cash and securities holdings, and short- and long-term debt.

POLICY IMPLICATIONS

There are large disparities in the levels of services that states and cities can afford (i.e., fiscal capacity differences). Disparities at the city level are of particular concern to us for two reasons. Unless the trend is reversed, which could happen with strong economic growth in the poorer cities, residents of those cities will be left further and further behind those of better-off communities in terms of receiving services at reasonable tax burdens.

Furthermore, the declines in budgetary surpluses at the state, county, and city levels, which have turned into deficits in some jurisdictions, are a disturbing trend. Unless reversed, it implies a decreasing flexibility at the state and local levels, at least in the short run, for undertaking major new investment programs and responding to emerging issues such as reforms to health care and welfare.

Finally, we note that the declining state and local budgetary surpluses may add to the federal deficit's effects in impeding stronger long-term growth in the U.S. economy. To the extent that this is the case, the "budget problem" as it affects the future of the nation's economy is not simply a federal deficit problem, but rather a general governmental problem in the federal system. Viewing the matter in this broader, total intergovernmental context could help federal officials better gauge the size of the overall problem and devise appropriate budget and economic growth strategies.

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Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you may have.

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Figure 1: State-Local Own-Source Receipts

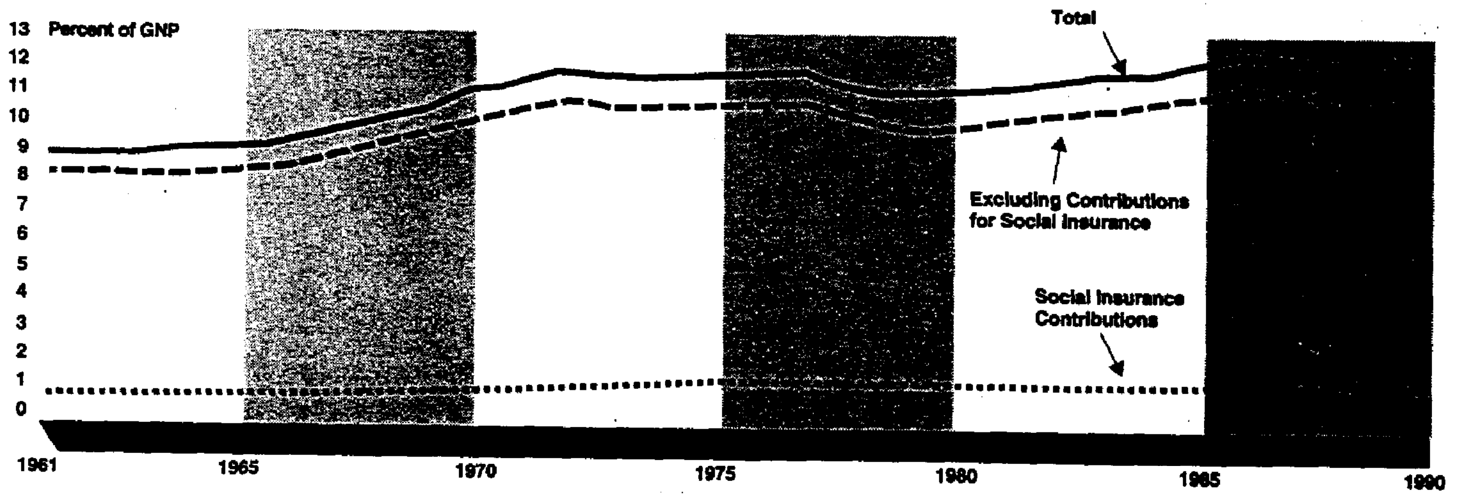

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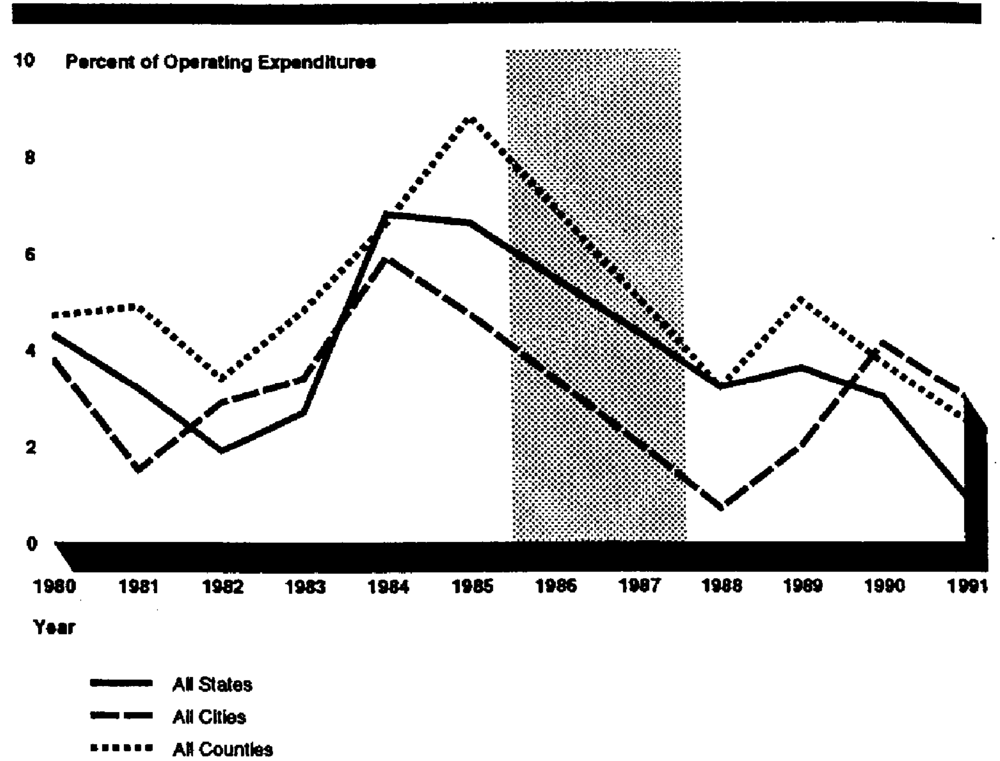
Figure 2: Operating Surplus/Deficit



Note: Shading indicates that data points for 1986 and 1987 are interpolated between those for 1985 and 1988.

(Percent of Operating Expenditures)

Year	All States	All Cities	All Counties
1980	4.3	3.8	4.7
1981	3.2	1.5	4.9
1982	1.9	2.9	3.4
1983	2.7	3.4	4.8
1984	6.8	5.9	6.6
1985	6.6	4.7	8.8
1986	5.5	3.4	6.9
1987	4.3	2.0	5.1
1988	3.2	0.7	3.2
1989	3.6	2.0	5.0
1990	3.0	4.1	3.7
1991	0.9	3.0	2.5

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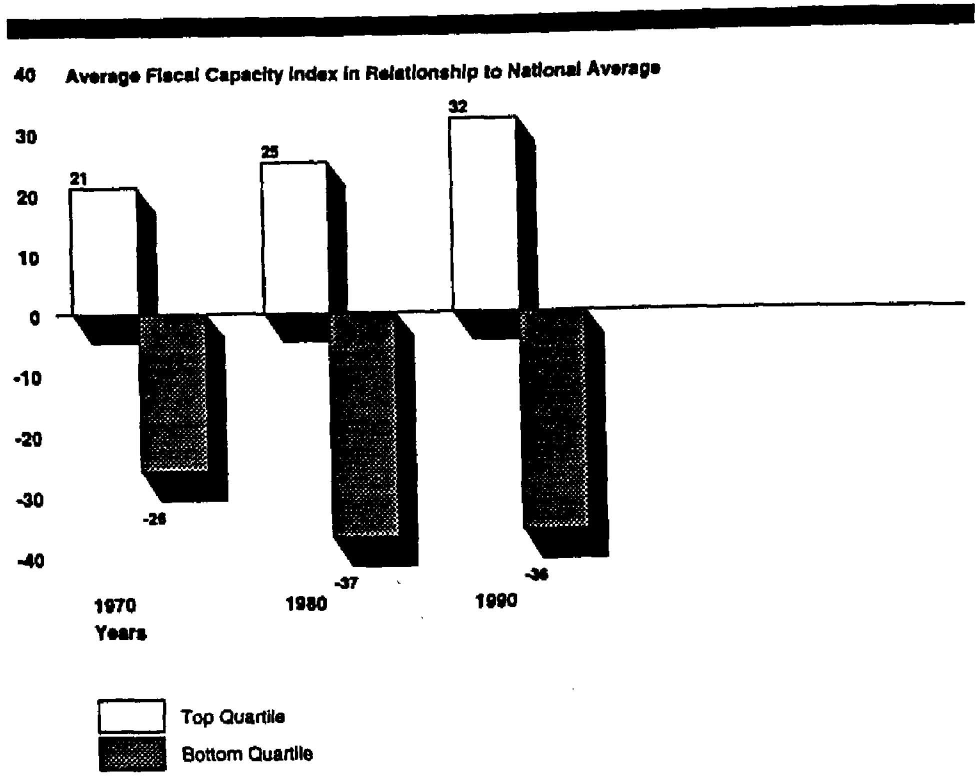
Figure 3: City Fiscal Disparities in 1970, 1980, and 1990



Analysis of Cities with Populations of 300,000 or More in 1990

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Figure 4: Poverty Rates of Large Cities in Top and Bottom Quartiles of Fiscal Capacity

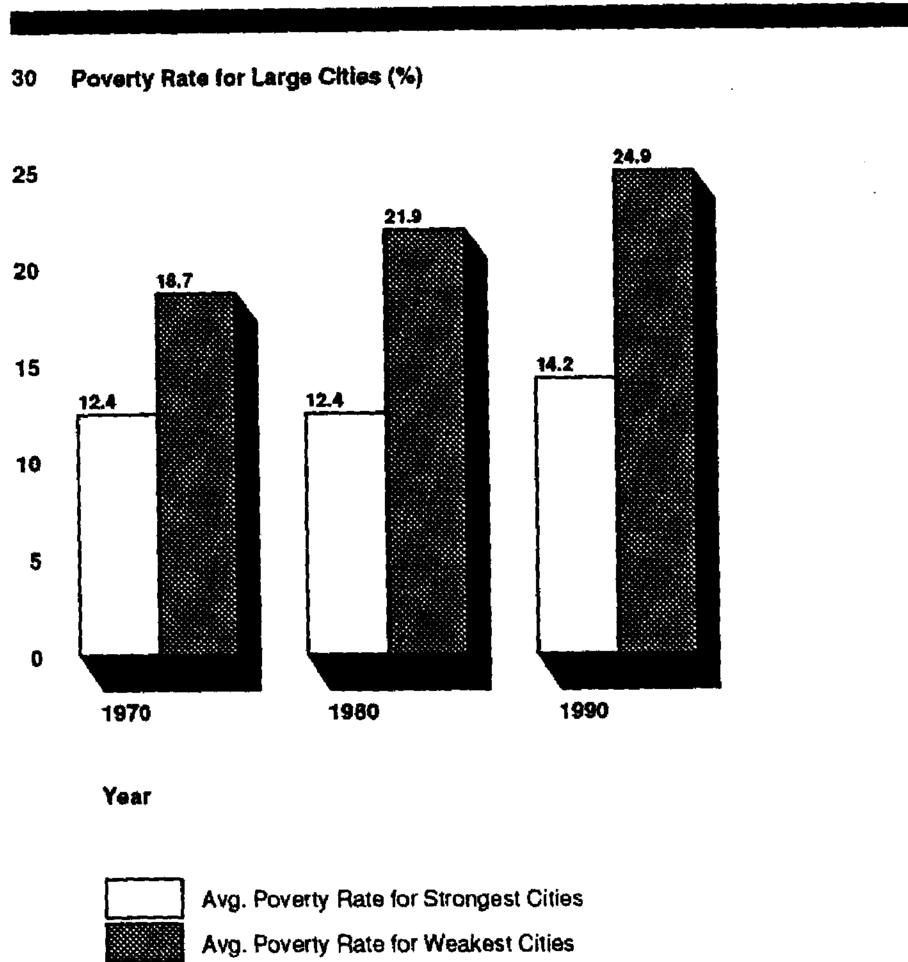

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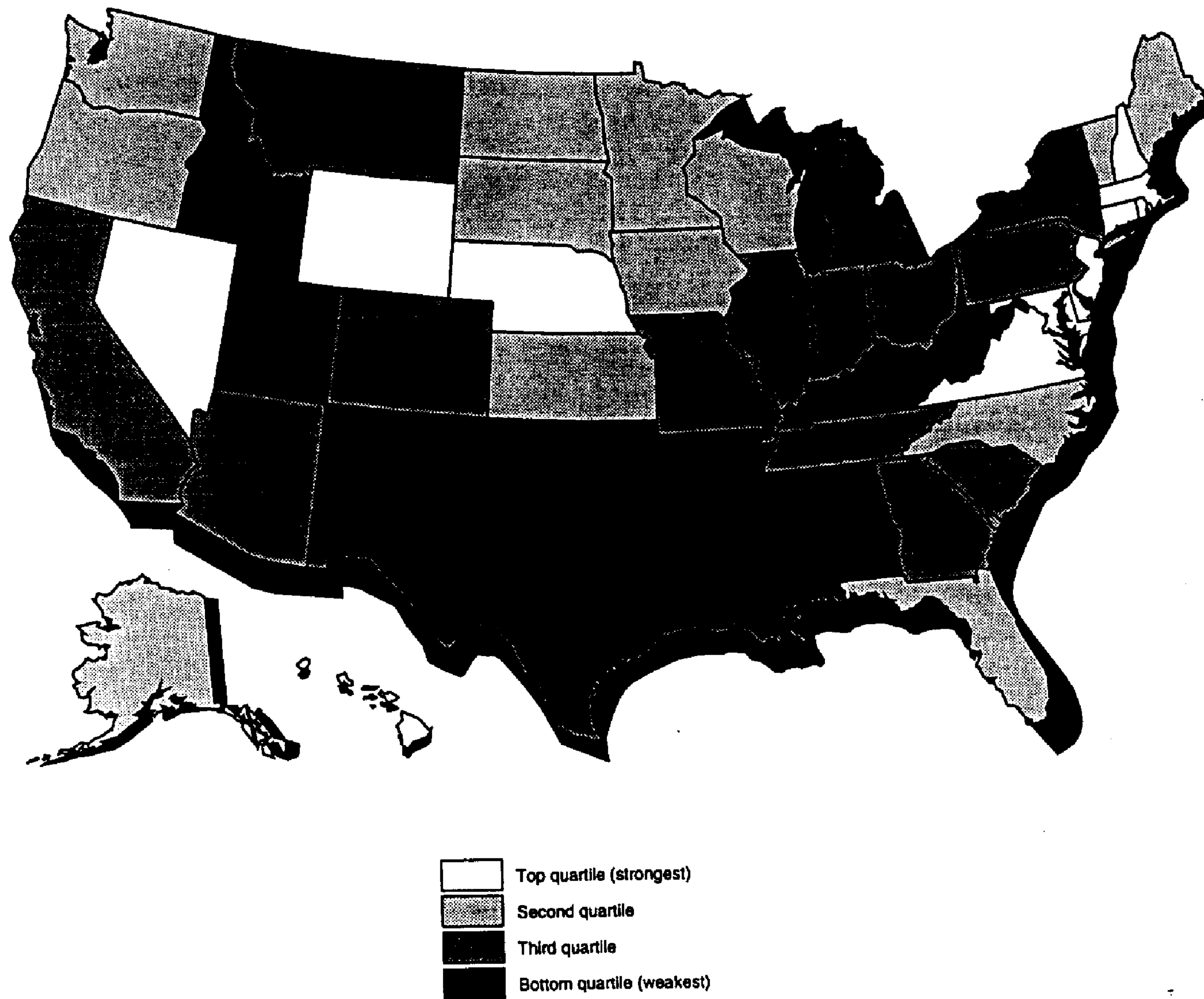
Figure 5: State Fiscal Capacities in 1990



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