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Report to the Honorable
Richard A. Gephardt, Majority Leader,
House of Representatives

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STATE AND LOCAL FINANCES

Some Jurisdictions Confronted by Short- and Long-Term Problems

GAO

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Human Resources Division

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The Honorable Richard A. Gephardt
Majority Leader
House of Representatives

Dear Mr. Gephardt:

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.

This report is the second in a series responding to your request that we study the financial conditions of state and local governments. It follows up on our earlier report, issued in March of 1992,[1] which addressed trends for the state and local sectors combined. This second report provides additional information on states, cities, and counties separately. Our objectives were to analyze (1) the short-term financial conditions of states, cities, and counties, as reflected in several budgetary indicators, (2) responses by state and local governments to budgetary pressures, and (3) longer-term trends in the ability of states and localities to meet the service needs of their residents.

Results in Brief

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, certain large 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. This growth in spending partly reflected factors beyond the immediate control of state and local officials, such as rising health care costs or regional economic problems, but it also reflected officials' choices favoring some new or expanded services and programs. 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. In addition, jurisdictions faced declines in some types of federal aid, and seeming voter reluctance to increase taxes.

[1]Intergovernmental Relations: Changing Patterns in State-Local Finances (GAO/HRD-92-87FS, Mar. 31, 1992).

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 revealed that spending cuts affected a variety of programs, government payrolls, and capital projects. Revenue actions also varied, ranging from increasing fees and charges to raising tax revenues. A notable example was Connecticut, which became the 41st state to enact a broad-based personal income tax.

As these actions occurred, spending continued to grow faster than revenues over the 1985 to 1991 period, bringing year-end budget surpluses down. With lower surpluses to carry forward as "budget cushions," jurisdictions probably experienced a reduced flexibility for increasing the funding of existing services or undertaking major new spending initiatives. More notably, many jurisdictions—including New Jersey, Detroit, Los Angeles County, and others widely reported on by the media—experienced greater 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.

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. 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.

Our study identified several 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 probably will have the most difficulty in overcoming their financial problems and meeting the service needs of their residents.

Background

State, city, and county governments—often in partnership with the federal government and one another—deliver a broad range of essential domestic public services. For example, education is typically a state and local responsibility. States and counties share responsibilities for delivering most welfare and other social services. Cities and counties provide police, fire, water, roads, and other basic services. All three levels share responsibility for police, jails, and other aspects of public safety.

In preparing their budgets, state and local governments face constraints imposed by law and custom. Most states, cities, and counties have some form of balanced budget requirement, although this may be less than absolute. For example, 48 states have constitutional or statutory balanced budget requirements for their general funds, but only a few have explicit requirements for a year-end balance. In most cases, the requirement is only that the governor must present a balanced budget, or that the state government must adopt a balanced budget.[2] Tradition and the expectation of balance, as well as concern with bond ratings, also motivate state and local officials to try to achieve such balance.

In addition, state and local officials may have to deal with other constraints on their spending and revenue actions. Since the late 1970s, marked by the passage of California's Proposition 13 in 1978, there has been a trend toward placing legal limitations on state and local taxing and spending levels. As of 1991, 21 states had spending limits, 7 had revenue limits, and 3 had both. Many cities and counties operate under similar constraints. For example, state law sets maximum allowable tax rates for some cities. Among large counties, one in three has a legal constraint on increasing property taxes.

During the 1980s and early 1990s, state and local governments faced a number of financial stresses. Three recessions, two in the early 1980s and the other in the early 1990s, plus the slowing economic growth of some years in the late 1980s, reduced revenue growth while increasing demand

[2]See Balanced Budget Requirements: State Experiences and Implications for the Federal Government (GAO/AFMD-93-58BR, Mar. 26, 1993).

for programs such as unemployment insurance and welfare. Spiraling health care inflation also affected budgets. Voter resistance to new taxes evident at all levels of government made revenue-raising more difficult. In addition, federalism policies of the 1980s and federal budgetary retrenchment were accompanied by increased regulatory requirements and less federal aid for certain general operations of government.

Scope and Methodology

A variety of perspectives exist on how to analyze the financial condition of state and local governments. One approach looks at the short-term financial results of decisions governments make about financing the services they provide. To do this, we used indicators that measure budgetary surpluses and deficits, debt levels, and cash and security holdings. It is important to note that these indicators of budget condition are not intended to measure any unmet needs for services in a jurisdiction. We examined trends in these indicators for the 1980 to 1991 period, with particular emphasis on 1985 through 1991, which our earlier report had identified as a period of declining surpluses for the state and local sector as a whole. In this current work, we used Census data on state and local government finances to facilitate comparisons among governments. For further details on this methodology, see appendix VI.

Financial measures such as these, however, do not illuminate the variety of adjustments state and local governments make in formulating and executing their budgets, and the sometimes significant effects of these adjustments on public services. To look at state and local matters from this perspective, we visited five states (California, Colorado, Connecticut, Michigan, and Tennessee) and eight urban areas (Fresno, San Jose, Memphis, Nashville-Davidson, Stamford, Hartford, Detroit, and Denver) to examine their responses to budgetary stress. The jurisdictions were selected to obtain broad geographic representation as well as a range of economic and institutional circumstances. Additional information on our case study methodology can be found in appendix I, and detailed summaries of our case studies on these jurisdictions are contained in appendix III.

Finally, a third perspective on state and local financial conditions is concerned with the longer-term capacities of state and local governments, given their underlying tax bases, to finance basic services at nationwide average levels. To examine trends in these capacities of state and local governments, we used economic models developed for this purpose, focusing on all 50 states and the 56 largest cities. Because we wanted to

look at this issue over the long term, we drew on demographic data from Census surveys of 1970, 1980, and 1990. Appendix VII contains more details on this analysis.

The last year reflected in our analysis of short-term financial conditions is 1991, and the last year in our analysis of longer-term capacities is 1990. Therefore, these analyses do not reflect any changes occurring later. Deteriorating conditions in states such as California due to the recession, defense cuts, or other, more recent events, are not reflected in our analysis results. On the other hand, improving conditions in some areas due to post-recession recoveries or other factors are also not captured. However, more recent events are covered in our case study work and discussed throughout this report where appropriate.

Our review was conducted between August 1992 and July 1993 in accordance with generally accepted government auditing standards. However, for purposes of this study we did not consider it necessary to independently verify the state and local governments' financial information. For an overview of our scope and methodology, see appendix I.

Revenue and Spending Pressures Increased at All Three Levels

Between 1985 and 1991, states, cities, and counties found it increasingly difficult to end the year with their previous levels of year-end budget surpluses. Before 1985, these surpluses had grown as the economy recovered from the recessions of the early 1980s. Between 1985 and 1988, real growth in gross domestic product (GDP) was relatively strong, averaging about 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. Such weakening not only increased spending pressures in the social safety net programs, such as Medicaid and Aid to Families with Dependent Children (AFDC), but also reduced revenues from the levels that otherwise might have been collected.

Beyond this, there were other factors. Officials at all three levels cited the budget effects of federal and state mandates. City and county officials were particularly concerned about the considerable costs of mandates to improve environmental quality. Also, jurisdictions' own policy decisions worked to increase spending and constrain revenues. Rising health care costs were also important. The story was somewhat different at each level of government, but at all three levels, spending for all major categories of

programs we examined grew, with spending for some growing faster than total spending.

Health Care a Major Factor in Driving Up State Spending

On the spending side of state and local budgets, some programs contributed more than others to the outpacing of revenues. At the state level, health care spending grew faster than spending for any other group of programs. In real terms, 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. For example, in Michigan spending for Medicaid accounted for an estimated 20 percent of general fund spending in 1993. Nationwide, total state health expenditures comprised, on average, 21 percent of general expenditures in 1991.

Various Factors at Work in Increased Spending at City and County Levels

For cities and counties, the stories were different. At the city level, spending on environment and housing programs—including such programs as sewerage and solid waste management, parks and recreation, and housing and community development—was an important factor. In 1991 programs in these areas accounted for 21 percent of general fund spending, and between 1985 and 1991 they grew faster than spending as a whole—4.2 percent per year versus 3.8 percent per year, respectively, in real terms. In addition, spending on education comprised a 13 percent share of total spending for cities in 1991. For cities providing education, this expenditure category grew at a real rate of 4.7 percent on average between 1985 and 1991.

At the county level, real public safety spending, including corrections, grew at 7.3 percent on average between 1985 and 1991, compared to 5.5 percent for total general expenditures. The growth in public safety spending was also important because of its share of the total—12 percent in 1991. Corrections at the county level grew even faster, at an average 9.5 percent per year over the same time period. On average, however, corrections represented only a 5 percent share of total county general fund spending in 1991. County programs for environment and housing also contributed to rising expenditures, growing at 6.8 percent per year on average from 1985 to 1991, with a 7 percent share of total spending in 1991.

Except for states, capital spending for roads, sewer systems, school buildings, and other projects grew faster than spending for operating expenses over 1985 to 1991. For counties, capital grew at a real average rate of 8.1 percent, and for cities it grew at an average of 4.2 percent. Also, at both levels, capital represented a significant part of total outlays—16 percent for cities and 11 percent for counties in 1991. Pressures from other programs were also at work. (See app. IV.)

Revenues Held Down by Several Factors

While such spending pressures were increasing, officials at all levels were facing formidable challenges in finding the needed revenues. For one thing, as noted previously, the economy slowed, turning into a national recession spanning parts of 1990 and 1991. In many cases, revenue projections based on previous years' growth did not materialize. In addition, federal grants for capital projects and other general operations (which excludes 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 [GNP]) approaching a 25-year high in the mid-1980s, 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. In one of the states we visited—California—there already had been successful voter initiatives in the late 1970s designed to limit the ability of officials to raise taxes and spend from general funds, while in another state we visited—Colorado—similar limits were approved by voters in 1992. (See apps. II and V.)

Jurisdictions Responded to Budget Pressures

Faced from the mid-1980s on with upward spending pressures and weakened revenue growth, and choosing to allow some new or expanded spending initiatives, many state and local governments took actions to control program growth or cut other services. They also undertook to increase revenues. National surveys show that these strategies ranged from raising taxes and imposing new fees, to measures to reduce spending in several areas. Our visits to several 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. (See app. VI.)

Fees and Charges Were Popular Means to Raise Revenue

On the revenue side, the jurisdictions we visited undertook a variety of measures. These included actions to initiate a personal income tax (Connecticut); increase property, sales, and gas tax receipts; and increase fees and charges. For example, 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.

The data we analyzed for overall trends in the state and local sectors indicate that fees and charges were particularly important, with their real annual growth rates exceeding that of other forms of revenue over 1985 to 1991. A prominent example from our case study work was California's decision to increase student fees for 1992-1993 to help fund its higher education system. Similarly, Tennessee for fiscal year 1992 imposed environmental fees as well as fees on doctors, lawyers, and other professionals. County officials in Santa Clara County, California, and Nashville-Davidson, Tennessee, also reported fee increases for various public services in recent years.

Such revenue actions increased somewhat the "revenue burdens" levied by state and local governments on their residents—that is, the amount of taxes, fees, and charges raised by governments as a percent of the personal income of their residents. At the state level, revenue burdens increased from 6.8 percent to 7.4 percent of personal income between 1980 and 1990. City and county revenue burdens were significantly lower during this period, increasing from 2.9 to 3.3 percent and 1.3 to 1.6 percent, respectively.

Cuts Affected Programs and Payrolls

State and local governments also instituted various program and payroll cuts to alleviate budget pressures. 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.

Similar program cuts occurred at the local level. Nashville-Davidson officials reported reductions in nonmandated school health programs, which affected services to rural areas. In Santa Clara County, officials told

us about closing a juvenile rehabilitation center and an acute psychiatric care facility. Tight budget conditions in Fresno County have reportedly resulted in overcrowded conditions in juvenile detention centers. The average stay for delinquents in these facilities was 28 days, which, according to officials, was inadequate time to affect behavior. Finally, in Detroit, officials instituted across-the-board budget cuts from each city department and reduced services in a variety of areas such as recreation, libraries, and cultural organizations.

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.

Some Budget Actions Could Carry Long-Term Consequences

Some budget actions taken by jurisdictions we visited may only postpone spending. Several jurisdictions reduced or deferred capital spending, a strategy that can add to long-term capital costs. For example, officials in Nashville-Davidson told us that all major improvements in the school system have been deferred since the late 1980s. Consequently, school building roofing has deteriorated since then, with leaks becoming common. Similarly, officials in Hartford told us about reductions in capital procurement and in the rate of road repair.

Also, Colorado and California reduced contributions to employee pension plans. We were not able to determine whether such changes increased the unfunded liabilities of the pension plans. However, officials in these locations said this was not the case in their states. To the extent that cutbacks in contributions to pension funds increase the unfunded liabilities of their plans, the cutbacks may not be true savings. We note as a matter of concern that our previous analysis of 189 state and local pension plans revealed that on average these plans were underfunded by about 15 percent.[3]

Off-budget treatment of significant transactions is another strategy that could have long-term adverse effects. An example of this occurred in California where the state made off-budget "loans" to education districts. Such practices could obscure actual long-term program costs.

[3]Underfunded State and Local Pension Plans (GAO/HRD-93-9R, Dec. 3, 1992).

Reduced Short-Term Flexibility

In spite of these actions, expenditures of states, cities, and counties grew faster than revenues over the 1985 to 1991 period, resulting in declining year-end budget surpluses. This meant that many jurisdictions had fewer year-end funds to carry forward to help finance the succeeding year's programs, suggesting a diminished flexibility, at least in the short-run, to increase the funding of current services or undertake major new spending initiatives.

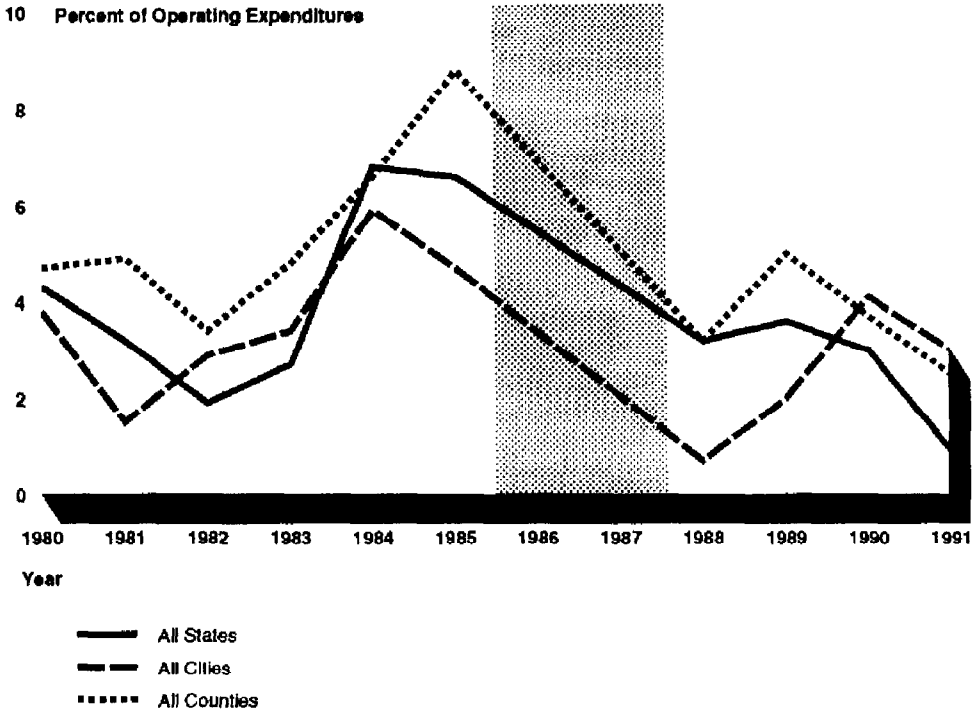
Surpluses Declined

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. 1).[4] The decline in surpluses roughly paralleled the decline in GDP growth from a peak in 1984 to recession in 1990-91.[5]

[4]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 the National Association of State Budget Officers reports that states' general funds account for only about half of total state spending.

[5]It was beyond the scope of this study to determine the extent of the effects of changes in the business cycle on the surpluses of state and local governments. Other researchers have found that state and local surpluses and deficits are responsive to cyclical changes in the economy, but that other factors, such as rising health care costs, are also very significant. See, for example, Edward M. Gramlich, The 1991 State and Local Fiscal Crisis, Brookings Papers on Economic Activity, Vol. 2, 1991 and Andrea L. Kusko and Laura S. Rubin, State and Local Fiscal Indicators, Board of Governors of the Federal Reserve System, Working Paper Series Number 132, April 1993.

Figure 1: 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

If expenditures and revenues are measured using the Census data inclusive of social insurance and capital accounts, comparable to the federal unified budget, cities and counties showed deficits in 1991. States, however, as a group, remained in surplus.

But Other Budget Indicators Were Stable or Improved

We note that the operating surpluses for each level of government, though substantially diminished by 1991, did not turn into deficits except in a minority of jurisdictions. Moreover, 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. (On bond ratings, see app. IX.) Our measures of short-term financial condition do not measure unmet needs for services that may exist in jurisdictions.

Some Governments Experienced Deficits

As indicated above, however, we found operating deficits in some jurisdictions.[6] 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) averaged deficit positions 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. (See pp. 16-17 for further discussion of relationships between operating deficits and economic factors.)

For more details on our analysis of short-term financial condition, see appendix VI.

[6]We used the same basic approach to measure the operating surplus or deficit of individual jurisdictions as we used for the aggregates of all states, all cities, and all counties. As such, our measure is not the same as the general fund balance reported in individual jurisdictions' budget or financial reports. Furthermore, we averaged our results for each jurisdiction for the three years 1989 through 1991. We did this both because surpluses or deficits can vary significantly from year to year, and because different parts of the country experienced recessionary impacts at different times over this period.

Longer-Term Problems in Capacities to Finance Services

In many cases, such unfavorable financial trends may be reversed in the short-term as the economy improves, or as elected officials adjust their spending and taxing priorities. However, the poorest jurisdictions may be confronted with an even greater longer-term problem. These jurisdictions, with higher concentrations of poverty, have relatively weak tax bases and cannot afford to finance services at the levels seen in better-off jurisdictions. Such conditions normally change relatively slowly.

The contemporary phenomenon of growing economic disparities between large central cities and their surrounding suburbs exemplifies this problem. Research has highlighted the deterioration of the industrial base of many cities and middle-class flight to the suburbs. As a result, high concentrations of people in poverty or with low personal incomes have been left in many central cities.

Examining the degree to which a jurisdiction can afford a specified level of public services requires exploring its capacity to finance its residents' public service needs, given its socioeconomic composition.[7] In the public policy research community, this capacity is sometimes referred to as the "fiscal health" or "fiscal capacity" of a jurisdiction. Our analysis gauges a jurisdiction's capacity to finance services at average spending levels with its own taxable resources (for example, resident income and business activity) and with an average tax burden on taxpayers.[8] Governments with stronger fiscal capacities can afford to finance above-average levels of services with average tax burdens on residents. In contrast, governments with weaker capacities cannot afford to finance an average level of services without levying tax burdens higher than average.

Substantial Differences Among Cities and Among States

We found substantial differences among large cities and among states in terms of the levels of services they can afford to provide. In 1990, cities with the strongest capacities had the ability to finance average service levels and to take on additional responsibilities over the long-term. With

[7]Socioeconomic factors, such as per capita income, poverty, and unemployment levels, are somewhat outside the immediate control of public officials and change slowly over time. Nonetheless, in the long-term, local government officials could have the ability to alter socioeconomic characteristics that affect long-term economic potential. For example, through economic development strategies, a jurisdiction may improve its prospects for employment and business opportunities, thus potentially increasing its per capita income and decreasing poverty levels.

[8]We note the following points about our analysis of fiscal capacity: (1) an average expenditure level is defined as the nationwide average per capita spending across all jurisdictions, and similarly, an average tax burden is defined as the national average; (2) the methodologies used do not yield separate results for counties—the state analysis considers services provided by all governments within a state, while the city analysis pertains to services provided within a city area, which may include counties; and (3) this analysis excludes intergovernmental aid.

average taxation levels, these cities would have been able to afford an average level of services and have additional resources equal to 32 percent of their tax revenues. In contrast, if the weakest cities had wanted to finance services at average levels but not raise tax burdens above average levels, they would have needed outside aid (for example, federal or state grants) equal to 36 percent of their tax revenues.

Large cities in the Far West and Plains states were the strongest while cities in the Midwest and Northeast were among the weakest. Differences in capacities between the strongest and weakest large cities were attributable to high poverty and unemployment rates, and low incomes for the weakest cities.

We also found widespread differences for states in terms of the public services they could afford to provide. With average tax burdens and providing an average level of services, the strongest states would have had discretionary resources left equal to about 18 percent of their tax revenues in 1990. In contrast, the weakest states would have needed outside aid equal to 14 percent of tax revenues to help them afford an average level of services.

Regionally, states in the New England and Far West regions ranked among the strongest, primarily because of higher per capita income levels. Conversely, Southeastern and Southwestern states, because of greater poverty rates and smaller taxable resources, generally were among the weakest.

Table 1 lists the large cities and states with the weakest fiscal capacities in 1990. It is important to note, regarding these and other jurisdictions, that their capacities may have changed in some cases since 1990 because of subsequent economic changes. For example, some jurisdictions have been especially affected by defense cuts and continuing recessionary impacts.

Table 1: States and Large Cities in Lowest Quartile of Fiscal Capacities in 1990 Based on GAO's Measures

States	Large Cities
Alabama	Buffalo, NY
Arkansas	Chicago, IL
Idaho	Cleveland, OH[a]
Kentucky	Detroit, MI[a]
Louisiana[a]	El Paso, TX[a]
Michigan	Memphis, TN
Mississippi	Miami, FL[a]
New Mexico[a]	Milwaukee, WI[a]
Oklahoma[a]	Newark, NJ
Texas[a]	New Orleans, LA[a]
Utah	New York, NY
West Virginia	Philadelphia, PA
	San Antonio, TX[a]
	Toledo, OH

[a]Denotes that these jurisdictions were among the one-quarter of states and large cities that experienced the largest declines in fiscal capacity between 1980 and 1990.

Declines Seen in Some Cities

Since 1970, the weakest cities diminished in their ability to provide services relative to the strongest cities whose condition improved in terms of the services they could afford to provide. Increasingly, the residents of the weakest cities, who could least afford it, would have had to shoulder higher tax burdens than residents of the strongest cities if they wanted to finance city services at the same levels seen in the better-off jurisdictions. We found that the percentage point difference between the strongest and weakest cities rose from 47 percentage points in 1970 to 68 percentage points in 1990.[9]

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. For example, Memphis, Tennessee, which ranked among the weakest cities in 1990, experienced increases in poverty and unemployment between 1980 and 1990, with little increase in per capita income. In contrast, Nashville-Davidson, Tennessee, one of the strongest cities, had relatively small increases in needs, accompanied by a relatively large growth in per capita income.

[9]In 1970, with average tax burdens, the strongest cities would have had discretionary resources left equal to about 21 percent of their tax revenues, while the weakest cities would have needed outside aid equal to 26 percent of their tax revenues (a 47 percentage point gap). In 1990, the strongest cities would have had discretionary resources left equal to about 32 percent of their tax revenues, while the weakest cities would have needed outside aid equal to 36 percent of their tax revenues (a 68 percentage point gap).

Reduced Disparities Between Strongest and Weakest States

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. Between 1970 and 1990, we found a 5 percentage point drop in the gap between the strongest and weakest states.[10] The reduced disparity was due primarily to an overall improvement by the weakest states, while the status of the strongest states remained relatively constant.

Regionally, 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.

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. Similar patterns in taxable resources and poverty were associated with changing disparities among the various regions of the country.

Some Cities Have Short- and Long-Term Problems

Our study identified some cities that faced a dual problem—namely, a short-term problem of diminished financial flexibility (related to their operating deficits) and also a longer-term problem of relatively weak capacity to finance public services. Furthermore, we found that the cities with the weakest capacities in 1990 were somewhat more likely to have experienced deficits and lower levels of cash and security holdings. For example, averaged over 1989 to 1991, these cities had a deficit of 0.1 percent of expenditures while the cities with the strongest capacities ran an average surplus of about 9 percent of expenditures.[11]

Table 2 shows the five large cities that had the weakest capacities to finance services and also ran operating deficits (according to our measures). Using per capita money income as a proxy for county fiscal

[10]With average tax burdens, the strongest states would have had discretionary resources left equal to about 17 percent of their tax revenues in 1970 but about 18 percent in 1990. Alternatively, the weakest states would have needed outside aid equal to 20 percent of their tax revenues in 1970 but 14 percent in 1990. We note that it is inappropriate to compare our results for cities with those for states, given our use of contrasting methodologies for the two analyses.

[11]The relationship between fiscal capacity and operating surpluses or deficits is fairly weak, explaining 9 percent of the variance, but is statistically significant at the .05 confidence level. We did not find a statistically significant relationship with respect to short- or long-term debt.

capacity, we also found four large counties (Milwaukee, Wisconsin; Jefferson, Alabama; Kern, California; and Pierce, Washington) that were among the weakest in their capacities to finance services and also experienced operating deficits. Although eight states averaged deficits between 1989 and 1991, none of these were among the states with the weakest fiscal capacities. Also, for states and large counties as groups, we did not find correlations between fiscal capacity and budget condition as we did for cities. (See app. VIII.)

Table 2: Large Cities With Low Capacities and Operating Deficits Based on GAO's Measures

Detroit, MI[a]
Miami, FL
Newark, NJ[a]
San Antonio, TX
Toledo, OH[a]

Note: The jurisdictions in this table were among the one-quarter of large cities with the lowest fiscal capacities in 1990 and also averaged operating deficits over 1989-91.

[a]Denotes jurisdictions whose general obligation bond rating in 1991 and 1992 was Baa or lower, the lowest rating categories for any of the governments we examined. Baa is the lowest category of investment grade bonds.

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 for two reasons. First, 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. This is a problem that the residents of such jurisdictions would continue to face even if they overcame their short-term operating deficit problems.

Second, it is at the city level where long-term and short-term financial problems are most likely to be found together in a jurisdiction. The cities with the weakest capacities tend to run deficits or lower operating surpluses. Despite legal requirements and other pressures for them to balance their budgets, the weakest cities will find it difficult to solve their short-term financial problems by relying on further tax hikes or service cuts, precisely because their service needs and tax bases already are seriously mismatched.

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.

We did not obtain written agency comments on this report because we were not evaluating agency programs or functions. However, we discussed its contents with experts in the field of public policy and state and local finance, representatives from federal, state, and local governments and public interest groups, and officials of the case study jurisdictions we visited. We incorporated their comments as appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies of this report to the Chairman and Ranking Minority Member of the Human Resources and Intergovernmental Relations Subcommittee of the House Committee on Government Operations and to the Chairman and Ranking Minority Member of the Subcommittee on Regulation and Government Information, Senate Committee on Governmental Affairs. We will also make the report available to others on request.

This report was prepared under the direction of Gregory McDonald, Director of Operations, who may be reached at (202) 512-6805 if you or your staff have any questions. Other major contributors are listed in appendix X.

Sincerely yours,

Janet L. Shikles

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Assistant Comptroller General

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Abbreviations

ACIR	U.S. Advisory Commission on Intergovernmental Relations
AFDC	Aid to Families with Dependent Children
BSF	Budget Stabilization Fund
GDP	gross domestic product
GFE	general fund expenditures
GFR	general fund revenue
GNP	gross national product
GSD	General Service District
GSP	gross state product
MSA	metropolitan statistical area
NACo	National Association of Counties
NASBO	National Association of State Budget Officers
NLC	National League of Cities
NGA	National Governors' Association
PAB	private activity bond
PCPI	per capita personal income
RES	Representative Expenditure System
TTR	total taxable resources
USD	Urban Service District

Objectives, Scope, and Methodology

In September 1991, the House Majority Leader requested that GAO study the financial condition of state and local governments in recent years. As a first step in responding to this request, we issued a fact sheet in March 1992 describing trends in the finances of the state and local sector as a whole, most notably a decline in its aggregate surplus beginning in the mid-1980s.[1]

The follow-on work summarized in this report sought to conduct a more detailed examination of the issue by identifying conditions at the state, city, and county levels separately and in selected jurisdictions. Moreover, this work went beyond our March 1992 fact sheet by looking at the issue in three different ways. Our specific objectives were to identify, at each of those levels, short-term financial conditions, longer-term fiscal capacities, and actions taken by state and local officials in response to their short- and long-term problems.

Short-Term Financial Condition

In this report, "budgetary" or "short-term financial" condition refers to the relationship of annual revenues to annual expenditures in a jurisdiction, and to certain assets and liabilities affected by decisions on how to finance expenditures (discussed below). In our work on short-term financial condition, we

- developed budgetary indicators we could use to assess levels of and change in short-term financial condition;
- analyzed indicators for all states, all cities, and all counties to permit overall comparisons among those sectors of government; and
- analyzed indicators individually for each of the states, large cities (cities with a population of 300,000 or over), and large counties (counties with a population of 500,000 or more) so as to permit comparisons among jurisdictions with major financial responsibilities. These cities and counties account for almost half of the total expenditures at the city and county levels of government.

We developed four budgetary indicators—surplus/ deficit; cash and security holdings; long-term debt; and short-term debt. For surplus/deficit, we developed two measures: a comprehensive measure reflecting current and capital transactions; and a narrower measure reflecting only a jurisdiction's current transactions. It is important to note that neither of our two measures of surplus/deficit parallels the "general fund" category

[1]Intergovernmental Relations: Changing Patterns in State-Local Finances (GAO/HRD-92-87FS, Mar. 31, 1992).

as it is defined by most jurisdictions. Results for particular jurisdictions on our measures will thus likely not correspond to the amounts reported by jurisdictions for their general funds.

Importantly, our measures of short- and longer-term financial conditions are not designed to measure the creditworthiness of a jurisdiction. There are other factors not captured in our measures, such as regional or local economic prospects and the quality of public management in a jurisdiction, that are important in that regard. The bond ratings we cite were independently reported by a professional rating company.

To examine trends in our indicators, we used U.S. Census Bureau data on state and local finances. This data, based on information provided by state and local governments but analyzed by Census into its unique categories, comprises the most comprehensive and consistent set of data on this subject of which we are aware. We considered, but did not use, the financial statements issued by state and local governments. While these statements typically conform to generally accepted auditing and accounting standards, each statement is based on a system of accounts and finances set up by its jurisdiction. Taken together, the statements thus do not yield consistent data.

In addition to developing indicators of short-term financial condition, we analyzed expenditure trends in each sector of government to determine what types of spending (e.g., spending on health, capital projects, corrections) have contributed the most to recent expenditure growth. We further determined how expenditures in 1991, the most recent year for which we had data, were divided among the different types of spending. Similarly, we analyzed patterns in the different types of revenue (e.g., taxes, fees, and charges) used by each sector of government. (See app. IV.)

We focused primarily on the time period from 1985, which was the year in which the surplus for the state and local sector as a whole began to decline, to 1991, which was the most recent year for which Census data were available. We also looked at data over the longer time frame of 1980 through 1991 as appropriate. Events occurring after 1991—for example, continuing budgetary and economic problems in states such as California—are thus not reflected in our work. For more details of our short-term financial condition methodology and additional results, see appendixes IV and VI.

Fiscal Capacity

Data on short-term financial condition and trends, reflect the decisions and constraints faced by public officials in the short-term. We supplemented our analyses of short-term financial condition with an analysis of the "fiscal capacity" of state and local governments. As used in this report, fiscal capacity measures the ability of a unit of government to finance public services at average expenditure levels through the application of an average tax burden. An average expenditure level is defined as the nationwide average per capita spending across all jurisdictions, and similarly, an average tax burden is defined as the national average.

The concept of fiscal capacity differs from that of short-term financial condition in several important ways. Unlike short-term financial condition, fiscal capacity deals with socioeconomic factors, such as poverty rate and per capita income. These characteristics affect a jurisdiction's public service needs and taxable resources—factors that generally change only slowly and over the long term. Fiscal capacity also differs from short-term financial condition in that for our purposes the concept of fiscal capacity is relative, not absolute. Statements in this report that a particular jurisdiction, or set of jurisdictions, is "fiscally weak" or "fiscally strong" are meaningful only in the context of all the jurisdictions being measured.

To determine fiscal capacity for states and large cities, we adapted existing models that measure fiscal capacity. For states, we relied on a model issued by the U.S. Advisory Commission on Intergovernmental Relations (ACIR);[2] for cities, we used the work of Helen Ladd and John Yinger.[3] We selected these models because they were the most comprehensive models for demonstrating the relationship between fiscal capacity and corresponding socioeconomic factors. Because we identified no similar models for counties, we did not do a full-fledged fiscal capacity analysis for counties. For certain analyses, however, we used a proxy for county fiscal capacity, as discussed below. Because fiscal capacity normally changes slowly and trends may be noticeable only over the long term, we looked at it using Census data from decennial years 1970, 1980, and 1990.

For more details on our fiscal methodology and additional results, see appendix VII.

[2]See Robert Rafuse, Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity (Advisory Commission on Intergovernmental Relations, Dec. 1990).

[3]Helen Ladd and John Yinger, America's Ailing Cities: Fiscal Health and the Design of Urban Policy (The Johns Hopkins University Press, 1989).

To examine possible relationships between the two measures of short-term financial condition and fiscal capacity, we compared the results on these two measures for states, large cities, and large counties, using regression analysis. For counties, we used per capita income as a proxy for fiscal capacity. (See app. VIII.) We also used bond ratings to look at this issue. A widely accepted measure, bond ratings incorporate elements of both budget condition and fiscal capacity. (See app. IX.)

Actions Taken by State and Local Officials

Finally, we looked at some ways in which the interaction of budget condition and fiscal capacity has impacted the budget decisions of officials in particular jurisdictions. To give a context to this work, we used data on revenue and expenditure strategies reported by state and local officials in response to surveys by the National Governors' Association (NGA), the National Association of State Budget Officers (NASBO), the National Conference of State Legislatures, the U.S. Conference of Mayors, the National League of Cities (NLC), and the National Association of Counties (NACo). While complete trend data from these sources were not available in all cases, available information did suggest the range of strategies used. (See app. II.)

We also conducted case studies in selected areas. In this work, our specific objectives were to describe budgetary and fiscal problems in selected jurisdictions, and actions taken by state and local officials in response to those problems. In selecting jurisdictions, we chose states and cities so as to have a set of jurisdictions with contrasting fiscal capacities and budget conditions as well as to include different regions of the country. We developed specific selection criteria using preliminary results from our fiscal capacity models and an index of recessionary impact based on employment data. In addition, to minimize the difficulty in comparing cities operating in different state environments, we chose city pairs within some of the case study states. Having picked those cities, we then selected adjoining counties in some cases to gain insights about county problems.

On the basis of these criteria, we selected five states (California, Colorado, Connecticut, Michigan and Tennessee) and eight cities (Fresno and San Jose; Denver; Hartford and Stamford; Detroit; Memphis and Nashville-Davidson). We did work in the relevant counties in California (Fresno and Santa Clara) and Tennessee (Shelby). In each jurisdiction we interviewed public officials and reviewed documents they provided. (See apps. II and III.)

In our case study work, we did not independently verify the financial data public officials provided us. Similarly, we did not verify Census data used in our budget and fiscal work, although we did do limited checks as appropriate to assess the reasonableness of the data.

Our work included seeking the advice of experts in the field of state and local finance by sponsoring a forum on our proposed areas and methods of investigation. Forum panelists included academic experts, representatives from federal, state, and local government and public interest groups, the chief financial officer of a large city, and a representative of ACIR. We received comments on the contents of this report from our panelists, as well as from officials of the state and local governments we visited, and we incorporated those comments as appropriate.

Legal and Institutional Requirements Affecting the Budgetary Environment

State and local governments have various legal and institutional requirements that can affect budget decisions. Such requirements include legal provisions that prescribe balanced budgets, earmark revenues for specific programs, and limit local tax rates. Many state and local officials believe that these requirements reduce their budgetary discretion. This appendix describes factors that shape the state and local budget environment from a national perspective. It also describes how voter initiatives have shaped the budget environment in two states we visited, California and Colorado.

National Overview of State and Local Budgetary Environment

Most states (Vermont and Wyoming are the exceptions) and all cities and all counties have some form of balanced budget requirement. For example, GAO recently reported that 35 states have a constitutional balanced budget requirement and 13 states have a statutory one.[1] Only a few states have explicit requirements for a year-end balance. However, officials in 39 states told GAO during interviews in 1992 that their budget was required to balance at the end of the budget period, although 11 of them added that their state could carry over a deficit from one budget period to the next if necessary. GAO found that while budget officials in 45 states identified the balanced budget requirement as a motivating factor for balancing their budgets, two other motivating factors—the tradition and expectation of balance and the concern over bond ratings—were cited by the officials almost as often.

Besides these factors, state and local officials face additional requirements in attempting to maintain balanced budgets. Some state requirements included debt limitations, earmarking of large portions of revenue, and limits on expenditures and revenues. According to state budget officials, 21 states have spending limits, 7 have revenue limits, and 3 have both.

Similar requirements exist at the local level. Fifty-two percent of the cities responding to a 1991 U.S. Conference of Mayors' survey reported that their local tax rates were at the maximum allowable amount under state law. Counties also reported having limited taxing authority. For example, in a 1991 survey of 66 large counties conducted by the National Association of counties, 49 reported having a legal limit on the real property tax and 1 in 3 were limited by law from increasing their property tax. Other limits on counties included organized resistance to property taxes and legal restrictions on their ability to impose or raise general sales taxes.

[1]See Balanced Budget Requirements: State Experiences and Implications for the Federal Government (GAO/AFMD-93-58BR, Mar. 26, 1993).

Voter-Imposed Limitations in California and Colorado

In some states and localities, voters have passed initiatives that have helped shape the budget environment. These initiatives often reduce the budget flexibility of state and local officials by limiting government's ability to raise revenues and earmarking revenues for specific programs. Such limitations may make the budgeting process particularly challenging. Voters in two states we visited—California and Colorado—have been actively involved in shaping their respective budget processes.

According to California's fiscal year 1993-94 Governor's Budget Summary, the state is currently suffering from its most severe economic recession since the 1930s. The economy's weakness is causing large revenue shortfalls for the state. Under these circumstances, the budgeting process would be difficult at best. However, currently the state is facing additional limitations imposed over time by voters.[2] Many of these voter initiatives were enacted when the state's economy was strong and not saddled with a $2 billion deficit.

In our visits to states and localities, we found that Colorado voters had also imposed limitations on its state and local governments. The ramifications of these restrictions are unknown, since they were only recently passed. However, state officials expect these restrictions to make the budgeting process more difficult.

Voter Initiatives Limit California's Budget Options

Proposition 13, passed by California voters in 1978, reduced local property taxes by more than 50 percent, changed the rules regarding property taxation, and restricted the revenue-raising capacities of local governments. The proposition limits the ad valorem property tax rates to 1 percent of market value, but permits an additional rate for indebtedness approved by voters before July 1, 1978. It also limits increases in assessed valuations to a maximum of 2 percent a year, except when property is sold, improvements on the property are made, or a change in ownership occurs.

Proposition 13 primarily affected the revenue base of local governments. It limited property taxes, a major source of local governments' general purpose revenues. At the time Proposition 13 was passed, the state had a large surplus, enabling it to provide local governments with the replacement for most of those lost funds. According to a Department of Finance official, the state no longer has the ability to provide these excess

[2]The limitations discussed in this appendix for both California and Colorado are constitutional amendments; thus, they are more difficult to change than, for example, a statute passed by the state legislature.

funds. As a result, local governments can no longer rely on additional revenue from state aid and the constraints of Proposition 13 are having a greater impact.

Another significant voter initiative was Proposition 4, passed in 1979. Proposition 4 placed a limit on the year-to-year growth in tax-supported appropriations of the state and most local governments. However, due to the state's low revenue growth since fiscal year 1990-91 and the 1990 amended changes to the index used in calculating the spending limits, state appropriation levels have fallen well below the Proposition 4 limits.

California voters also passed Proposition 98 in 1988 and amended it in 1990. Proposition 98 requires the state to fund K-14[3] education at a determined minimal level. This funding can be based either on total state general fund revenues or total state and local funding levels. Under Proposition 98, funding for education is determined by a set of complex formulas. Proposition 98 gives the schools the greater of (1) a percentage of the state's general fund tax revenues, about 40 percent, or (2) the prior year state and local tax revenues used to support schools adjusted for changes in enrollment and inflation. Under the original provisions of Proposition 98, K-14 education was always guaranteed a level of funding at least as great as the amount received in the prior year, plus adjustments for enrollment growth and inflation—irrespective of whether there were sufficient general fund revenues available to support this level of funding. However, the 1990 changes provided that in low revenue growth years for the state, a lower cost-of-living is used to calculate the amount guaranteed for education.

In the last 2 fiscal years, the state shifted much of the Proposition 98 funding requirements to local governments. In fiscal year 1992-93, to meet the minimum guaranteed funding levels required by Proposition 98, the state reallocated local property tax revenues from local governments and to schools. The state shifted about $1.3 billion to schools in fiscal year 1992-93 and then shifted an additional $2.6 billion in fiscal year 1993-94. California officials we spoke with viewed these shifts as a return to the allocation that existed before the passage of Proposition 13.

The budgetary challenges created by these voter mandates and a weak state economy culminated in California's fiscal year 1992-93 historic budget crisis. The state did not approve a budget until more than 2 months past the start of its fiscal year. During this time, state general fund

[3]K-14 includes K-12 grades and community colleges.

obligations to its employees, contractors, service providers, and suppliers were paid through "registered warrants." The budget that was ultimately passed contained significant cuts in health and welfare programs, including a 5.8-percent reduction in Aid to Families with Dependent Children (AFDC) benefit grants and a 10-percent reduction in In-Home Supportive Services. The budget did not include any tax increases but rather imposed additional fees on higher education. As a result, resident fees for California State University students increased about 40 percent and University of California students saw a 24-percent increase.

In addition, California voters have also repealed taxes approved by the state legislature. In November 1992, California voters repealed a sales tax on snack foods, further reducing the level of available revenues. General fund revenues from the snack tax for fiscal year 1992-93 were estimated at about $200 million.

Voter Initiatives Limit Colorado's Budget Options

Voters in Colorado passed Amendment 1 in November 1992. The intention of Amendment 1 was to restrain the growth of government by limiting all spending of state and local governments. Under Amendment 1, spending for the next fiscal year cannot increase more than the percent change in population and inflation. It also restricts the legislature's ability to raise tax revenues. Any new tax, tax rate increase, mill levy increase, valuation for assessment rate increase for property class, extension of an expiring tax, or any tax policy change that will result in net revenue gain will require voter approval. A requirement to establish an emergency reserve amounting to at least 3 percent of total spending was also instituted under Amendment 1. Although the state already had a statutorily required reserve for the general fund, the amount required by statute has fluctuated in recent years in order to balance the state's budget. In fiscal year 1992-93 the state lowered the general fund's statutory reserve amount from 4 percent to 3 percent, saving about $28 million. Now the reserve amount will be required on total spending, not just the general fund.

In recent years, state officials have struggled to balance the budget and they fear that Amendment 1 could compound earlier budget difficulties, despite an improving economy. These budget difficulties were due, in part, to increased costs in Medicaid, K-12 education, and corrections. In response to these rising costs, the state has delayed loan payments, lowered the state's required reserve, imposed a hiring freeze, imposed across-the-board program cuts of 1 to 2 percent, and eliminated the double deduction for state income tax. While state and local officials anticipate

additional burdens from Amendment 1, the ultimate ramifications of the new amendment are unknown.

Colorado voters also passed Amendment 8 in November 1992, which may reduce the legislature's flexibility in balancing the budget. The amendment requires that all funds from state lottery proceeds previously designated for the Capital Construction Fund be designated to the Great Outdoors Colorado Trust Fund, which allocates funding to state parks and wildlife. However, before the trust fund receives any revenue, existing capital construction obligations will be met. If these obligations are met, any remaining funds will go into the trust fund. Before Amendment 8, the Capital Construction Fund had two funding sources: (1) statutory transfer from the general fund and (2) lottery funds. The amendment went into effect on April 1, 1993.

Lottery proceeds for fiscal year 1992-93 used for funding capital construction were estimated to be $43 million. The Assistant Director of the Office of State Planning and Budgeting stated that he was unsure how losing this revenue will affect capital spending. However, they are afraid it may severely limit any new construction or maintenance. According to Colorado's fiscal year 1993-94 budget, needs for deferred maintenance and other types of capital construction total over $500 million for the next 5 years.

Illustrations of Budget Actions at the Local Level

This appendix presents detailed illustrations of how large cities and counties have responded to recent changes in budgetary and fiscal conditions. Media reports have portrayed how many jurisdictions have instituted budget actions to deal with changing conditions—including tax increases and program cuts. Here, we focus primarily on pairs of localities in California, Connecticut, and Tennessee—each pair demonstrating contrasting fiscal and budgetary conditions. We chose to compare localities within the same state so that we could control for differences between states regarding their policies and relationships toward localities. In selecting localities, we also considered geography, size, and patterns in the area's employment level.

In addition to our focus on the within-state pairs of localities, we also discuss various aspects and effects of changing budgetary and fiscal conditions for Detroit, Michigan. This illustration follows up on previous GAO work on Michigan communities (see Michigan Communities: Services Cut in Response to Fiscal Distress, GAO/HRD-92-142, Sept. 29, 1992).

California Counties

We focus on two large counties in California: Fresno and Santa Clara. Fresno County, located in central California, is an agriculturally based county with relatively weak fiscal capacity and moderate budgetary conditions. By contrast, Santa Clara County, a northern California locality, has relatively strong fiscal capacity and weak budgetary condition.

Fresno County

Fresno County is the nation's number one agricultural county[1] and is home to large numbers of migrant farm workers and refugees with backgrounds in farming. According to 1990 Census data, Fresno County had more overcrowded housing, a lower median family income, lower per capita income, a higher poverty rate, and a higher civilian unemployment rate than the state. In 1990, over 21 percent of the county's population was living in poverty compared to over 12 percent for the state. In fiscal year 1991-92, approximately 16 percent of the county's population were AFDC recipients, as compared to the state's average of slightly more than 7 percent. In addition, the county's rate of unemployment in 1991 was almost 12.6 percent, compared to the state's 7.5 percent. County budget officials believe the area has a growing population of welfare grants recipients due to its low cost-of-living as compared with that of other California counties.

[1]Fresno County is the nation's number one farm community as determined by gross crop value. In 1991, Fresno County's gross crop value exceeded $2.9 billion.

In the 1980s, Fresno's economy grew, but not as rapidly as the rest of the state's. Real personal income in Fresno County grew by 55 percent[2] from 1980 to 1990, while the state's grew over 78 percent. However, from 1980 to 1990, the county's population increased more rapidly than the state's, with a growth rate of almost 30 percent, or 4 percent above the state's average growth rate. The county's refugee population, comprised mostly of Southeast Asian refugees, accounted for a large percentage of the growth. From 1980 to 1990, the refugee population increased almost 3,000 percent from 1,244 to 37,540. According to county budget officials, more than 50 percent of Fresno County's recipients of AFDC Unemployed[3] cash grants in fiscal year 1992-93 were Southeast Asian refugees.

Service Needs Are Exceeding the County's Financial Capacity

According to the county Administrator's fiscal year 1992-93 budget letter, the county's service demands are exceeding its capacity to address them. Services and supplies have been held constant or have been reduced, and many capital projects have been deferred. According to county officials, discretionary revenue growth has declined. Property tax revenues grew on average about 8 percent per year in the 1980s but slowed in the 1990s to about 4 to 5 percent.

Demand for county services has increased dramatically over the past 10 years. For example, juvenile arrests climbed almost 55 percent from 1982 to 1991, while motor vehicle thefts increased over 300 percent. AFDC caseloads grew almost 150 percent from fiscal year 1980-81 to fiscal year 1991-92, and Medi-Cal users increased over 75 percent. The county's public assistance (social services) budget has increased as a percentage of the total budget, climbing from almost 44 percent in fiscal year 1981-82 to 52 percent in fiscal year 1991-92. Growth in AFDC caseloads has contributed to this growth.

The county is highly dependent upon intergovernmental aid, which accounted for more than 68 percent of the county's total revenues in fiscal year 1991-92, and was its single largest revenue source. However, according to a county administrative analyst, intergovernmental revenue is mostly dedicated to specific health and welfare programs and not available for other county priorities. Moreover, the county is responsible

[2]Fresno County's per capita personal income grew from $10,544 in 1980 to $16,365 in 1990. These are nominal figures and not adjusted for inflation.

[3]AFDC recipients can be separated into two groups based on the federal definition of deprivation. AFDC Unemployed cases are two-parent families. AFDC Family Group cases are single-parent families.

for some of the cost of administering these federal and state programs. As a result, the county's general purpose revenues are being squeezed by the combined pressures of state and federal mandates concerning health and welfare due to the county's growing dependent population. According to county budget officials, the county has fewer dollars for remaining program areas, such as law enforcement and judicial services. Property taxes represent the second largest source of revenues, accounting for more than 12 percent of the county's total revenues in fiscal year 1991-92. However, since 1978, growth in property tax rates has been severely constrained by Proposition 13.[4]

In addition, the state's current financial crisis has placed additional pressures on the county's budget. In fiscal year 1992-93, the state adjusted the formula for the allocation of local property tax revenues, decreasing the county's share and increasing the share allotted to school districts. The loss in property tax revenues for the county in 1992-93 was $6.3 million. Other county revenues were also shifted to the state. In fiscal year 1992-93, the state's budgetary actions resulted in an estimated general fund revenue loss of $23.5 million, of which $12 million was due to a reduction of state welfare aid payments. In fiscal year 1993-94 the state again adjusted the formula for property tax revenues, resulting in a loss to the county of $40.5 million. This loss, however, was offset in part by additional state sales tax revenues and relief from some state-mandated requirements.

County Services Levels Have Been Affected

In recent years the county has taken many actions to manage its budgetary problems. For example, the county used its general fund balance to balance its budgets. As a result, the county's general fund balance has fluctuated over the past 10 years, with a high of over $26 million in fiscal year 1982-83 and a low of $2.5 million in fiscal year 1992-93. In addition, the county reduced transfers out of the general fund to other funds, eliminated vacant positions, laid off employees, reduced funding for library materials, services, and maintenance, and postponed numerous and necessary infrastructure repairs and improvements.

During fiscal year 1992-93, programs significantly affected by budget cuts included law enforcement and judicial services, and public assistance. For example, the opening of the new county jail was delayed even though the facility is complete and ready to occupy, and the Sheriff's Department lost 22 positions (4 vacant and 18 full-time extra help positions). According to

[4]Proposition 13, enacted in 1978, changed the rules regarding property taxation and restricted the revenue-raising capacities of local governments. See appendix II.

a county principal administrative analyst, due to overcrowded conditions in juvenile detention facilities, the average stay for a juvenile delinquent is only 28 days even though an average stay of 90 to 120 days is required to impact behavior. Juvenile auto theft offenders are also only being cited rather than detained. In addition, despite a rise in AFDC caseloads, Fresno County was unable to provide additional staff to administer the programs.

Santa Clara County

Santa Clara County, home to the Silicon Valley, is one of the wealthiest urban areas in the country. It was ranked third in the nation in the percentage of households with incomes of $50,000 or more. According to 1990 Census data, Santa Clara County had a higher per capita income, higher median family income, and a lower civilian unemployment rate than the state. With the growth in the Silicon Valley during the 1980s, the county sustained large economic growth. This resulted in increased property tax revenues for the county during this period, with the county's level of property tax revenues increased an extraordinary 10 to 14 percent a year.

In the 1990s, however, economic growth slowed. The county's property tax growth rate diminished, and this significantly affected the county's revenues. At the same time, the county's expenditures were increasing. The county's demand for entitlement programs such as AFDC, Food Stamps, and general assistance has increased in the 1990s. According to Santa Clara's fiscal year 1992-93 Budget Message, approximately 50 percent of the county's economy can be tied to defense spending, and with the cuts in federal spending the county may be facing tougher economic times.

From 1980 to 1990, the county's population grew by almost 16 percent, while unemployment decreased from 5.1 percent to 4.0 percent for this same time period. However, unemployment increased to 6.7 percent by 1992 as the state experienced the effects of a significant recession. Although the poverty rate for the county rose slightly from 7.1 percent in 1980 to 7.5 percent in 1990, it was still far below the state average of 12.5 percent for 1990.

Recession Contributing to County's Budget Problems

During the 1980s, growth in Santa Clara's expenditures was primarily due to increased costs for employee salaries and benefits. As assessed property values grew from 1980 to 1990, the county realized more property taxes, and the county was able to fund the increased expenditures from

the extraordinary growth in property taxes. In fact, the assessed value increased by over 1,000 percent from $7,819.3[5] million in 1980 to $91,316.7 million in 1990.

According to budget documents, Santa Clara's expenditures are continuing to increase in the 1990s due to the cost of employee benefits, primarily health benefits. At the same time, the county will not have the benefit of an increasing property tax growth rate. In addition, expenditure needs are increasing to meet increased demand for services or added mandates. The county was unable to fund additional staff to meet these new demands in fiscal year 1992-93.

According to the county's Budget Director, county budget problems have coincided with the state's budget problems. The state's actions in balancing its budgets over the last few years have placed increased pressure on the county's budget. For example, in an attempt to alleviate the state's budgetary problems in fiscal year 1992-93, the state adjusted the formula for the allocation of property tax revenues by decreasing the counties' share and increasing the share allotted to school and community college districts. Over $19 million was allocated away from the county and given to school and community college districts. In fiscal year 1993-94 the state reallocated an additional $103 million for the same purpose, although some of the property tax revenue losses were offset in part by additional sales tax revenues and relief from some state-mandated requirements.

The current recession is also impacting the county's budget through reductions in the level of property tax growth. Property tax revenues, a major source of the county's unallocated revenues, have undergone a permanent shift downward in growth rates. In fiscal year 1992-93, unallocated revenues, such as property taxes, were expected to grow by only 1.7 percent, while dedicated revenues, such as state and federal aid, were expected to grow by 11 percent. Most of the increases in state and federal aid can be attributed to increased caseloads in health and social service programs. However, county programs dependent upon unallocated revenues, such as infrastructure investments, could be severely impacted in the future.

While the county's general fund balance grew steadily from fiscal year 1987-88 through fiscal year 1989-90, it dropped almost $14 million in fiscal year 1990-91 from $36.4 million to $22.6 million. A large portion of this county's general fund balance is the contingency reserve allocation.

[5]These are nominal figures and are not adjusted for inflation.

According to the county's Budget Director, the contingency reserve is not used to balance the county's annual budget at the time of enactment. These reserves are used to cover emergencies or other expenditures not anticipated in the annual budget. Since fiscal year 1986-87, the county has maintained a contingency reserve of at least $12 million although, as a percentage of general fund revenues, the reserve has fallen from 2.0 percent in fiscal year 1986-87 to only 1.4 percent in fiscal year 1990-91.

County Services Are Starting to Be Affected

Since fiscal year 1990-91, Santa Clara County has experienced budget gaps during the development of its annual budget. These gaps have ranged from $21 million to $66 million. According to the Budget Director, before fiscal year 1992-93, the county had not been forced to cut any major programs or significantly reduce county services. Before fiscal year 1992-93, we were told, the county's budget was balanced with a number of actions. These included reducing the subsidy to the county's medical center, using one-time additional funds from the Public Employees Retirement System,[6] eliminating positions,[7] increasing revenues through fees, and reassigning functions to lower paid employees. In fiscal year 1992-93, however, the county faced a budget deficit of $66.3 million, of which $25.3 million resulted from state actions. To close the gap, the county eliminated 332 positions, terminated contracts with service providers, and increased fees and other revenue sources. The county also closed an acute psychiatric care facility and a rehabilitation facility for juveniles. According to the Budget Director, the elimination of positions will affect the level of services provided by the county in the future.

Connecticut Cities

We present illustrations for Stamford and Hartford, two of the largest cities in Connecticut. Stamford is fiscally weaker than Hartford, but the two cities are similar in their overall budgetary condition.

Hartford

For its size, Hartford has long been viewed as one of the poorest cities in the country. From the mid- to late 1980s a statewide economic boom driven by real estate speculation, the insurance industry, the defense industry, and the national economy masked some of Hartford's fiscal difficulties. During that time, the state was allocating large amounts of

[6]These funds were the result of a $40 million windfall the county recorded due to an accounting change by the state in the way assets were valued.

[7]These positions included vacant positions as well as positions that were vacated by employees who were offered other positions. The county did not lay off any employees.

state aid to the cities while Hartford was experiencing substantial annual growth in the tax base and had collection rates of 97 percent.

During the latter part of the boom, indicators of structural difficulties with Hartford's tax base became evident as revenues decreased and the service needs increased. From 1988 to 1992 the property tax collection rate dropped from 97 percent to 92 percent. Also, the percentage of the population on public assistance grew from 30 percent in 1987 to 39 percent in 1992. Additionally, Hartford experienced unemployment rates higher than the state's. Hartford's unemployment rate increased from a low of 5.8 percent in 1988 to a high of 10.5 percent in 1991 while Connecticut's increased from only 3 percent to 6.7 percent during the same period. According to the city manager, the growth in service needs since 1988—especially general assistance, AFDC, and subsidized housing—have put stress on the social service delivery system. Even though Hartford accounted for only 4.2 percent of Connecticut's population in 1990, the city accounted for 30 percent of the state's general assistance cases. Hartford's general assistance caseload increased from 3,300 in fiscal year 1991 to 10,000 by fiscal year 1993. According to the director of Connecticut's general assistance program, general assistance enrollment closely tracks the state's unemployment rate. Moreover, the composition of general assistance recipients is changing. According to Hartford's director of social services, 70 percent of Hartford recipients in the past did not have a high school diploma or equivalent, but now 60 percent are high school graduates and 36 percent have some college education.

Intergovernmental Revenue Has Increased, Resulting in Decreased Flexibility

Intergovernmental revenue played a large role in stabilizing Hartford's operating revenue, accounting for 45 percent of general fund net operating revenues in fiscal year 1992. From fiscal year 1987 to fiscal year 1992, real per capita operating revenue rose by 29.6 percent. During the same period, intergovernmental revenues rose by 60 percent, while own-source revenue grew by 17.4 percent from fiscal year 1987 to fiscal year 1991 and then dropped 4.6 percent in fiscal year 1992.

Most of the increase in intergovernmental aid came from the state. From fiscal 1982 to fiscal year 1992, federal aid to Hartford decreased by almost 50 percent, dropping from $25.5 million to $13.0 million. However, the majority of the intergovernmental revenue is earmarked to support programs mandated by the state, such as educational grants and general assistance.

Unlike intergovernmental revenue, taxes and charges for services decreased the most relative to total general fund revenue from fiscal year 1987 to fiscal year 1992. Taxes as a percentage of total general fund revenue declined 5 points, the largest decline of all revenue sources, and charges for services decreased 1.1 points relative to total revenue. Additionally, Hartford's designated general fund balance fell both in nominal terms and as a percentage of general fund revenue, from $5.6 million (or 1.7 percent of GFR) in 1989 to $1 million (or 0.2 percent of GFR) in 1992.

Between fiscal years 1987 and 1992 human services expenditures had the largest increase relative to general fund expenditures (GFE), which is an indicator of the city's increasing needs. Public safety expenditures decreased the most relative to GFE between 1987 and 1992.

Expenditure Reductions Dominate Hartford's Budget Actions

Efforts to raise revenue to cope with the budgetary stress have legal and practical limits in Hartford. Connecticut law prohibits cities from imposing new taxes, such as a commuter tax. Hartford's tax base is eroding, and the taxpayers remaining are overburdened relative to surrounding cities. Hartford's business property tax is more than three times higher than an adjoining city. According to the city manager, when Hartford raised the millage rate in the late 1980s, many corporations left the city. He added that 80 percent of the businesses leaving the city between 1989 and 1992 moved to the suburbs. In an attempt to put more land and buildings to use, Hartford is going to aggressively pursue tax foreclosures. According to an assistant city manager, however, the plan could backfire if the city is not able to unload the foreclosed properties.

The city has taken a variety of actions designed to reduce expenditures, ranging from staffing changes to capital outlay reductions. The fiscal 1993 budget is 1 percent less in nominal terms than the fiscal 1992 budget. Some examples follow.

Municipal full-time equivalent work years were reduced by 7.66 percent from 1988 to 1992. However, during the same period, Board of Education work years increased 6 percent. The Planning Department staff decreased from 38 in 1980 to 15 in 1993. Because of the decline, the Planning Department is unable to develop its own demographic data on the neighborhoods, relying instead on Census data. However, according to the director, the Department had not as of January 1993 received the 1990 Census data, which the official believed was already outdated. The

Department of Public Health has had layoffs each of the last 3 years. Department officials stated that in public health it is difficult to move people to other positions even though they may have the same general job classification because each program requires specific, often nontransferable, skills. However, union contracts require layoffs to be based on seniority, which forces officials to place people in programs for which they may not be trained. The Sanitation Department also has suffered staffing cutbacks. According to the Director, Sanitation had 140 people on staff 7 years ago; today the staff level is down to 69. During the same period, Sanitation's workload increased when the state-mandated recycling efforts began. One director noted that as a result of the layoffs the Department's work force has become older. As a result, they have a higher percentage of sick time and annual leave than before.

Actions to prevent layoffs have been taken, but with unclear long-term results. The fiscal year 1992 budget shifted $800,000 from police overtime to departments slated for layoffs. According to an assistant city manager, this action only deferred eventually having to address the size of city government. Similarly, a departmental director noted how the city has a tendency to cut capital acquisition before cutting labor. The director added that the practice may be costlier overall due to increased maintenance costs of the older equipment and the decreased productivity of workers using older equipment.

Infrastructure maintenance expenditures have decreased over the past 5 years in both real and nominal dollars. In 1987, the city spent $23 million on infrastructure. This dropped to a low of $12.1 million (current dollars) in 1991 and increased to $16.6 million by 1992. Since 1988 capital outlay as a percentage of net operating expenditures has decreased from 1.45 percent to 0.7 percent.

During the 1980s Hartford undertook a major residential street repaving program. According to city officials, to get the maximum life from the project, Hartford should be spending $2 million annually on maintenance but is spending only $500,000, and the newly repaved streets are falling into disrepair. In the past, Hartford spent $1.3 million annually on the city's fleet of vehicles; in fiscal year 1993 no funds were appropriated for the fleet. Though it is difficult to document, there has been a substantial decrease in the maintenance of its aging school building stock, according to an official. The neglect of the physical aspect of the schools has an impact beyond the condition of the building. The official noted that there

tends to be lower morale among staff and more misbehavior among children in neglected buildings.

Other Budget Actions

- Hartford has a city action plan to address child mortality. The Department of Public Health is working with private foundations and coordinating with other agencies to affect child health. Officials stated that their efforts appear to be working but infant mortality remains high, teenage pregnancy rates are increasing, and mothers are becoming younger.
- In fiscal 1993 Hartford Public Schools were undertaking a salary give-back, wherein the teachers agree to a reduction in salary one year to have it paid back to them in a forthcoming year. Next year the school system will have to pay back the salaries that were foregone in the previous years.
- The Sanitation Department has reduced the rate of garbage pickup from weekly to every other week. Additionally, bulky waste, which was picked up the same day as regular garbage, is now collected on an appointment basis only. Sometimes the bulky waste may be left for weeks before it is collected.
- Hartford is considering consolidating service delivery with adjoining cities. According to city officials, however, other cities may not want to support Hartford's burden.

Stamford

While Hartford is among the poorest cities in the county, Stamford is among the wealthiest. In 1991, the median disposable income in Stamford was $42,933, far above the $36,961 median for Connecticut and $27,912 for the nation as a whole. In the late 1970s and continuing through the mid- to late 1980s, Stamford experienced an economic boom as corporations moved from New York City, and the city's daytime population increased from 104,000 to 300,000. From fiscal 1986 to fiscal 1989 Stamford's list of taxable property grew annually by an average of 4.8 percent and collection rates averaged 97.5 percent.

Since 1989, however, the economy's growth has stagnated. As Stamford's overinflated business property values declined, the city experienced both a decreasing revenue base and increasing service needs and costs. From fiscal 1990 to fiscal 1992 the list of taxable property averaged only 2.2 percent annual growth and actually decreased by 0.3 percent in fiscal 1993. In addition, collection rates averaged only 95.7 percent from fiscal 1990 to 1992. Likewise, Stamford's unemployment rate has been increasing, though it has remained lower than the state average, from 2.4 percent in 1988 to 6.5 percent in June of 1992. During the same period,

Connecticut's unemployment rate increased from 3 percent to 7.3 percent. Stamford is a diverse city, with over 50 percent minorities and 10 percent immigrants in the public school system, according to school officials. The cost of living—especially housing—is high in Stamford, and this creates an ongoing demand for services, especially public housing.

Stamford's composition of rich and poor residents creates conflicting demands for city services. Many of the wealthier residents expect a high level of public services. For example, in fiscal 1991 when the city attempted to reduce expenditures by changing twice-a-week backyard garbage collection to weekly curbside collection, the city received so many complaints that it did not change the service. Likewise, when the city attempted to eliminate bulk leaf collection in favor of bagged collection, it received so many complaints that it opted to keep the bulk collection. According to an official, bulk leaf collection costs 3 to 4 times as much as bagged leaf collection and requires 6 weeks to complete rather than 15 days for bagged collection. However, both the slow economic times and changing demographics have worked to place a high demand on Stamford's social services. For example, according to a departmental director, the general assistance caseloads have risen from 400 to 1,100 in the last 10 years; the population over 75 years of age has increased significantly; and the number of hard-core drug users has increased. According to the official, this trend is compounded by people with high service needs moving to Stamford to benefit from its services.

As Stamford's Tax Base Stagnated, So Did Its Intergovernmental Revenue

Unlike Hartford, Stamford experienced a relative decline in intergovernmental aid, its second largest source of revenue during its time of flat revenues and increasing needs. Intergovernmental revenue grew 15.4 percent in nominal dollars from fiscal years 1987 to 1992, compared to 35.4 percent growth in total general fund revenue for the same period. Intergovernmental revenue decreased from 10.6 percent of general fund revenue in 1987 to 9.1 percent in 1992—the largest percentage point decline among all revenue sources. Stamford's largest source of revenue—taxes—accounted for the largest percentage point gain of 3.1 percentage points relative to total general fund revenue. In contrast, Hartford experienced a relative decrease between fiscal 1987 and fiscal 1992. Similar to Hartford, Stamford's third largest source of revenue—licenses, fees, and other—decreased relative to total revenue by 0.9 percent between 1987 and 1992.

As in Hartford, Stamford's general fund balance not only decreased as a percentage of total general fund revenue each year but has also decreased in nominal terms. In 1988, the general fund balance was $12.9 million, or 6 percent of total general fund revenue; by 1992 it had dropped to $3.5 million, or 1.3 of total general fund revenue.

Budget Actions Have Not Cut Into Direct Services

The city has taken a range of actions attempting to keep expenditures down, as illustrated in the following examples. Departmental directors and other officials noted that the budget decisions they faced were not as difficult as those faced by their counterparts in more distressed cities.

From fiscal years 1988 to 1992 Stamford's general government work force decreased by 12.5 percent. For example, the police department went from 317 officers in 1990 to 280 by 1991. In April 1992, the 12-person police recruiting class was laid off on graduation day. The Fair Rent Commission recently went from two employees to none even though its function is required by the city charter. Beginning in 1988 the Human Rights unit was cut from four to one and one-half while its case load was increasing due to complaints regarding discriminatory layoffs. In the last 3 years, the Department has lost 88.5 positions in public works. Thirty-eight percent of the citywide layoffs have come from the public works department. However, according to a deputy director, the city has not eliminated any services since the layoffs. The Stamford Community Development Program's staff decreased from 30 in 1982 to 5 in 1992.

The city is also making cuts in capital spending. During the last 2 years, the police department has requested $350,000 and $400,000 for new cars. It received an average of $25,000 each year, the cost of one car. Cruisers were replaced at 50,000 miles; now police cars are in use more than 100,000 miles. Most of the fleet is out of warranty, which increases the cost of maintenance. Other city actions included scrapping plans to build a new senior citizen center in favor of renovating existing space; budgeting a 25-year street life rather than 15; and using asphalt to maintain sidewalks rather than more costly, but longer-lasting, concrete.

Tennessee Cities

In what follows, we highlight two of the largest municipalities in Tennessee: Nashville-Davidson and Memphis. Nashville-Davidson, a metropolitan form of government, has relatively strong fiscal capacity and moderate budgetary condition. Memphis is fiscally weaker, but is similar to Nashville-Davidson in budgetary condition.

Memphis

The city of Memphis, located in Shelby County, is situated in the extreme southwest corner of Tennessee bordered by Arkansas to the west and Mississippi to the south, a location that places it in direct economic competition with those states. Memphis provides a basic set of services, such as public safety, public works, and education. Community Services (AFDC, the Special Supplemental Food Program for Women, Infants, and Children, Head Start, the public defenders program, affordable housing programs, etc.) and Public Health are jointly funded by Memphis and Shelby County but primarily administered by Shelby County.

Historically, Memphis has had a weaker tax base than Nashville. Its geographically central location in the United States places Memphis in a strong position in the warehousing, distribution, and agribusiness sectors of the economy, but these are historically low paying sectors that require large amounts of physical space. The Memphis economy has diversified, however, into the health and medical, manufacturing, and communication fields. Between 1987 and 1990 its unemployment rate declined each year from 5.7 percent to 4.6 percent. The rate increased to 5.7 percent in 1992 and to 6.3 percent during the first quarter of 1992. Nevertheless, with 160,000 persons in Memphis at or below the poverty line, including 60 percent of the African-American community, the city can be characterized as younger and poorer than Nashville.

According to a government official, due to its social service delivery system and health and medical infrastructure, Memphis attracts the poor and others with high service needs from the surrounding rural areas, including Mississippi and Arkansas. This puts an extra burden on Memphis' social service system. Additionally, officials told us that due to a lower unemployment rate than surrounding areas, Memphis is an attraction for the unemployed within the region.

While service needs in Memphis have increased, the tax base has weakened. Both the property tax base and sales tax base were weakened as the residential population decreased 5.5 percent from 1980 to 1990. Between fiscal 1987 and fiscal 1992, property tax revenue decreased in nominal terms by 4.6 percent. During that same period property tax slipped from the largest source of revenue to second behind sales tax revenue. Even though Memphis' daytime population increased during the 1980s from an influx of non-resident workers, Tennessee law prohibits the imposition of an income tax. Memphis thus does not have a direct means to tax commuting non-resident workers. In addition, Memphis is vulnerable to "tax-leakage" because nonresident workers, as well as

mobile residents, can avoid much of the high city sales tax by purchasing goods across the border in Mississippi.

General Fund Expenditures Have Been Outpacing General Fund Revenues

In each fiscal year from 1987 to 1992, Memphis' general fund expenditures exceeded revenues.[8] During the same period expenditures grew by 18.3 percent while revenues grew by 14.5 percent. Expenditures for police, the largest single expenditure, were also the fastest growing. Police expenditures grew 3.4 percentage points relative to total expenditures between fiscal years 1987 and 1992 while public works and sanitation expenditures decreased by a combined 2.3 percentage points. From fiscal 1988 to 1992 the total general fund balance decreased from $35.0 million in fiscal 1988 (13.8 percent of general fund expenditures) to $30.8 million in fiscal 1992 (10.4 percent of total general fund expenditures). During the same period, service needs in the city were also increasing. According to a local government official, AFDC expenditures in the county increased from $28 million to $76 million from 1986 to 1992.

Further compounding budgetary stress were factors that increased the cost of providing service in an aging inner city. According to top city officials, the older buildings of the school system exemplify this problem. Aside from what they believe are demotivational aspects, older school buildings are costly to operate and maintain. Asbestos removal currently costs Memphis schools $5 million per year and the project is not near completion. Also, complying with fire and earthquake codes is more difficult and costly in older buildings. According to a deputy superintendent of the school system, the Americans with Disabilities Act will compound these difficulties, affecting older areas like Memphis much more than newer school districts. An official noted that older systems such as Memphis are likely to include more building maintenance costs than newer systems, which are able to commit a greater share of expenditures on direct services and supplies.

Memphis Has Taken an Array of Budgetary Actions

In response to the budgetary stress and due to the fiscally conservative philosophy of the city government, Memphis took an array of actions to both increase revenue and decrease expenditures during the early 1990s.

On the revenue side, the city used general fund reserves to finance current services. Memphis' use of its reserves over the past 5 fiscal years has reduced the general fund reserve balance as a percentage of general fund

[8]Last year of available data.

expenditures, falling steadily from 13.1 percent in fiscal year 1988 to 10.4 percent in fiscal year 1992. To bolster the fund balance and avoid layoffs, Memphis raised its property tax rate for fiscal years 1993 and 1994. In fiscal 1991, the city increased the city service fee for garbage collection. In addition, the city started charging for parking at the local stadium/fairground and imposed a rental fee for its use.

Memphis' proximity to Mississippi and Arkansas constrains its ability to raise taxes. Tennessee's state and local sales tax is one of the nation's highest, and currently it induces so-called "tax leakage" to Mississippi. This occurs when Memphis residents cross the state border to purchase items at a lesser sales tax rate.

On the expenditure side, Memphis has not cut or eliminated any services during the recent recession. Because of its fiscally conservative philosophy, Memphis historically has only offered services it could afford. Because 80 percent of general fund expenditures are for personnel, the city's main cost-cutting action is the hiring freeze, which it has been under for the last 3 years. Memphis also had layoffs in 1981 and 1982, losing 300 positions. However, according to top city officials, Memphis is experiencing a service gap in the areas of police protection, recreation facilities, solid waste disposal, and low- and moderate-income housing.

Memphis has also deferred capital projects as a cost-cutting action. In fiscal 1992 all capital procurement was deferred for the year. The school system's infrastructure, which is aging, has been one of the main areas for cost cutting from deferred maintenance. As a result, according to a city official, building complaints are more frequent and more serious in nature. The school system planned to air condition each of the district's school buildings but halted the project due to resource constraints with one-third of the buildings completed.

Nashville-Davidson

The city of Nashville and county of Davidson have operated as the consolidated Metropolitan Government of Nashville and Davidson County (Metro Government) since 1963, performing all of the functions of city and county governments. Metro Government divides Nashville-Davidson into two service districts, the General Service District (GSD) and the Urban Service District (USD). The GSD is synonymous with Davidson County, while the USD includes the city of Nashville plus some other areas. The USD has a higher property tax rate than the GSD but receives supplementary public safety and public works services in addition to the GSD service

package it receives. Each service district has its own general fund and debt service fund; both districts operate under the same school fund and school debt service fund. These six budgetary funds comprise the majority of Metro Government's expenditures.

The Nashville-Davidson economy is both stable and diverse. The economy is anchored by such sectors as government, higher education, tourism, auto manufacturing, printing and publishing, health and medical, and banking. Because of Nashville's economic diversity, the latest recession has not affected it as much as other cities, such as Memphis. The Nashville metropolitan statistical area's (MSA) unemployment rate has been lower than the state's and nation's for every month from 1972 to June 1992. In 1980 Davidson County's unemployment rate measured 4.9 percent while Tennessee's was 7.2 percent and the rate for the nation as a whole was 7.1 percent. Davidson's unemployment rate dropped to 4.3 percent by 1986, while Tennessee's was at 8 percent and the United States[9] was at 7 percent. By July 1992 Davidson's rate increased to 4.9 percent. In 1990, Davidson County had the second highest per capita income in the state.

Nashville-Davidson's Economy and Budget Has Been Affected by the National Economy

Despite its stable economy, however, Nashville-Davidson is not without budgetary stress. Expenditure demands, according to city officials, have increased in recent years as the area experienced an increasing non-English speaking population, an aging population, and an increase in the number of homeless. During the same period, revenue growth began to slow. In fiscal year 1989 revenue grew by 13.3 percent over the previous year but only by 5.6 percent, 4.0, and 4.7 percent over the next 3 fiscal years, respectively. In fiscal years 1990 and 1992, the budget was cut $2 million and $1.3 million, respectively, from the previous year.

Metro Government's primary source of revenue is taxes, which in fiscal year 1991 accounted for 60 percent of total general fund revenue. Ranking second is intergovernmental revenue which accounted for 17.5 percent of the general fund revenue. However, relative to total revenue composition, intergovernmental revenue, increased by 2.4 percentage points from fiscal year 1987 to fiscal year 1991, while taxes increased by 2.1 percentage points. During the same period revenue from licenses and permits, the third largest source accounting for 12.3 percent of revenue, experienced a decrease of 3.3 percentage points.

[9]Includes revenue from state, federal money passed through the state, direct federal funds, and funds from other governments.

Tennessee and its cities cannot impose a broad-based income tax but must rely instead on the sales and property tax. The current state sales tax rate of 6 percent combined with the 2.25 percent local option sales tax is among the highest in the country. The high sales tax induces sales leakage into bordering states. However, because Nashville-Davidson, unlike Memphis, is located in the middle of the state, some of the tax leakage is mitigated.

Nashville-Davidson Has Taken an Array of Budgetary Actions in Recent Years

Despite the relatively healthy economic climate, Metro Government has had to cope with the stress of the most recent recession, due mostly to slow revenue growth related to the recent recession. Between fiscal years 1987 and 1989, the final budget grew by an annual average of 12.4 percent. From fiscal 1989 to fiscal 1992 the budget grew by an annual average of only .8 percent, actually decreasing in nominal terms in fiscal 1990 and 1992. In response to the budget stress created by the economic downturn, Metro Government has had to take an array of actions to both increase revenue and decrease expenditures.

To enhance revenue, Metro Government has taken the following revenue actions since fiscal year 1989: raised the property tax, transferred sales tax revenue from school debt service to school operations, raised motor vehicle taxes, and transferred property tax revenue from the general fund to school operations. Metro Government has also raised the ceiling for applying the sales tax from $1,100 per single article of tangible personal property to the state maximum of $1,600. In addition, Metro Government has increased its use of fees and charges to include ambulance fees, court costs, and library and recreation fees. It has also begun assessing more fees for public works services.

Before 1989 the budget reserve fund was used to help support current service. In fiscal 1987 the combined GSD plus USD fund balance was $31 million, or 10.9 percent of the combined general fund budget, but this dropped to $7.1 million by fiscal year 1989, or 2.0 percent of the combined general fund budget. Since then Metro Government has had a policy of holding budget reserves to at least 5 percent of operating expenditures. The combined budget reserve was $44.8 million or 11.2 percent of combined expenditures.

Metro Government has also taken a series of expenditure-reducing actions to keep its budget balanced. These actions include the following:

- A hiring and wage freeze. To avoid budget shortfalls, Metro Government had layoffs in fiscal year 1989. For the 2 previous years, the city had been under a hiring freeze. Since 1989 departments have been able to replace workers but not add to the roster unless authorized under the budget. Also, for the 4 years prior to fiscal year 1994 Metro Government employees had been under a wage freeze, receiving step increases only. However, in fiscal year 1994, Metro employees received an across-the-board 5-percent salary increase.
- Privatizing some services or functions. Many departments have opted to privatize some functions: the county jail is managed by a private firm; the health center has eliminated one of its labs by using private contractors; and the housing authority contracts out more of its painting duties than previously. However, some of the savings realized through privatization are a result of reduced service levels, such as cutting semi-weekly garbage collection to weekly pickup with a private firm.
- Deferring capital projects. Aside from cutting back on direct services, Metro Government also has delayed some capital projects. The rate of road repaving went from 200 miles per year to 100 miles per year. All major capital improvements in the school system have been deferred since the late 1980s when the last bonds for capital improvement were issued. School building roofing has deteriorated since then, with leaks becoming more common.
- Reducing nonmandated services. Since much of the intergovernmental funds Metro Government receives are categorical, discretionary programs, according to some departmental directors, are likely to be the first ones cut during times of budgetary stress. For example, the composition of the Health Center's budget has changed since 1987 when 58 percent of the funding came from the Metro Government and 42 percent from outside sources. Today, only 35 percent of the budget is from Metro Government and 65 percent from outside sources. Due to this change, the Health Center has reduced or cut nonmandated school health programs and reduced or cut back the home health care program. Also, in the late 1980s the school district eliminated three discretionary programs. School officials believe that the programs eliminated require long-term assistance to be effective and that all positive momentum gained by the programs was lost as soon as they were eliminated. These programs were reinstated in school year 1992-93 with funds from the state's 1/2-percent sales tax increase.

Detroit, Michigan

Over the past 40 years, Detroit has experienced a steady loss of residents and businesses. Since 1950, when Detroit's population peaked at over

1.8 million, the city has lost over 800,000 people. According to the 1990 census, Detroit's population is 1,027,974—175,365 fewer than in 1980. From 1972 to 1987, the number of business establishments in the city declined by nearly half.

Not only do these losses translate to fewer taxpayers to support the city's fiscal and budgetary needs, but those left behind are often poorer. For example, Detroit's per capita income is only $9,443 and median income is $18,742. In 1989, 32.4 percent of the population were below the poverty level, nearly half of whom were children under 18. Less than half of the population is in the work force, according to April 1993 Michigan Employment Security Commission statistics. Of those who are, 12.1 percent were unemployed as of April 1993.

Moreover, if the out-migration from Detroit continues, the city will experience further reductions in state aid, as distribution of state revenue-sharing funds is based on population. State revenue sharing, budgeted at $247.3 million in fiscal 1991, provided 12.70 percent of Detroit's budgeted general fund revenues. The city also receives subsidies, grants, and other forms of assistance from the state, including single business tax-inventory reimbursement, gas and weight taxes, a state equity package, and public health, mass transportation, and other grants. State source revenues have grown from $250.0 million (17 percent) of the total city budget in 1980 to $444.1 million (23 percent) in 1991. However, the loss of 14.6 percent of the city's population between 1980 and 1990 will result in a loss of $30 million per year over the next decade.

Detroit's federal aid has declined substantially both in total dollars and as a percent of budget. In 1980, federal revenues of $336.2 million accounted for over 23 percent of the total city budget, whereas federal revenues in 1991 were $161.1 million, or 8.3 percent of budget. Federal revenue sharing and counter-cyclical funding have been discontinued, and federal funds received for job training, community development block grants, pollution control, mass transportation, and other grants have declined sharply. While the city continues to receive federal support for specific programs, the general fund no longer receives noncategorical federal aid.

Exodus of Businesses Also Took Jobs

According to a report issued by the Citizens Research Council of Michigan, a nonprofit study organization, the number of businesses in Detroit have declined sharply since 1972 and continues that downward trend. Since 1972, the number of manufacturing establishments in Detroit declined by

1,143, or 48 percent, a loss to the city of 78,200 manufacturing jobs by 1987. Likewise, Detroit's wholesale trade establishments declined by 1,216, or 51 percent, and Detroit lost 16,000 jobs. Also, during this period, retail establishments fell by over 45 percent. In 1987, for example, the city's retail trade establishments employed about 24,300 fewer people. Similarly, service businesses declined by 800, or 18 percent.

At the same time, Detroit's suburbs were growing: manufacturing firms in counties immediately surrounding Detroit increased by 1,450, or 31 percent. In 1972, Detroit had 34 percent of all manufacturing establishments in the three-county region; in 1987, it accounted for only 17 percent. Wholesale trade establishments in out-county Wayne, Oakland, and Macomb counties increased by 2,476, or 68 percent, and services establishments tripled in number from 7,432 to 22,530.

The only employment growth in the city, and the greatest growth in the region, was in service employment. Although Detroit's service establishments declined by 800 from 1972 to 1987, the number of employees grew from 51,670 to 53,411.

Major Remaining Employers Include City Government and Detroit School District

The decline of business and industrial activity in the city reflects a continuing statewide economic restructuring, with increasingly less dependency on the manufacturing base. As of January 1991, the city's two largest employers were the city government and school district, accounting for 19,903 and 17,949 positions, respectively. According to a September 1990 survey by Detroit's finance department, the 10 largest private employers in the city included five hospital/health corporations, which collectively employed 21,992 workers, and three auto companies accounting for 29,882 workers.

City Expenditure Trend Has Been Upward, Often Exceeding Revenues

Historically, general fund deficits have been the norm for Detroit. Through fiscal year 1992, the city's general fund ran a deficit in 30 of the previous 43 years. In fiscal year 1989, expenditures and transfers from the general fund totaled $1.1 billion—about $1,070 for each resident. This was up from $777 million, or about $646 per capita, in 1980, and $385 million ($255 per capita) in 1970. In 1970 dollars, general fund expenditures per capita grew from $255 in fiscal year 1970, to $313 in 1980, and to $355 in fiscal 1989.

Over the past decade, the largest percentage increases in city departments and agencies have occurred in the arts, historical, and zoological

departments funded by the state equity grant; the Council of the Arts, also funded by state grants; the expanded civic center; and the legislative City Clerk and City Council. For the past 6 fiscal years, the major expenditure drivers were public safety and public works, consuming over 50 percent of the general fund budget appropriations.

Detroit's Efforts to Cope With Revenue Shortfalls

The city has taken a variety of budget actions to cope with the deficits, ranging from increasing revenues to reducing or restricting the growth of expenditures.

Revenue Actions Included Tax Increases and Borrowing

As sources of revenues have shrunk, the city government has become increasingly reliant on local source revenues to support city services. For example, in 1980, local source revenues of $882.1 million supported 60 percent of the total city budget. By 1992, local source revenues had grown to $1.4 billion, supporting 69 percent of the budget, a full 15-percent increase. As Detroit's population and relative personal wealth declined, the city's tax levels, which are the highest in Michigan, have increased. Detroit's relative tax effort is approximately 6.5 times greater than the average for Michigan cities, villages, and townships. The tax burden borne by Detroiters is also among the highest in the nation.

In 1981 the deficit grew to $115.7 million—nearly 8 percent of the total budget. To survive, in 1982 the city borrowed money through the sale of deficit funding bonds, increased the city income tax on residents and nonresidents, and froze city employees' wages and salaries. The 1990-91 city of Detroit budget is based on a city property tax rate of 30.908 mills. The tax rate includes one mill for library operations, which was originally approved by voters in 1984, and a second mill approved by voters in November 1990. All components of the property tax rate are at the legal maximum limit.

Expenditure Actions Included Cuts in Staff and Services

The city has taken numerous actions to deal with revenue shortfalls. Most notably, it has cut the size of the payroll and reduced or eliminated some services. For example, to deal with the 1980 general fund deficit of $80.9 million, the city closed the Detroit General Hospital. According to the Budget Director, in 1986, the city created the Budget Stabilization Fund (BSF) to help provide some measure of fiscal stability regarding budgetary resources. The BSF flourished due to general fund surpluses through 1989. However, general fund deficits in fiscal years 1990 through

1992 depleted the fund. To offset a $106 million deficit in 1991, the city sold its trash incinerator for $54 million, eliminated 1,100 budgeted positions, shortened the work week, and borrowed $110 million through the sale of deficit reduction bonds. Due to Detroit's continuing fiscal crisis, the Mayor laid off another 1,096 workers in 1992, eliminated 1,145 positions, and eliminated the Detroit Council for the Arts. In addition, the Mayor mandated a 10-percent wage reduction for all city employees and, according to the Budget Director, persuaded trustees of one of the city's two pension funds to accept a $33 million-a-year reduction in retirement contributions, and maintained a shortened work week for certain departments. Moreover, according to the Budget Director, for fiscal year 1992, the city

- picked up 20,000 fewer tons of garbage than the previous year,
- made 1,460 fewer building inspections, and
- paved 39 percent fewer miles of streets.

The impact and potential consequences of these budget actions on the citizens of Detroit have been significant. According to the City Ombudsman's report, as a result of cutbacks in various departments:

- Parts to repair ambulances and fire trucks have been scarce since the city laid off 78 Finance Department clerks who ordered parts and paid suppliers. Vehicles have broken down during emergency runs. In addition, with the layoff of Finance Department clerks, the city recently scrapped plans to raise $2.5 million in revenue by pursuing delinquent taxpayers and checking income tax returns more carefully.
- Patients, many of them uninsured, have been turned away from city-run health clinics since the layoffs of 80 Health Department clerks. Clinics specializing in TB and venereal disease are testing fewer patients since these layoffs. Both diseases are on the upswing in Detroit.
- Results of children's blood tests have been stacking up since the clerk who kept track of them was laid off. Parents and others who rely on the tests to find out if children have lead poisoning cannot receive the information in a timely manner.
- Mothers have had to wait up to 2 months to get an appointment to be certified for free baby formula since 17 clerks for the Women, Infants and Children program clerks were laid off.
- Officers have had to spend more time in the precincts doing paperwork, and 911 operators must type and file reports instead of answering phones full time because the city laid off 67 clerical workers in the precincts.

- The city has closed recreation centers, summer jobs programs, and playgrounds since the layoff of more than 200 employees.

Detroit's Budgetary Outlook

According to the Budget Director, sooner or later the reality that the city can no longer afford to provide adequate services will have to be faced and cuts made. The Budget Director concluded that some of the options that were available previously are no longer realistic: new state or federal revenues are unlikely. Indeed, reductions in those revenues are more probable, and increasing local taxes would be counter-productive. Increasing local tax rates further or instituting new taxes would require changes in state law and an affirmative vote of the people. The Director acknowledged that this was difficult, if not impossible, to achieve in today's climate of voter resistance to higher taxes. Moreover, increasing the base of an existing tax would require a corresponding reduction in the rate of the tax under the Headlee Amendment to the State Constitution, unless authorized by the voters.

City officials have also concluded that the use of fees, fines, and charges as sources of additional revenues is not the long-term solution to Detroit's revenue problem. According to the Budget Director, revenue enhancement, which has been so effective in the past, does not appear feasible at this time. As a consequence of revenue constraints, continued cuts in expenditures offer the best opportunity to maintain fiscal solvency.

Expenditure and Revenue Patterns

Between 1985 and 1991, state, city, and county government surpluses fell as expenditures grew faster than revenues. At each level of government, the factors fueling expenditure growth differed. For states, health care spending was a major influence on rising expenditures. City spending growth was driven by environment and housing programs. Also, in cities with dependent school systems, spending growth on education was significant. At the county level, public safety and environment and housing were key contributors to rising expenditures.

Revenues continued to grow between 1985 and 1991, although not as fast as expenditures. Fees and charges grew faster than taxes for all three levels of government. Also, states received more aid from the federal government, while cities and counties experienced significant cuts in their federal aid. However, these cuts were offset by increases in state aid to cities and counties.

We examined the components of expenditures and revenues for all states, all cities, and all counties over the 1985-91 period. In our analysis of these components, we focused on two distinct, but interrelated, concepts: change over time; and size in relation to the total budget. Both of these concepts are important for estimating the impact of a particular item on overall budgetary trends. For example, a small program that is growing relatively rapidly may have less impact on expenditure growth than a larger program that is growing more slowly.

We calculated average annual rates of change for each component of expenditures and revenues and computed each component's share of the total in 1991, the most recent year available.[1] For this analysis, we used data from and categories used by the Governments Division of the U.S. Bureau of the Census.[2]

Expenditure Categories

Census classifies its expenditure data in two different ways: by "functional" groups, which are divided into programmatic areas like public safety, social services, and transportation; and by "object class," which includes items such as current operations and capital that cut across various government functions. The functional and object classifications

[1]All rates of change were calculated using constant 1987 dollars. Constant 1987 dollars were calculated using the gross domestic product (GDP) implicit price deflator for state and local government purchases.

[2]Census classifies city-counties, such as Nashville-Davidson and San Francisco City and County, as cities.

each equal 100 percent of total expenditures.[3] Tables IV.1 and IV.2 include a more detailed listing of functional and object class categories.

Trends in Expenditure by Function

The programmatic areas of state and local budgets that grew most rapidly from 1985 through 1991, and also accounted for significant shares of spending, differed by level of government.

- For states, spending on health care, including Medicaid, was a major contributor to expenditure growth.[4] Health care spending increased at an average annual rate of 7.6 percent and, by 1991, accounted for 21 percent of state general expenditure.[5] Spending on public safety also grew rapidly, but it made up only 5 percent of state budgets. (See figs. IV.1, IV.2, and table IV.1).

[3]State aid to local governments shows up in the Census data as an expenditure for both the donor and the recipient government. For example, if a state provides money to a county under the AFDC program, the amount will be classified as a "social service and income maintenance" expenditure for the state and for the county.

Salaries and wages is a separate expenditure category that Census classifies as an "exhibit." It is not combined with other categories to add to 100 percent of total expenditures. We chose to list it with the object class items because, like these items, it cuts across various government functions.

[4]For our analysis of health care spending, we combined three separate Census categories: "medical vendor payments," "hospitals," and "[public] health." Census includes each of these items in a broader category called "social services and income maintenance." However, we have excluded the three health care items from this broader category, and we report their combined spending as a new category called "health." Also, Medicaid is not listed as a separate Census category. Most Medicaid payments are included in the category called "medical vendor payments." The remainder are classified in the "[public] hospitals" category.

[5]General expenditure excludes expenditure for utilities, liquor stores, and insurance trust systems.

Figure IV.1: General Expenditure by Function—Average Annual Percentage Change of Selected Items for All States, All Cities, and All Counties (1985-91)

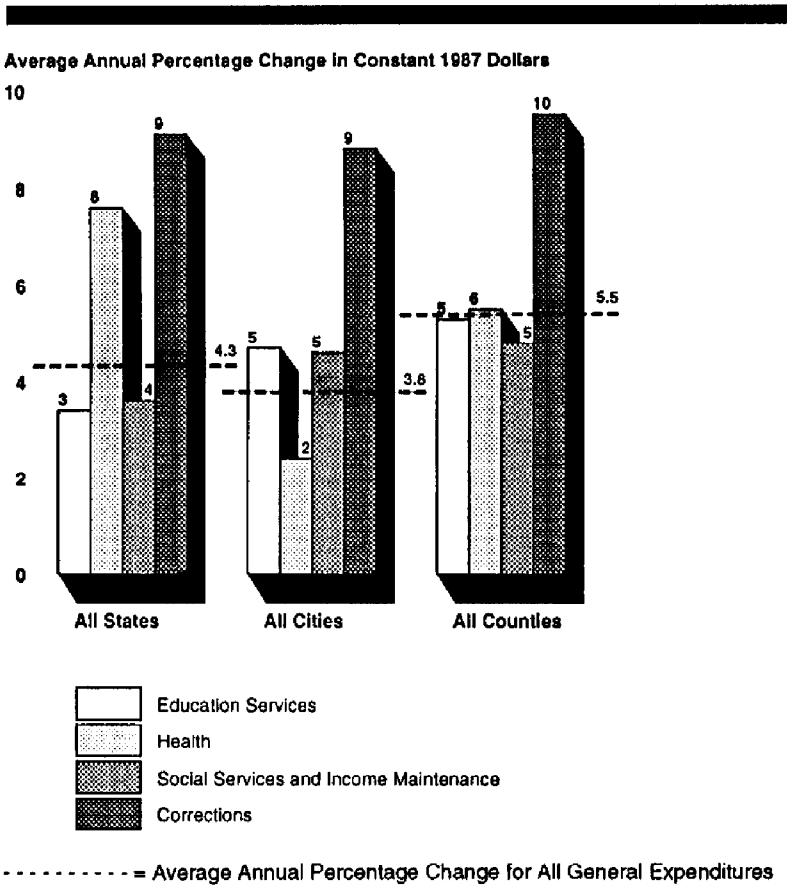
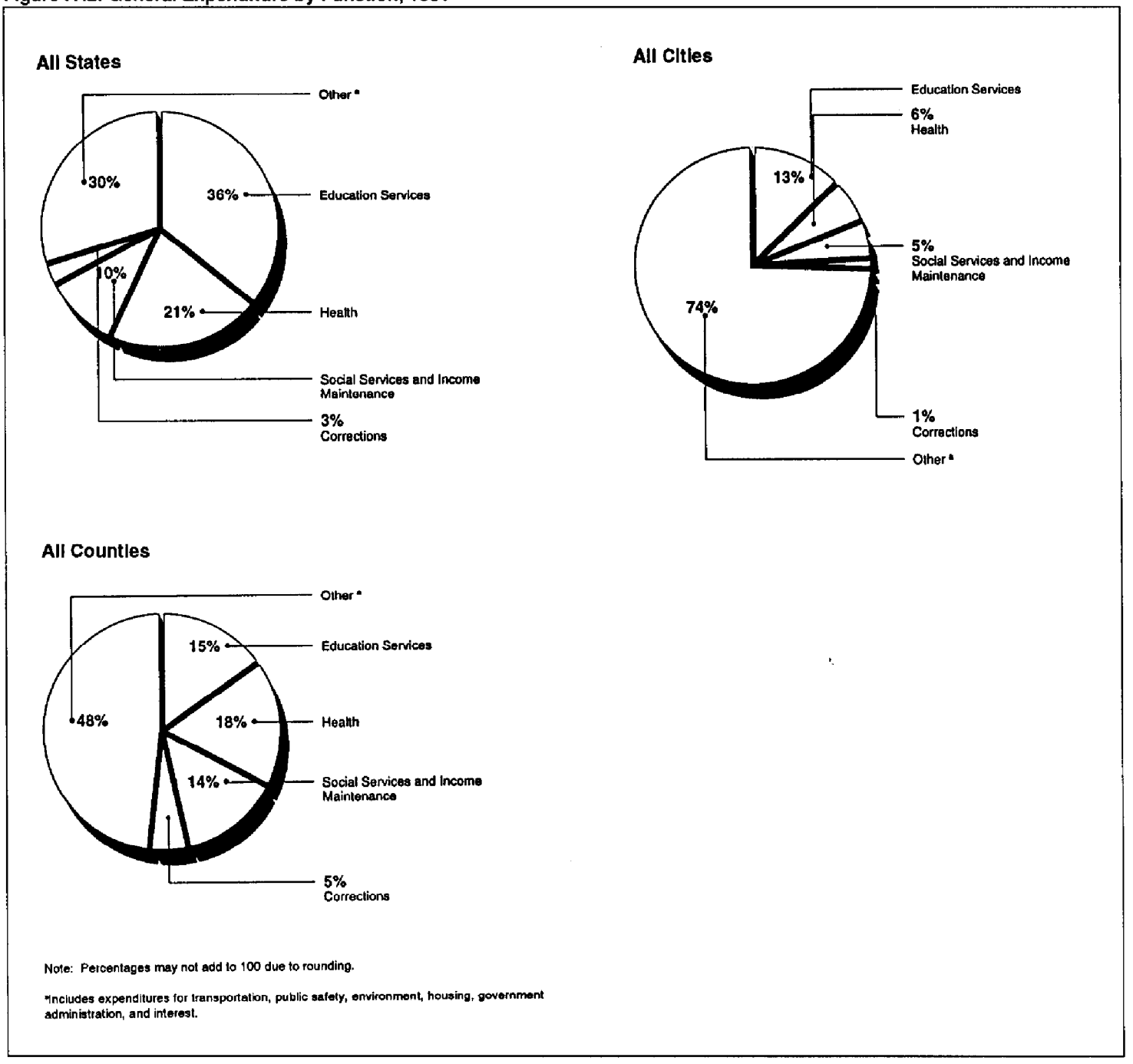


Figure IV.2: General Expenditure by Function, 1991



Note: Percentages may not add to 100 due to rounding.

*Includes expenditures for transportation, public safety, environment, housing, government administration, and interest.

Table IV.1: Average Annual Percent Change and Share of Total for Selected Functional Expenditures

	1985-91 average annual percent change (constant 1987 $)			1991 share of general expenditure (percent)		
General expenditure by function	**All states**	**All cities**	**All counties**	**All states**	**All cities**	**All counties**
Education services	3.4	4.7	5.3	36	13	15
Health	7.6	2.4	5.5	21	6	18
Medical vendor payments[a]	9.5	-8.4	5.1	13	[b]	1
Social services and income maintenance	3.6	4.6	4.8	10	5	14
Transportation	2.2	2.9	3.6	9	11	9
Public safety	7.2	3.9	7.3	5	20	12
Corrections	9.1	8.8	9.5	3	1	5
Environment and housing	5.6	4.2	6.8	3	21	7
Government administration	6.1	4.1	5.1	4	7	11
Other general expenditure	2.4	3.0	6.4	12	16	13
General expenditure— total	**4.3**	**3.8**	**5.5**	**100**	**100**	**100**

Note: Detail may not add to total due to rounding.

[a]The medical vendor payments category is a close proxy for Medicaid.

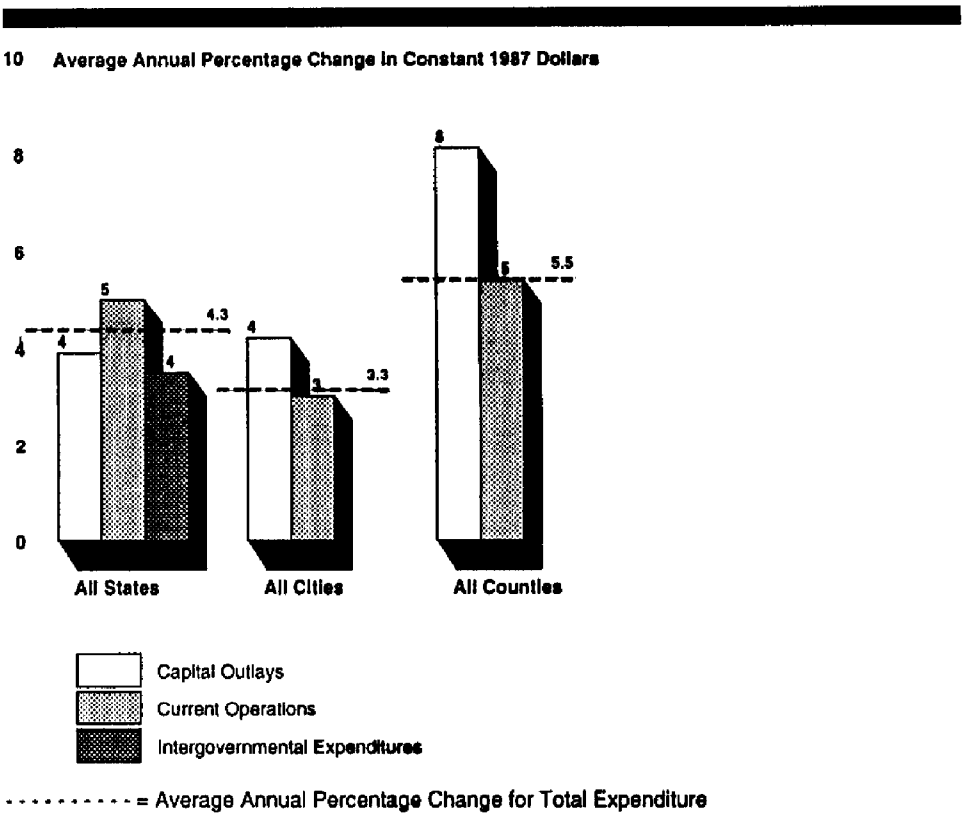
[b]Less than 1 percent.

- At the city level, total education spending was one of the main contributors to expenditure growth with an average annual increase of 4.7 percent. Spending on education also made up 13 percent of total general expenditure at the city level in 1991. However, education spending varies widely across cities; cities with their own school systems, such as New York City, typically spend large shares of their budget on education, while cities with independent school districts spend little or nothing on this function. Spending on environment and housing functions also contributed to general expenditure growth; its average annual increase was 4.2 percent and it accounted for 21 percent of the budget.
- For counties, public safety spending had a significant influence on rising expenditures with a 7.3-percent average annual increase and a 12-percent share of general expenditure in 1991. The most rapidly growing component of public safety spending was corrections; this area grew at an average rate of 9.5 percent per year. Although corrections spending also grew rapidly at the state and city levels, it was less than 4 percent of spending for these governments. As at the city level, environment and housing spending also grew relatively quickly, and it made up about 7 percent of county general expenditures.

Trends in Expenditure by Object Class

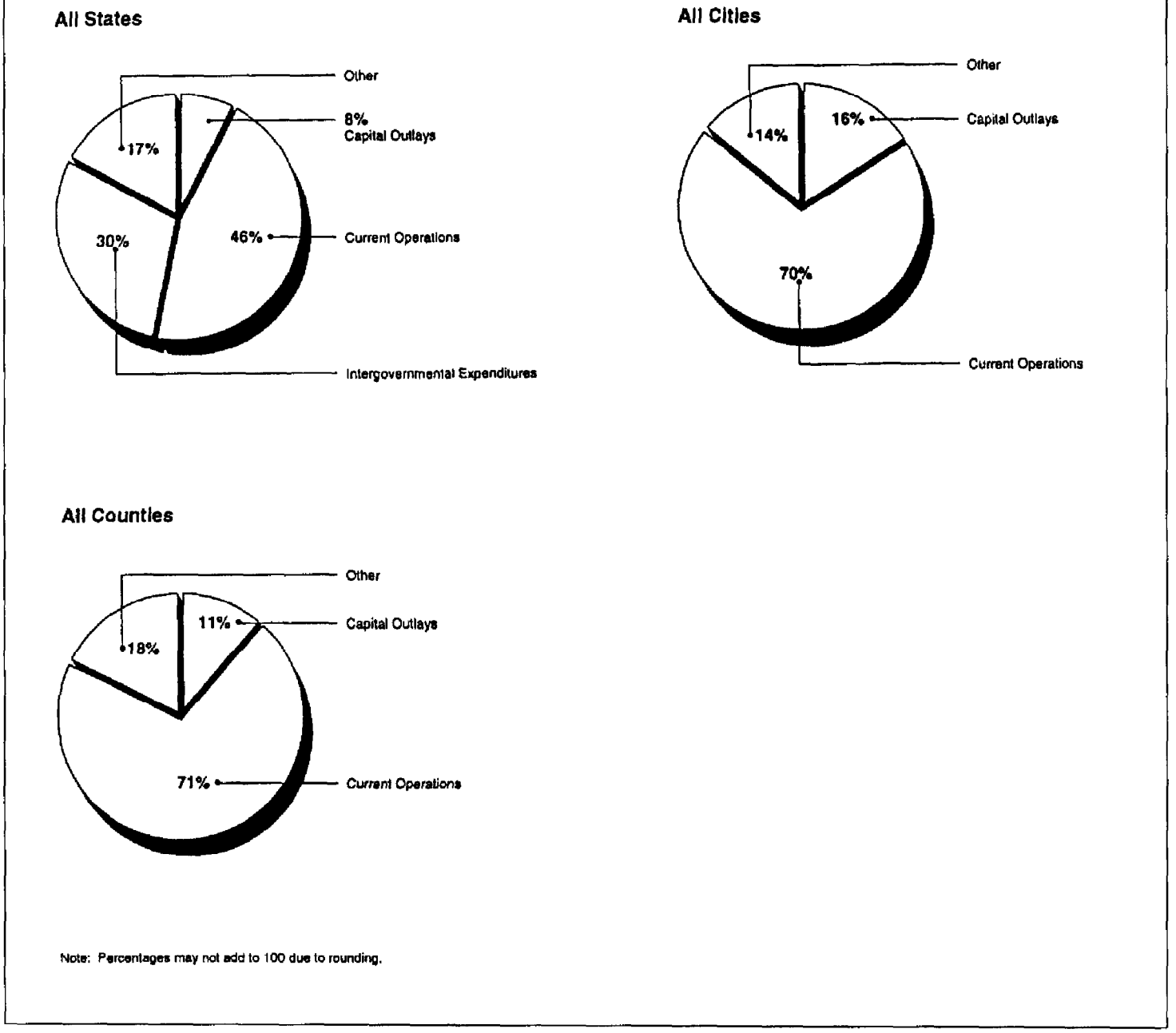
Our previous work showed little growth in capital spending for the whole state-local government sector from 1961 to 1990. Our closer examination of capital spending over the 1985 through 1991 period shows that it grew at a faster pace than total expenditures for all cities and all counties, but not all states. (See figs. IV.3, IV.4, and table IV.2). Capital's share of total expenditures in 1991 ranged from a high of 16 percent for cities to a low of 8 percent for states. The growth rate of spending on current operations was slower than that of capital for cities and counties, but not states. Current operations made up 70 percent of total expenditures for cities, 71 percent for counties, and 46 percent for states.

Figure IV.3: Total Expenditure by Object Class—Average Annual Percentage Change of Selected Items for All States, All Cities, and All Counties (1985-91)



Note: Most intergovernmental expenditures represent aid provided to lower levels of government. Thus, this graph excludes such expenditures at the city and county levels.

Figure IV.4: Total Expenditure by Object Class, 1991



Note: Percentages may not add to 100 due to rounding.

Table IV.2: Average Annual Percent Change and Share of Total for Selected Object Class Expenditures

	1985-91 average annual percent change (constant 1987 $)			1991 share of total expenditure (percent)		
Total expenditure by object	**All states**	**All cities**	**All counties**	**All states**	**All cities**	**All counties**
Intergovernmental expenditure	3.5	2.3	4.0	30	2	4
Direct expenditure	4.7	3.3	5.6	70	98	96
Capital outlay	3.9	4.2	8.1	8	16	11
Current operation	5.0	3.0	5.4	46	70	71
Total expenditure	**4.3**	**3.3**	**5.5**	**100**	**100**	**100**
Salaries and wages[a]	3.4	3.1	4.6	17	34	35

[a]Salaries and wages is a separate Census expenditure category that is not combined with other categories to add to 100 percent of total expenditures. We chose to list it with the object class items because, like these items, it cuts across various government functions.

One of the largest components of current operations is salaries and wages, which grew at a slower rate than total expenditures for all three levels of government. As a share of total expenditures, salaries and wages were 34 to 35 percent for localities and 17 percent for states. State aid to all local governments (including school districts and townships in addition to cities and counties) also grew at a slower rate than total expenditures, and its share of total state spending was 30 percent.

Revenue Sources

Census data on general revenue[6] is divided into two main categories: revenue from a government's own sources; and revenue received from other governments (i.e., intergovernmental revenue). Intergovernmental revenue includes aid that states, cities, and counties receive directly from the federal government, and aid that cities and counties receive from state governments.[7] A government's "own-source" revenue includes taxes (e.g., sales, property, and income), fees and charges, and miscellaneous revenue such as interest earnings, rents, and royalties.

Trends in Own-Source Revenue

At all three levels of government, fees and charges grew faster than total taxes or miscellaneous revenue. (See figs. IV.5, IV.6, and table IV.3). In terms of budget shares, fees and charges were most significant at the local level where they accounted for 16 percent of county general revenue and

[6]General revenue excludes revenue from utilities, liquor stores, and insurance trust systems.

[7]Direct federal aid is aid that does not pass through any other government. Some federal aid to states is passed through to local governments. However, the Census data that we used do not specify how much of the federal aid to states is "pass-through" aid.

17 percent of city general revenue in 1991. For states, charges made up 9 percent of general revenue.

Figure IV.5: General Revenue by Source—Average Annual Percentage Change of Selected Items for All States, All Cities, and All Counties (1985-91)

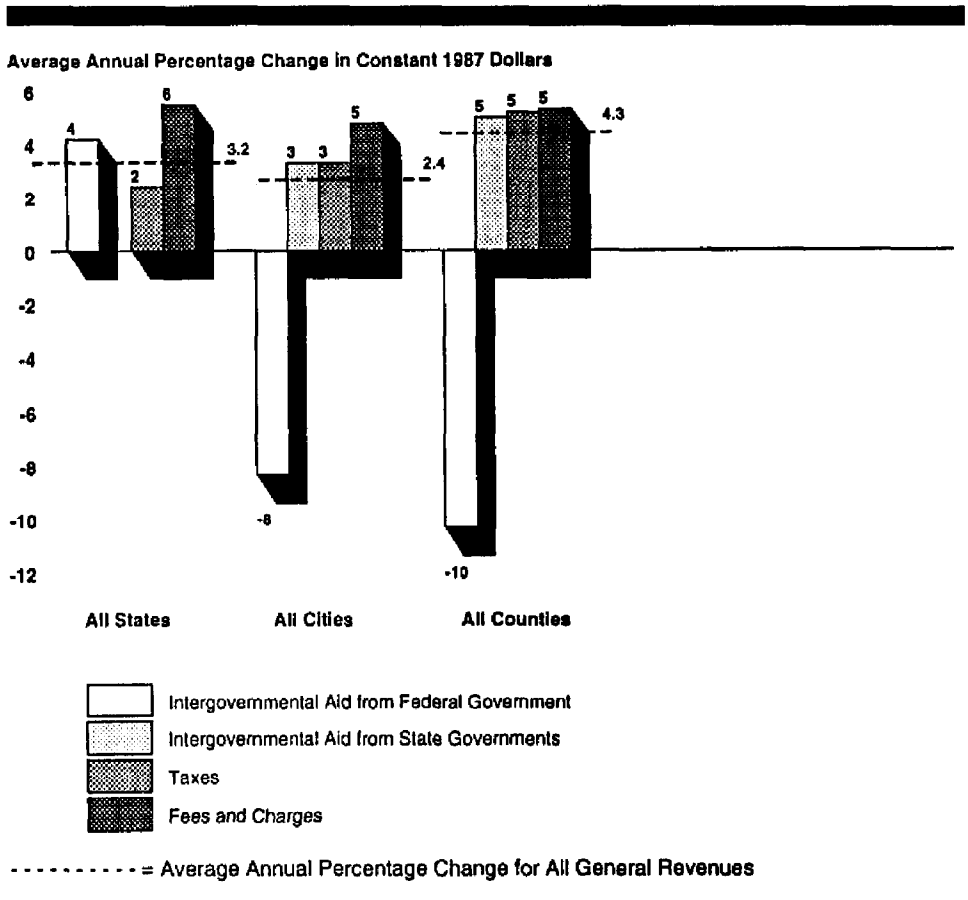
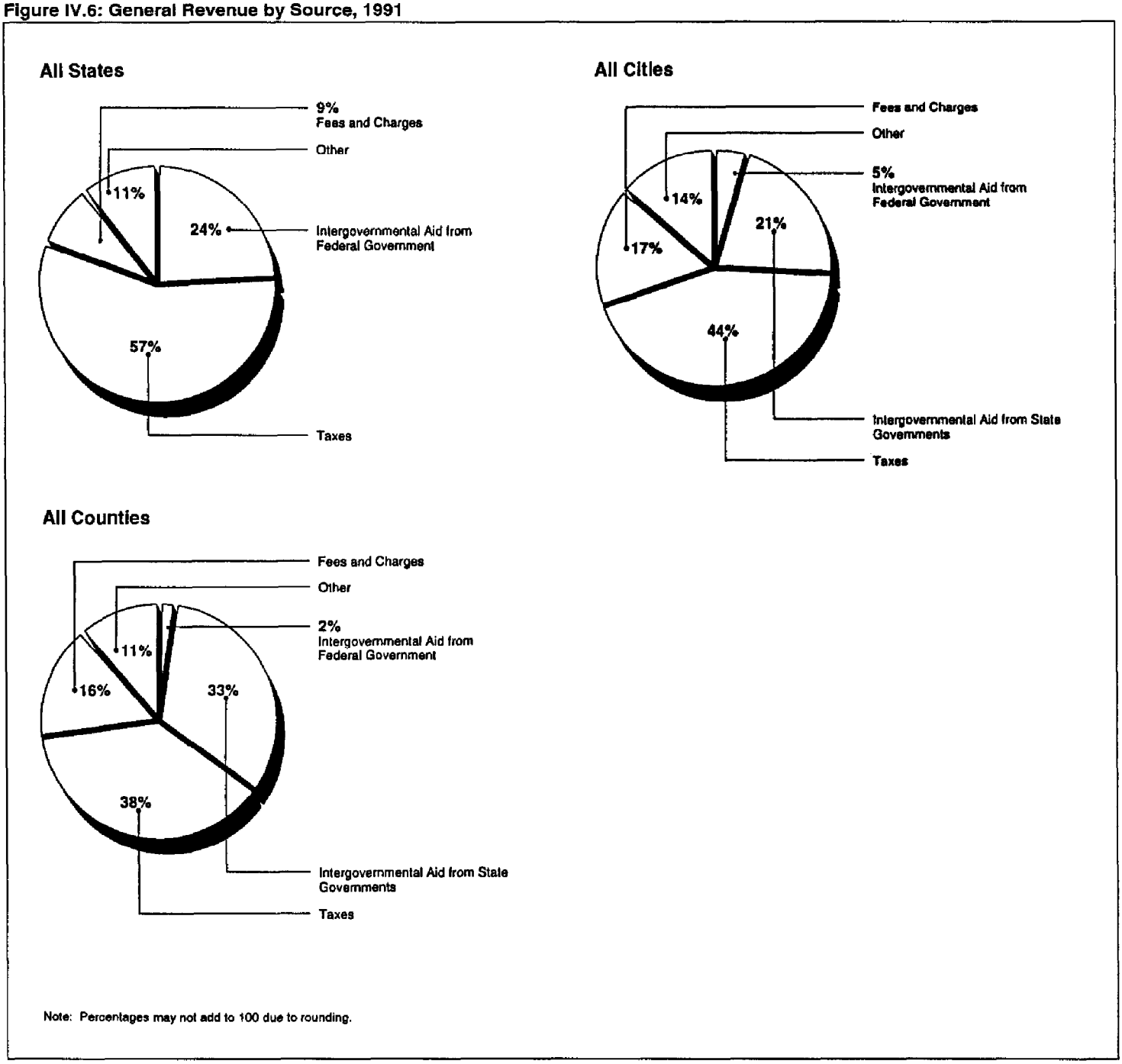


Figure IV.6: General Revenue by Source, 1991



Note: Percentages may not add to 100 due to rounding.

Table IV.3: Average Annual Percent Change and Share of Total for Selected General Revenue Components

	1985-91 annual average percent change (constant 1987 $)			1991 share of general revenue (percent)		
General revenue by source	**All states**	**All cities**	**All counties**	**All states**	**All cities**	**All counties**
Intergovernmental (IG) aid	4.2	0.6	3.5	26	28	36
IG aid from federal govt.	4.2	-8.3	-10.3	24	5	2
IG aid from state govts.	N/A	3.3	5.0	N/A	21	33
Own-source general revenue	2.9	3.1	4.8	74	72	64
Taxes	2.4	3.3	5.2	56	44	38
Property	3.8	4.3	4.9	1	23	28
Sales	2.6	2.1	5.9	28	12	7
Income	2.8	2.5	6.6	22	6	1
Fees and charges	5.5	4.8	5.3	9	17	16
Miscellaneous	3.6	0.4	2.7	9	11	10
General revenue— total	**3.2**	**2.4**	**4.3**	**100**	**100**	**100**

N/A = Not Applicable

Taxes (including property, income, and sales) grew most rapidly at the county level. States experienced the slowest growth in taxes. The three levels of government differed in their reliance on taxes in general and in their mix of taxes. States were the most reliant on taxes, primarily sales and income taxes, receiving 56 percent of all general revenue from this source in 1991. For cities, taxes made up 44 percent of general revenues, and the main taxes were property and sales. Counties were the least dependent on taxes; 38 percent of their general revenue came from this source, primarily in the form of property taxes. However, counties were the most reliant on intergovernmental aid. (See below.)

Trends in Intergovernmental Aid

Between 1985 and 1991, direct federal aid to cities and counties declined sharply, while direct federal aid to states grew faster than state general revenue. The increase in direct federal aid to states reflects the growth of entitlement programs, such as Medicaid. The drop in direct federal aid to cities and counties was greatest between 1985 and 1988 due, in part, to the termination of the General Revenue Sharing program in 1986. However, during the 1985 through 1991 period, direct federal aid was only a small part of the intergovernmental aid received by cities and counties; in 1991, direct federal aid was 5 percent of city general revenue and 2 percent of county general revenue.

State aid to cities and counties increased during this period and offset the decline in direct federal aid to counties and cities. However, we did not break down the components of either state or federal aid, so we do not know what the net effects of changes in such aid were for specific programs. In contrast with direct federal aid's small share of local revenue, state aid accounted for 21 percent of city general revenue and 33 percent of county general revenue.

Tax and Revenue Burdens

From 1980 through 1990, state, city, and county taxes, fees, and charges grew at a faster rate than did the personal income of their residents, including during the period of declining budget surpluses that began in the mid-1980s. For states and cities, growth in revenue burdens, which include fees and charges in addition to taxes, outpaced growth in tax burdens. For counties, tax and revenue burdens grew at about the same rate. Of the three levels of government, states assessed the highest tax and revenue burdens while counties imposed the lowest burdens. For example, in 1990, the average state taxpayer paid 65 dollars in state taxes for every thousand dollars of personal income while the average county taxpayer paid 12 dollars per thousand.

Our definition of "tax burdens," as used in this report, expresses taxes (e.g., property, sales, income) as a share of personal income. We did not include social insurance taxes, such as those levied for pensions or unemployment compensation, in our definition.

Our definition of "revenue burdens" is a broader concept that expresses taxes, fees, and charges as a share of personal income.[1] GAO used tax and revenue data from the Governments Division of the Census Bureau and income data from the Commerce Department's Bureau of Economic Analysis.

Tax and revenue burdens were calculated for each level of government in even-numbered years from 1980-90.[2] However, we focus primarily on the 1984-90 period to coincide with the decline in budgetary surpluses. The tax burden measure was derived by expressing the total per capita taxes of each level of government as a percentage of the U.S. average per capita personal income.[3] The revenue burden measure, which includes fees and charges in addition to taxes, was calculated in the same manner.

Tax Burdens Rose

During the 1980-90 period, taxes grew at a faster rate than personal income for taxpayers at all three levels of government. The growth trend over the decade was fairly stable, even during the period of declining budgetary surpluses in the mid-to-late 1980s. States had the highest tax

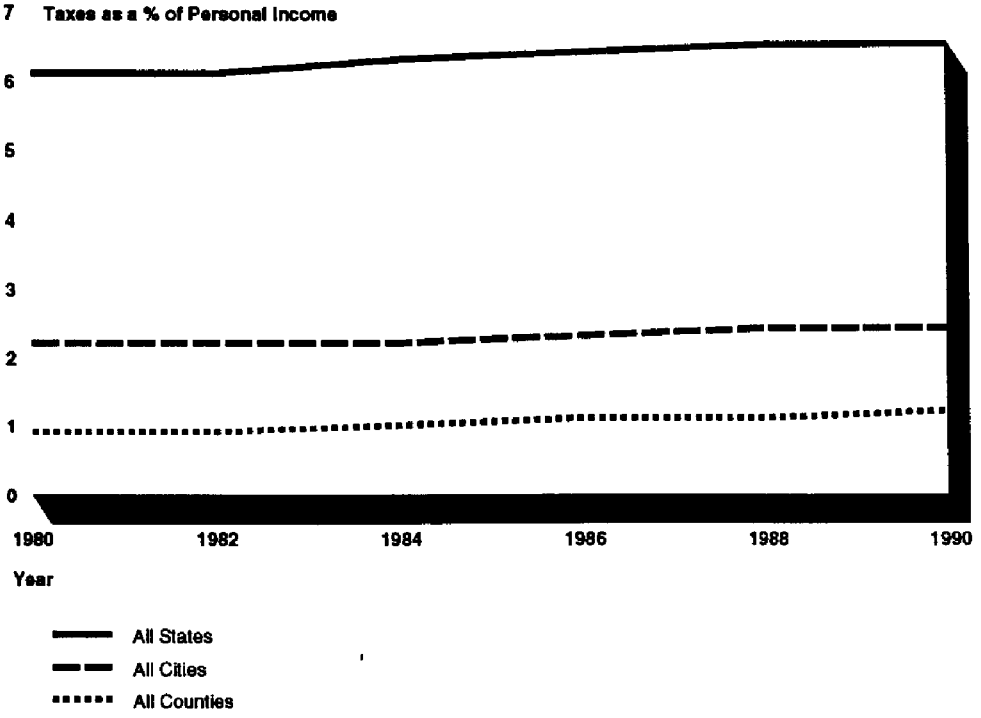
[1]Fees and charges include revenues used to support general government functions, such as hospitals and highways, and exclude revenues used for utilities, liquor stores, and insurance trust systems.

[2]Data for odd-numbered years were not available from the sources that we consulted.

[3]GAO used U.S. average per capita personal income as a proxy for the average per capita personal income of all states, all cities, and all counties. We used the U.S. average because comparable data were not available for each level of government.

burdens while counties imposed the lowest burdens. In 1984, the average state taxpayer paid $63 in state taxes for every $1,000 of income. By 1990, state taxes had risen to $65 per thousand. By comparison, the average county taxpayer spent $10 per thousand on county taxes in 1984 and $12 per thousand in 1990. And city taxpayers' burdens rose from $22 to $24 per thousand during this period. (See fig. V.1.)

Figure V.1: Tax Burdens for All States, All Cities, and All Counties (1980-90)



(Taxes as a % of Personal Income)

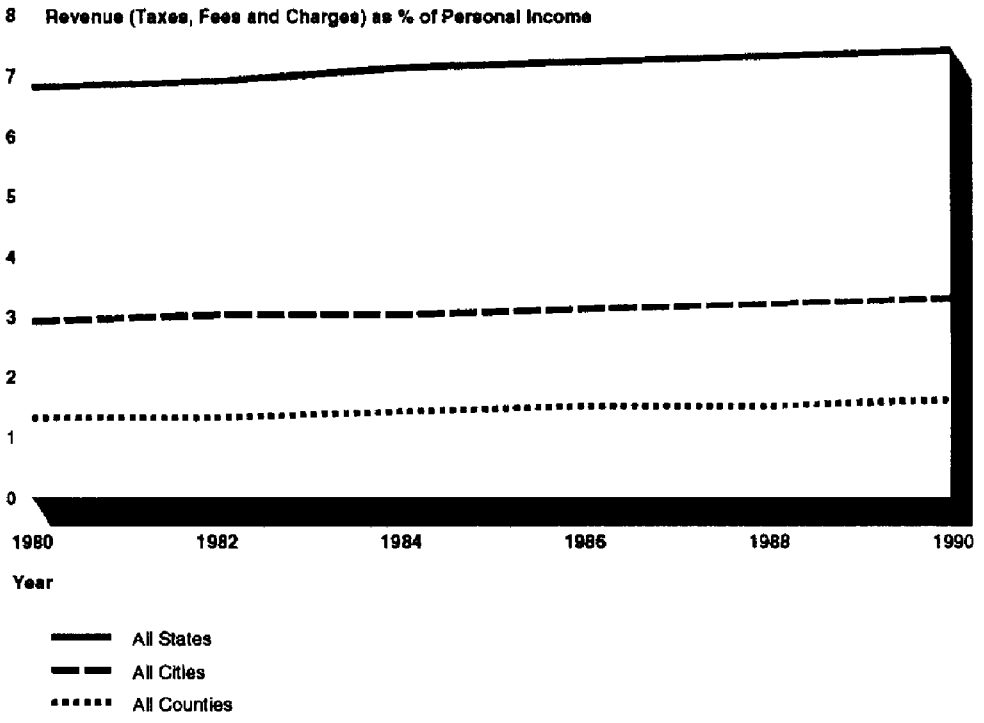
Year	All States	All Cities	All Counties
1980	6.1	2.2	0.9
1982	6.1	2.2	0.9
1984	6.3	2.2	1.0
1986	6.4	2.3	1.1
1988	6.5	2.4	1.1
1990	6.5	2.4	1.2

Revenue Burdens Also Rose

Our broader measure of revenue, which includes fees and charges in addition to taxes, also grew more rapidly than personal income during the decade for states, cities, and counties. Growth in revenue burdens was relatively steady throughout the 1980s. For states and cities, revenue burdens grew at a faster rate than tax burdens over the decade. At the county level, tax and revenue burdens grew at essentially the same pace.

Again, state governments assessed the highest level of revenues while county governments imposed the lowest burden. State revenues increased from $71 of every $1,000 of personal income in 1984 to $74 per thousand in 1990. Counties raised their revenues from $14 to $16 per thousand during the decade. City burdens increased from $30 to $33 per thousand during this period. (See fig. V.2.)

Figure V.2: Revenue Burdens (Taxes, Fees, and Charges) **for All States, All Cities, and All Counties** (1980-90)



(Revenue (Taxes, Fees and Charges) as % of Personal Income)

Year	All States	All Cities	All Counties
1980	6.8	2.9	1.3
1982	6.9	3.0	1.3
1984	7.1	3.0	1.4
1986	7.2	3.1	1.5
1988	7.3	3.2	1.5
1990	7.4	3.3	1.6

Indicators of Short-Term Financial Condition

Over the 1985 to 1991 period, the budgetary flexibility of state, city, and county governments for increasing the funding of current services or undertaking major new spending initiatives in the short-run declined. Operating surpluses for each of the three levels of government fell from a peak of about 6 to 9 percent of expenditures in the mid-1980s to between 1 and 3 percent in 1991. However, other key indicators of short-term financial condition, such as cash and security holdings and debt levels, remained relatively stable or improved during this period.

In this appendix, we discuss in more detail the concepts, methodologies, and data used in developing our indicators of short-term financial condition. We also present graphically and discuss more fully the trends we found for all states, all cities, and all counties.

Overview of Short-Term Financial Condition Concepts and Data

In this report, short-term financial condition refers to the relationship of a government's annual revenues to its annual expenditures and to certain assets and liabilities affected by decisions on how to finance expenditures. We used four primary indicators of short-term financial condition: surplus/deficit, cash and security holdings, long-term debt outstanding, and short-term debt outstanding.

We analyzed trends in the short-term financial condition of all states, all cities, and all counties between 1980 and 1991 to describe the changing condition of each of these levels of government in recent years. In this analysis, we focused particularly on 1985 through 1991, which our previous work showed to be a period of declining surpluses for the state-local sector as a whole. We also analyzed trends in short-term financial condition for each of the 50 states, the 56 largest cities, and the 77 largest counties for the same time period to provide information on the range of conditions that existed among state and local governments with, generally, the largest financial responsibilities.

Four Key Indicators Selected From Many

In developing our four key indicators of short-term financial condition, we surveyed the relevant literature to determine what measures of short-term financial condition had been previously used. We identified nearly 50 indicators of financial condition, with many variations and combinations. Furthermore, a number of studies did not distinguish between indicators of short-term financial condition and indicators of longer-term fiscal capacity in assessing governmental financial condition. From this we

concluded that no consensus exists among experts about what the best indicators of short-term financial condition are.

From the universe of indicators we identified, we selected a few that represent different dimensions of financial condition and, we believe, reasonably portray the cash flows, financial assets, and debt positions of state and local governments. Our indicators exclude, however, certain other measures of financial strength, such as balance sheet measures of physical assets and unfunded liabilities, that are not included in the Census database we used for this analysis.

One of the measures of short-term financial condition most widely referred to is the annual excess (or shortfall) of revenues over expenditures; hence, our preeminent indicator of short-term financial condition is surplus or deficit.[1] While surpluses and deficits relate to the inflow and outflow of funds in a year, our other three indicators measure stocks of financial resources that are built up or drawn down over time: cash and security holdings, long-term debt outstanding, and short-term debt outstanding.

Deficits and downward trends in cash and security holdings, or upward trends in short- or long-term debt, indicate that governments did not finance annual expenditures entirely from annual revenues and may have had to draw on cash and security holdings or borrow to balance budgets. These actions, of course, are not exhaustive of the actions state or local governments may have taken and, in and of themselves, may not reflect improvement or deterioration in short-term financial condition. However, to the extent these mechanisms were used, they imply lessened budgetary flexibility to respond to new problems in the context of existing revenue and expenditure policies.

However, this reduced flexibility may be of shorter or longer duration depending on the underlying reasons for the trends. For example, reduced surpluses due to a temporary weakening of the economy or larger than desired beginning balances would not necessarily indicate a long-term problem. Likewise, decreased levels of cash due to increases in federal or state aid payable would not be a sign of budget stress. On the other hand, reduced surpluses reflecting a major structural change in the socioeconomic base of a jurisdiction would indicate a more serious problem. It was beyond the scope of this study to make such distinctions.

[1]We actually calculate two measures of surplus/deficit: comprehensive surplus/deficit and operating surplus/deficit. These two measures are explained later in this appendix.

Census Data Used to Calculate Short-Term Financial Indicators

The short-term financial indicators we use in this report were calculated using state and local finance data compiled by the Governments Division of the U.S. Bureau of the Census. The Census Bureau defines a governmental entity as not only the parent government but also the dependent agencies and enterprises connected to it—such as water utilities or airports—that lack either fiscal or administrative independence. In addition, the Bureau's statistics show a government's finances in their entirety, without regard to the many accounting or legal distinctions that may separate a jurisdiction's funds. Census bases its data on the official records of individual governments but classifies the data into its own categories that are uniform across governments. The use of Census data permitted us to make standardized comparisons of financial indicators across jurisdictions, as well as to analyze the aggregate short-term financial condition of states, cities, and counties on a consistent basis.

Reported Census data lag governments' fiscal years by about 2 years; thus, the latest Census data presented in this report are for 1991. Short-term financial conditions can be somewhat volatile, and recent events, such as slow economic growth or defense spending reductions, may have affected certain jurisdictions more than others. Accordingly, a particular jurisdiction's financial condition in 1991 may or may not reflect its current financial situation. To help draw as complete a picture as possible of short-term financial conditions, in this report we have supplemented our analysis with illustrations from our case study work and various published sources to provide more current (1992 and 1993) information, where appropriate.

In addition, short-term financial condition results presented in this report for any particular jurisdiction may differ from the figures familiar to a state or local official based on that jurisdiction's own budget or financial documents. This may occur not only because we chose to use Census data rather than budget or financial data produced directly by state and local governments but also because the short-term financial condition indicators we developed will likely differ from similar concepts found in state and local financial documents. For example, while most state and local governments focus on surpluses/deficits or ending balances for the jurisdiction's general fund only, our measures of surplus/deficit are generally broader.

Technical Discussion of Surplus/Deficit Indicators

Surpluses or deficits are key measures of budgetary condition because they summarize a government's relationship between its revenues and expenditures for a particular year. Regardless of exactly which funds or set of transactions the measure covers, in principle, governments experiencing a surplus can carry over the unused revenues to the next year and either spend those revenues or build up reserves, both of which make financing future expenditures easier. Governments experiencing a deficit, however, may draw down reserve funds or borrow to finance current-year expenditures—a situation that is not sustainable in the long run given requirements for state and local governments to balance their budgets and constraints on their borrowing.

We developed two measures of state and local surplus/deficit: comprehensive surplus/deficit and operating surplus/deficit. Both pertain essentially to the cash revenue and expenditure transactions of a jurisdiction. This approach reflects Census's records, which do not attempt to capture accrual transactions.

The comprehensive surplus/deficit indicator measures all revenue and expenditure transactions of a state or local government (as reported by Census) on an annual basis. Thus, this concept is basically comparable with the measurement of the federal deficit on a unified budget basis. Because of the breadth of this measure, it is most relevant for comparing the budgetary condition of states, cities, and counties with that of the federal government.

In contrast, the operating surplus/deficit indicator is designed to measure the surplus or deficit resulting only from a state or local government's costs of current operations. It is based on concepts that seek to measure the using up of economic assets on an annual basis. The operating surplus/deficit measure relates more closely than the comprehensive surplus/deficit measure to how state and local governments budget; therefore, we focus mainly on this measure when analyzing the budgetary condition of states, cities, and counties as groups or as individual governments.[2]

[2]It is difficult to compare the coverage of our operating surplus/deficit measure with that of state and local government general funds. For one, each government defines a unique set of transactions to be included in its general fund. For example, the Congressional Research Service reported that state general funds ranged in coverage from 21 to 74 percent of total state expenditures. A National Governors' Association and National Association of State Budget Officers report states that general funds represent about half of total state spending. Also, our measure of operating surplus/deficit uses categories—such as current revenues used to finance capital outlays—that may cut across fund definitions. In general, however, our operating surplus/deficit measure is probably more comprehensive than most state and local government general funds. For example, our measure includes utilities and other enterprises, which are typically excluded from general funds.

The major differences in the calculation of the two measures are the treatment of capital spending, insurance trust funds, and private activity debt. Most revenues and expenditures for capital and insurance trusts are excluded from the operating surplus/deficit calculation because they do not constitute an ongoing use of economic resources; however, amounts for capital consumption and government contributions to insurance trust funds are included. In addition, although the Census accounts do not separately identify all financial transactions pertaining to private activity debt, we have excluded such transactions (estimating them where necessary) from our operating surplus/deficit measure on the rationale that obligations arising from this debt are not normally governmental obligations.[3]

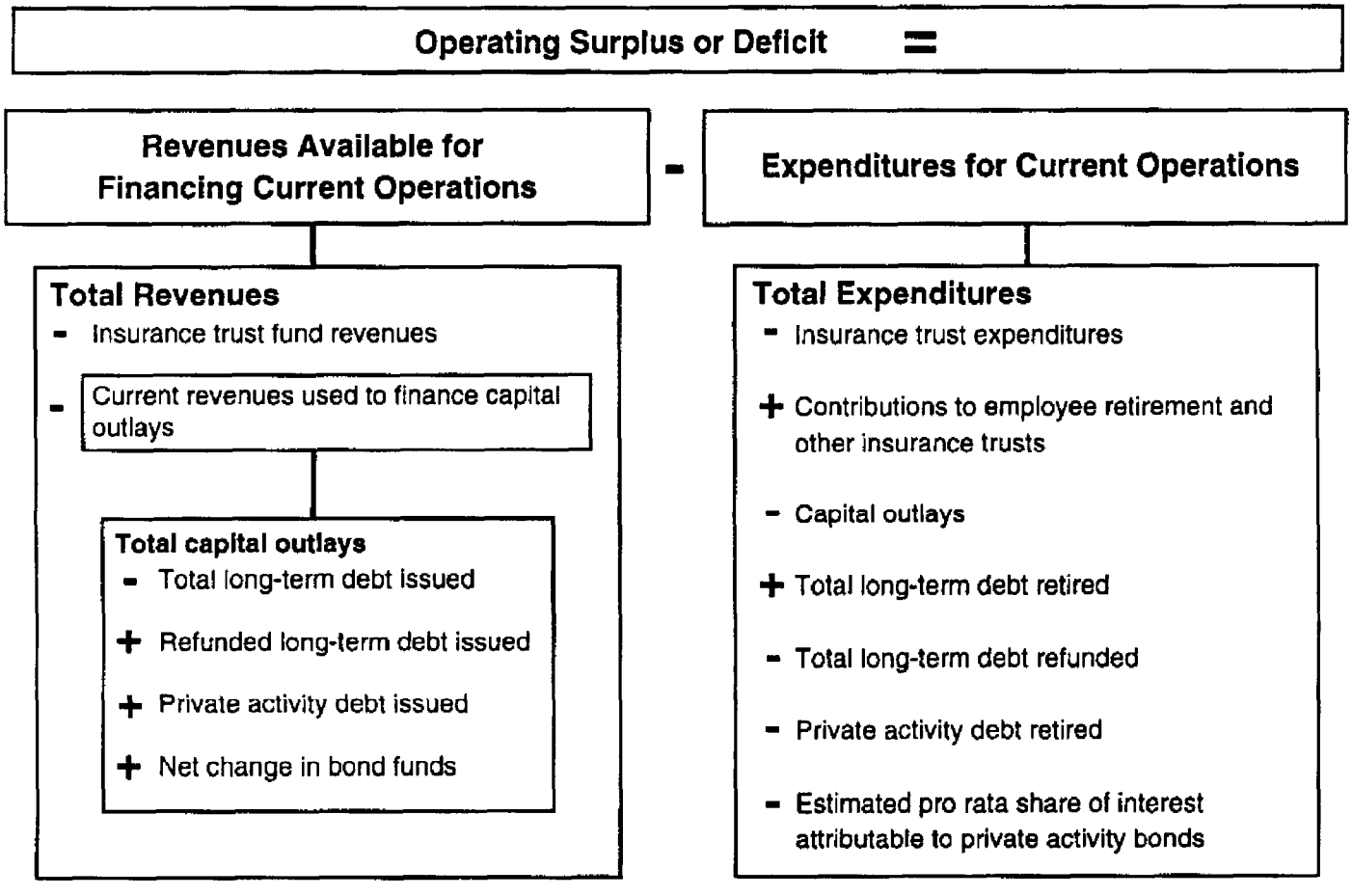
Methodologies for Calculating Comprehensive Surplus/Deficit and Operating Surplus/Deficit

We calculated the comprehensive surplus/deficit measure simply by subtracting total expenditures from total revenues, as these concepts are defined and reported in the Census government finance accounts. For example, Census does not treat borrowed funds as revenues or debt principal repayment as expenditures. The operating surplus/deficit is a more complex measure that we developed in consultation with experts. It combines various elements of the Census accounts as described in figure VI.1. Both measures are calculated as a percentage of expenditures (total expenditures for the comprehensive measure, operating expenditures for the operating measure) to factor out the effects of inflation over the years and to put the results on a comparable basis across jurisdictions (and levels of government) with different sized budgets.

We estimated the operating surplus/deficit results for 1986 and 1987 by interpolating between our results for 1985 and 1988. (These estimates are presented as shaded areas in figs. VI.3 and VI.5.) We did this because the application of our formula for calculating operating surplus or deficit produced unusual patterns in these 2 years, particularly in portions of the formula related to debt. On the basis of discussions with Census officials

[3]Because our analysis of short-term financial condition uses Census data, we also use Census's definition of private activity debt. Census defines public debt for private purposes as "credit obligations of a government or any of its dependent agencies for the purpose of funding private sector activities, including debt that is backed solely by the private organization(s) involved....Examples of private sector activities funded include industrial and commercial development, pollution control, housing and mortgage loans, private hospital facilities, student loans, and such private ventures as sports stadiums, convention centers, and shopping malls." This definition is broader than the private activity debt defined in the federal tax code. Although state or local governments may not be legally obligated to repay any portion of such private activity bonds, in rare instances they have chosen to do so upon default by the private entities involved.

Figure VI.1: Formula for Calculating Operating Surplus or Deficit



Revenues: Revenues included in this measure are all non-borrowed funds available for financing current operations. However, revenues reported by Census include those used to finance current operations as well as those used for capital improvement. Consequently, our measure of revenues nets out revenues used to finance capital outlays, including only revenues available for financing current operations.

Revenues available for financing current operations are calculated by excluding from total revenues insurance trust revenues and current revenues used to finance capital outlays. Current revenues used to finance capital outlays are approximated by subtracting capital expenditures financed from newly and previously issued governmental debt from total capital expenditures.

Expenditures: Expenditures included in this measure are all expenditures made for current operations, including contributions to employee retirement and other insurance trusts and repayment of long-term debt (as a proxy for capital consumption). Capital outlays and insurance trust fund expenditures are excluded, however, since they do not constitute a cost of current governmental activities. Expenditure transactions related to private activity bonds are also excluded.

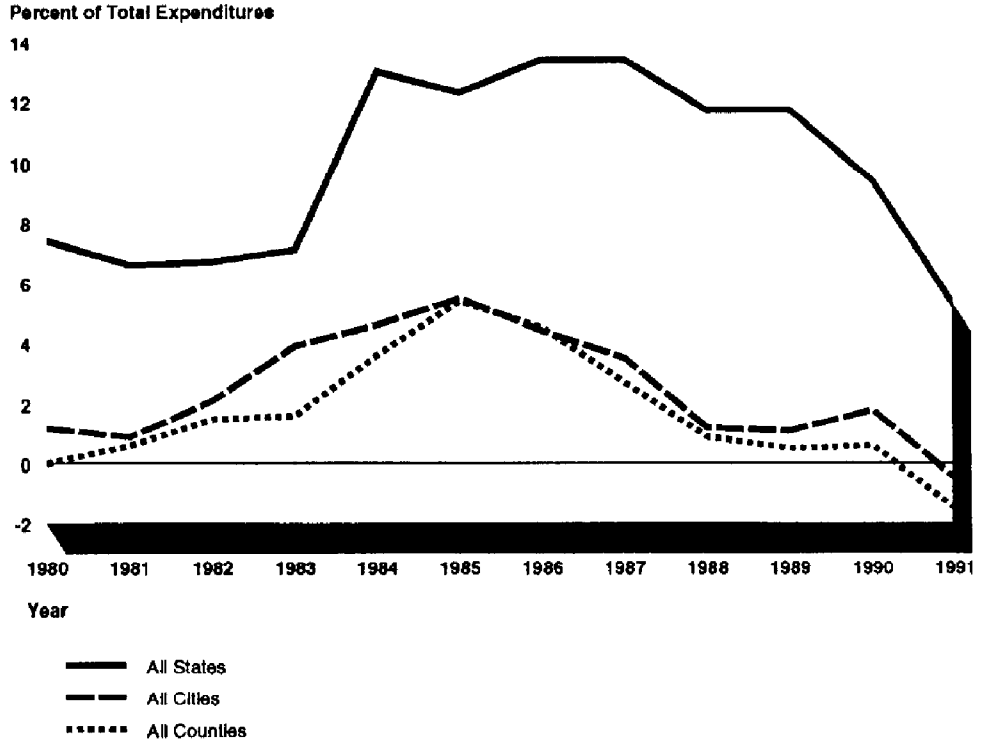
and other experts, we believe these unusual results were caused by one-time responses by state and local governments to institutional factors, such as the Tax Reform Act of 1986 and other tax law changes. Consequently, our results for the previous and later years were not affected.

Surpluses Deteriorated in Late 1980s to Early 1990s

Despite some differences in results between the comprehensive and operating measures and among the three levels of government, the overall trends in surpluses/deficits are similar, as seen in figures VI.2 and VI.3. Generally, surpluses were relatively low or declining in the early 1980s, increased substantially to peak at relatively high levels by 1984 or 1985, and then declined in the late 1980s to levels about the same as in the early 1980s. By 1991, surpluses were at lower levels than at any time in the preceding decade, and cities and counties fell into deficit on the comprehensive surplus/deficit measure.

Throughout the 1980 through 1991 period, states, cities, and counties showed generally similar patterns of operating surpluses as a percent of operating expenditures, with counties at a slightly higher level in most years and cities at a somewhat lower level in several years (see fig. VI.3). On the comprehensive surplus/deficit measure, however, states had much higher surpluses as a percentage of expenditures than either cities or counties. Cities and counties had very similar levels and patterns of comprehensive surpluses and deficits (see fig. VI.2).

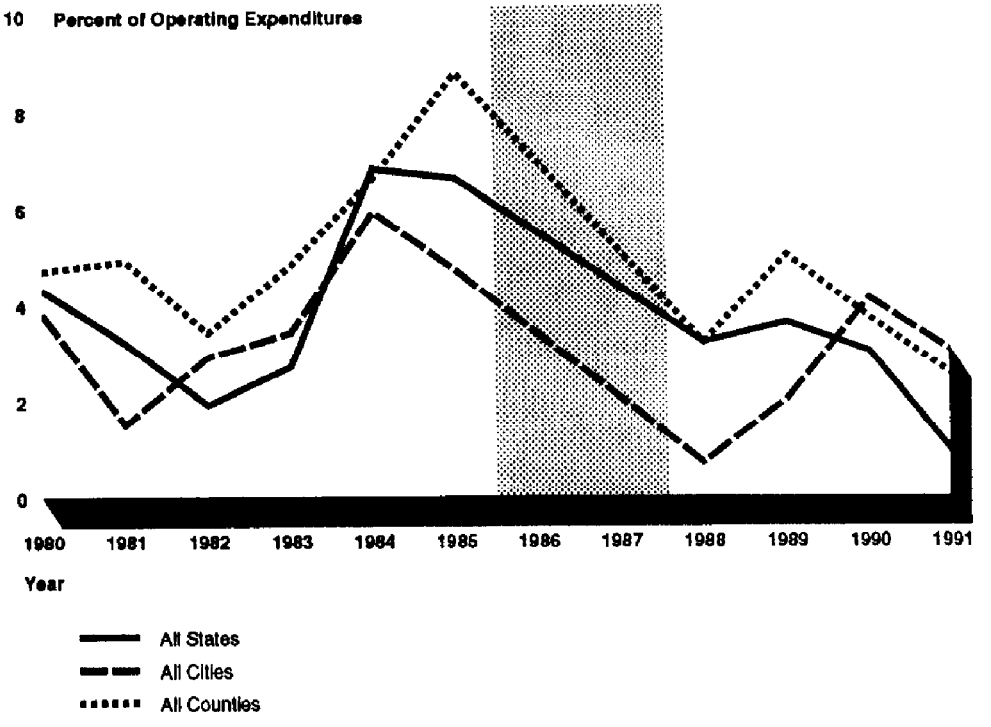
Figure VI.2: Comprehensive Surplus/Deficit



(Percent of Total Expenditures)

Year	All States	All Cities	All Counties
1980	7.4	1.2	0.0
1981	6.6	0.9	0.6
1982	6.7	2.1	1.5
1983	7.1	3.9	1.6
1984	13.0	4.6	3.6
1985	12.3	5.5	5.4
1986	13.4	4.4	4.5
1987	13.4	3.5	2.7
1988	11.7	1.2	0.9
1989	11.7	1.1	0.5
1990	9.4	1.8	0.6
1991	5.2	–0.5	–1.5

Figure VI.3: 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

From our data, there appears to be an influence of the economy on state, city, and county surpluses and deficits, particularly in the latter part of the 1980 to 1991 period.[4] The trends in both comprehensive and operating surpluses for states, cities, and counties roughly track the trends in the annual percentage change in GDP (see fig. VI.4). However, the operating surplus/deficit measure appears to be more volatile in response to the economy. It is also interesting to note that in 1982 and 1991—the 2 years the economy experienced the lowest negative overall growth—state, city, and county operating surpluses fell but did not go into deficit. This may have occurred because, in the aggregate, these governments acted to maintain favorable budgetary conditions despite downward pressures from the economy.

The comprehensive and operating surplus/deficit measures are most similar for cities, showing roughly similar patterns and levels. For states, however, the comprehensive surplus is at a much higher level in all years than the operating surplus. For counties, the opposite is true: their surpluses are higher when measured by the operating measure than by the comprehensive measure.[5]

[4]It was beyond the scope of this study to determine the extent of the effects of changes in the business cycle on the surpluses of state and local governments. Other researchers have found that state and local surpluses and deficits are responsive to cyclical changes in the economy, but that other factors, such as rising health care costs, are also very significant. See, for example, Edward M. Gramlich, The 1991 State and Local Fiscal Crisis, Brookings Papers on Economic Activity, Vol. 2, 1991 and Andrea L. Kusko and Laura S. Rubin, State and Local Fiscal Indicators, Board of Governors of the Federal Reserve System, Working Paper Series Number 132, April 1993.

[5]One of the main factors causing comprehensive surpluses to exceed operating surpluses at the state level is that surpluses of state insurance trust funds, which typically are actuarially funded and in a number of states also cover local employees, help to offset state capital spending. For example, net trust fund surpluses exceeded capital spending in 6 of the 12 years we examined. In contrast, counties' capital spending outweighed their trust fund surpluses in each year from 1980 to 1991, contributing to operating surpluses that were higher than surpluses on the comprehensive measure.

Figure VI.4: Annual Percent Change in Gross Domestic Product

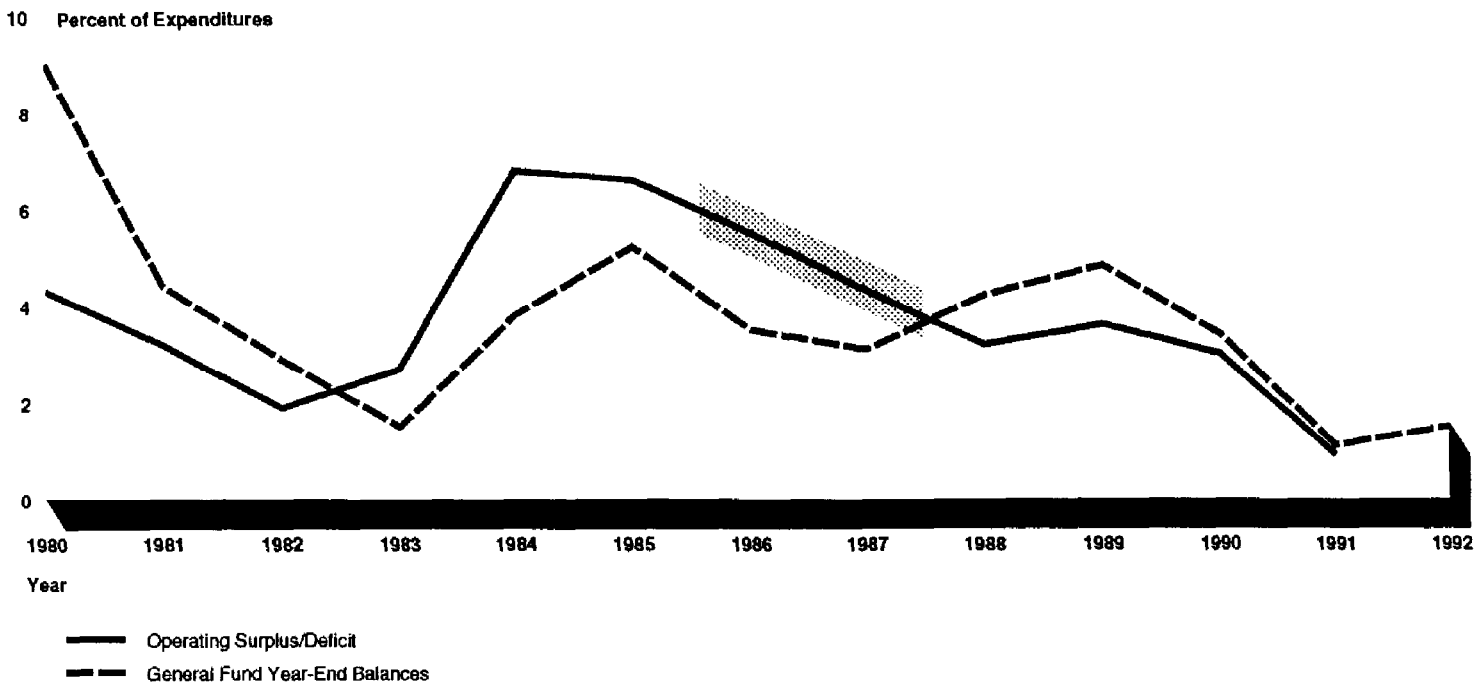
(Percent)

Year	
1980	–0.5
1981	1.8
1982	–2.2
1983	3.9
1984	6.2
1985	3.2
1986	2.9
1987	3.1
1988	3.9
1989	2.5
1990	0.8
1991	–1.2

Note: Percent changes are based on GDP measured in constant 1987 dollars.

State operating surpluses also track state year-end balances reported by the National Governors' Association and National Association of State Budget Officers fairly closely, even though the two measures differ in their coverage of financial transactions (see fig. VI.5). If this relationship continues to hold, the upturn in state general fund balances reported for 1992 and estimated for 1993 implies improved state operating surplus positions beyond 1991. Data from the National League of Cities on the percentage of cities reporting ending balances of 5 percent or more and –5 percent or less also indicate a deterioration in the budgetary condition of cities between 1985 and 1991; however, unlike for states, these data show a continuing deterioration through 1992.

Figure VI.5: State Operating Surplus/Deficit and General Fund Year-End Balances



Percent of Expenditures

Year	Operating Surplus/Deficit	General Fund Year-End Balances
1980	4.3	9.0
1981	3.2	4.4
1982	1.9	2.9
1983	2.7	1.5
1984	6.8	3.8
1985	6.6	5.2
1986	5.5	3.5
1987	4.3	3.1
1988	3.2	4.2
1989	3.6	4.8
1990	3.0	3.4
1991	0.9	1.1
1992	NA	1.5

(Figure notes on next page)

Notes: Shading indicates that operating surplus/deficit data points for 1986 and 1987 are interpolated between those for 1985 and 1988.

Data on state general fund year-end balances are from the National Governors' Association and National Association of State Budget Officers.

Other Indicators of Short-Term Financial Condition Do Not Show Deterioration

Our three other measures of short-term financial condition—cash and security holdings, long-term debt, and short-term debt—do not show the deterioration seen in our measures of surplus/deficit. For the 1980 through 1991 period, all three levels of government show trends for these three indicators that are generally stable or improving.

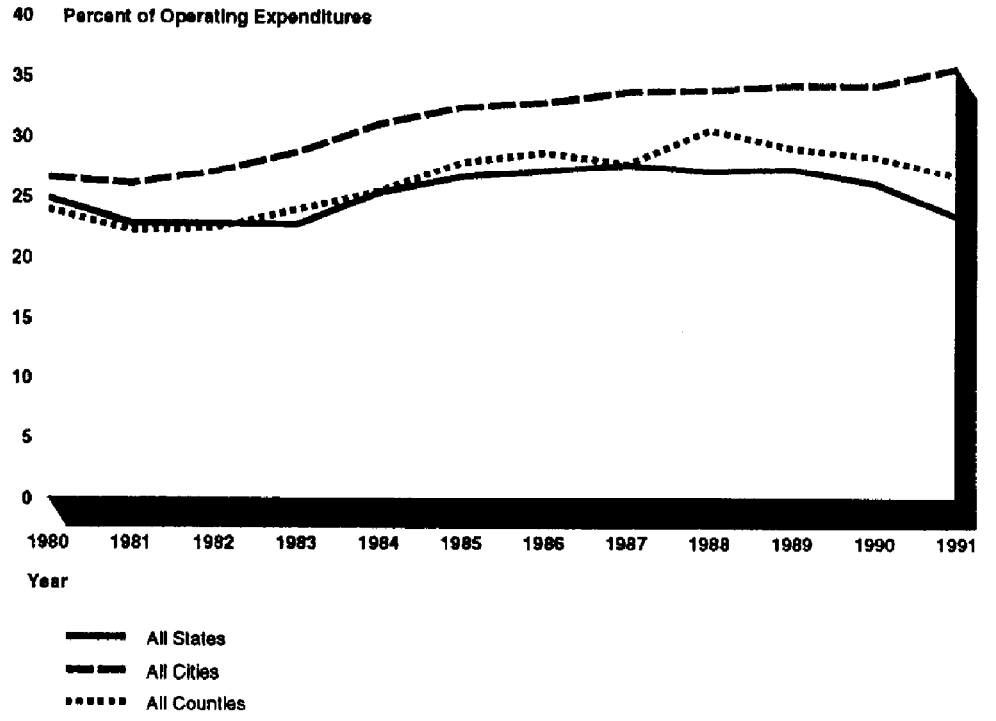
Cash and Security Holdings

Our measure of cash and security holdings includes cash and security holdings of all funds and accounts except those of insurance trust systems, offsets to debt, and bond funds. This is the narrowest measure of cash and securities reported in the Census accounts, but because it includes holdings of such accounts and funds as utilities, liquor stores, capital project funds not financed by bond issues, and endowment funds, this concept is broader than cash and security holdings of general funds or "rainy day" funds reported in most state or local budgets. Like our measures of surplus/deficit, this indicator is calculated as a percentage of operating expenditures to give it a perspective relative to total finances.

The value of cash and securities is reported in the Census accounts as of the last day of the government's fiscal year. Thus, the trend in our measure over time provides an indication of whether the cash and security holdings position of states, cities, and counties is improving (increasing) or weakening (decreasing).

Figure VI.6 shows that the cash and security holdings indicator for each of the three levels of government in the aggregate improved in the period 1980 through 1991. Cities had the highest and most improved level of cash and security holdings as a percentage of operating expenditures. Even though the indicator for states and counties leveled off and turned slightly downward in the latter part of the 1980s, their 1991 values were still above their lowest points of the early 1980s.

Figure VI.6: Cash and Security Holdings



(Percent of Operating Expenditures)

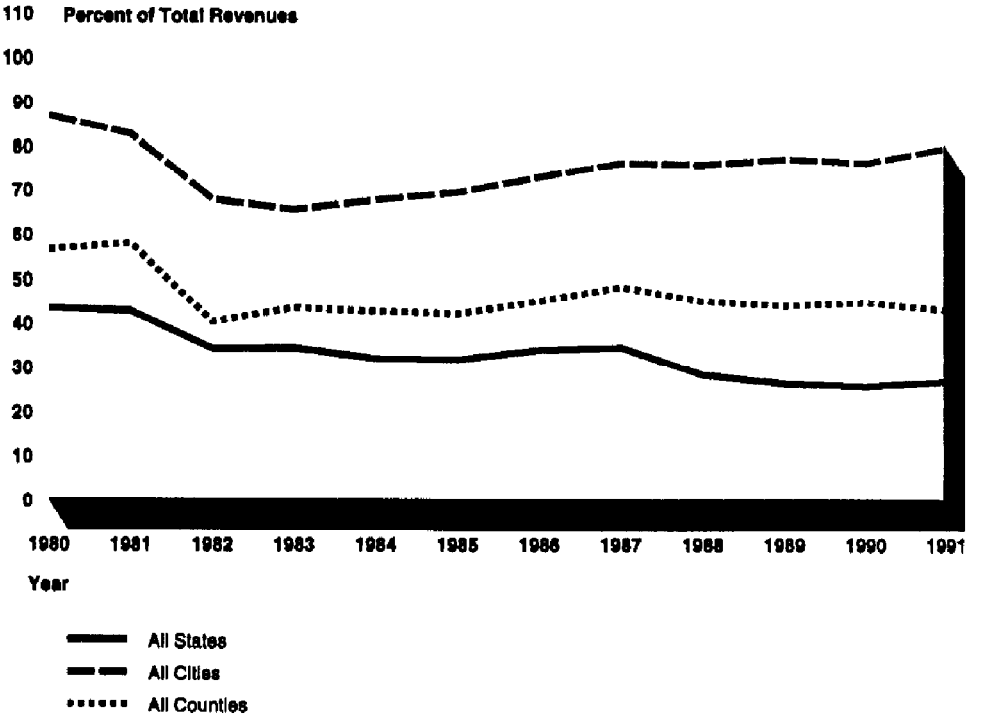
Year	All States	All Cities	All Counties
1980	25	27	24
1981	23	26	22
1982	23	27	22
1983	23	29	24
1984	25	31	25
1985	27	32	28
1986	27	33	29
1987	28	34	28
1988	27	34	31
1989	27	34	29
1990	26	34	28
1991	23	36	27

Long-Term Debt

Our indicator of long-term debt consists of long-term debt outstanding at the end of the fiscal year as a percentage of total revenues. It includes both full faith and credit debt and nonguaranteed debt except for private activity debt. As in our measure of operating surplus/deficit, we have excluded all private activity debt because such debt is normally repaid by the private entity on whose behalf the debt was issued. We have measured long-term debt relative to total revenues because the principal and interest on such debt is paid from such revenues.

Figure VI.7 shows that all three levels of government had improved (decreased) positions on the long-term debt indicator net of private activity bonds in 1991 compared to 1980. States had the lowest and most improved long-term debt position for the period. Counties' long-term debt increased after 1982 but was still at a lower level in 1991 than in 1980. Cities experienced the highest level and steadiest increase in this indicator between 1983 and 1991. Nevertheless, their long-term debt position was lower in 1991 than it had been in 1980.

Figure VI.7: Long-Term Debt Outstanding Net of Private Activity Debt

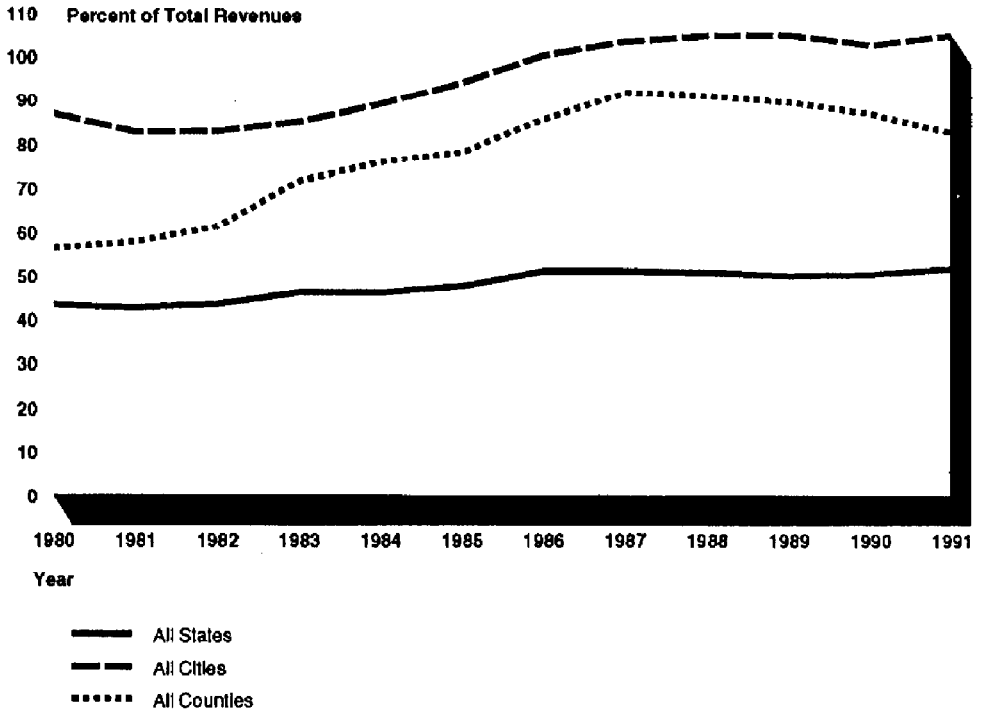


(Percent of Total Revenues)

Year	All States	All Cities	All Counties
1980	43	87	56
1981	43	83	58
1982	34	68	40
1983	34	65	43
1984	32	68	43
1985	32	69	42
1986	34	73	45
1987	34	76	48
1988	28	76	45
1989	26	77	44
1990	26	76	45
1991	27	80	43

If private activity debt is not excluded from long-term debt, however, all three levels of government show increases in their total long-term debt between 1980 and 1991. Furthermore, cities and counties show higher and faster growing levels of debt than states when private activity debt is included (see fig. VI.8).

Figure VI.8: Total Long-Term Debt Outstanding



(Percent of Total Revenues)

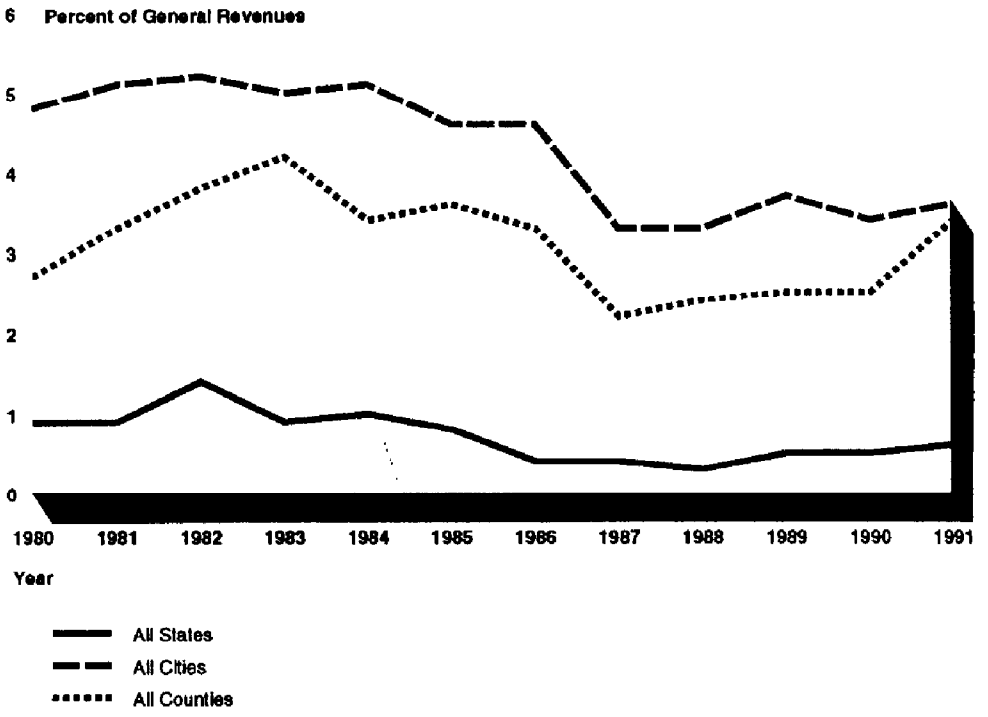
Year	All States	All Cities	All Counties
1980	43	87	56
1981	43	83	58
1982	43	83	61
1983	46	85	72
1984	46	89	76
1985	48	94	78
1986	51	100	86
1987	51	103	92
1988	51	105	91
1989	50	105	89
1990	50	103	87
1991	52	105	82

Short-Term Debt

Our indicator of short-term debt is debt outstanding at the end of each fiscal year as a percentage of general revenue. Short-term debt is defined as interest-bearing debt payable 1 year or less from its date of issue or having no fixed maturity date. Although the use of short-term debt often reflects anticipation of bond sale receipts or the timing of other tax or revenue collections, it is also sometimes used to cover shortfalls in operating funds. As an indicator of short-term financial condition, therefore, we measure short-term debt relative to general revenue because general revenues are the closest Census category to revenues from which operating funds are financed.

Although many states, cities, and counties used no short-term debt in the period we examined, in the aggregate cities had the most short-term debt relative to revenues (between 3 and 5 percent of general revenues) and states the least (less than 1 percent of general revenues in most years). All three levels of government experienced improvement (decreases) in their short-term debt positions between 1984 and 1987 and a leveling off or increase thereafter. Counties experienced a relatively sharp increase between 1990 and 1991. But short-term debt positions in 1991 for all three levels were still below their highest points in the early 1980s (see fig. VI.9).

Figure VI.9: Short-Term Debt Outstanding



(Percent of General Revenues)

Year	All States	All Cities	All Counties
1980	0.9	4.8	2.7
1981	0.9	5.1	3.3
1982	1.4	5.2	3.8
1983	0.9	5.0	4.2
1984	1.0	5.1	3.4
1985	0.8	4.6	3.6
1986	0.4	4.6	3.3
1987	0.4	3.3	2.2
1988	0.3	3.3	2.4
1989	0.5	3.7	2.5
1990	0.5	3.4	2.5
1991	0.6	3.6	3.4

Definition and Measurement of Fiscal Capacity

We observed widespread disparities among states and large cities in 1990 regarding the level of public services they could afford. More importantly, for cities, these disparities had grown over a 20-year period between 1970 and 1990. In contrast to cities, we observed narrowed disparities among states during the same period.

In this appendix, we discuss in more detail our approach to measuring fiscal capacity among the 50 states and 56 largest cities. This appendix also presents additional analysis results to further demonstrate the extent and nature of fiscal disparities.

Fiscal Capacity Defined

In this report, fiscal capacity pertains to whether a jurisdiction, if it imposed an average tax burden on its residents, would be able to raise enough revenues to finance average expenditure levels for services for its residents.[1] Governments able to do this and still have discretionary revenues left for additional uses would be considered fiscally strong, and jurisdictions without sufficient revenues to finance such services would be considered fiscally weak.

The amount of expenditures required to provide average public service levels, also referred to as expenditure needs, reflects a jurisdiction's needs for public services and the costs of providing services. How extensive these needs are in a particular location depends on various socioeconomic factors, such as poverty concentrations, crime rates, and other elements that affect the amount a government spends for public services. For example, spending for public safety, transportation, and recreation tends to be greater for cities with a large concentration of poor people than cities with lower poverty levels. Moreover, public service costs (that is, the amount that a jurisdiction pays to provide public services) are largely influenced by the prevailing prices and wages in the jurisdiction's private sector.

As for the amount of revenues a jurisdiction could raise through an average level of taxation, this reflects the jurisdiction's financial resources that could be taxed. In our analysis, these taxable resources are measured by the total income produced in a jurisdiction. Similar to public service needs, taxable resources are affected by socioeconomic factors, such as resident income, which could change with a flight of businesses and high income residents from one jurisdiction to another. Additional factors that

[1]An average expenditure level is defined as the nationwide average per capita spending across all jurisdictions. Similarly, an average tax burden is defined as the nationwide average.

may influence a jurisdiction's taxable resources include the value of its retail sales and commercial and industrial property.

Fiscal disparities between jurisdictions reflect differences in their fiscal capacity. Because fiscal disparities arise largely from differences in socioeconomic factors that local governments have limited ability to control, minimizing disparities may require outside federal or state aid. Such intergovernmental aid could offset significant imbalances between average public service expenditures and the resources to finance them.

GAO's General Approach

To measure fiscal capacity we relied on existing methodologies to construct an index. In effect, the index approximates the gap between (1) the amounts that would be required to provide average expenditure levels for services in a jurisdiction, considering local price and wage levels and (2) the revenues that the jurisdiction could raise from its taxable resources, assuming imposition of an average level of taxation. The index measures fiscal capacity for each jurisdiction relative to the national average. Because it depicts relative differences among jurisdictions at a point in time, the index is not designed to show the fiscal capacity of an aggregation of jurisdictions—say, all 50 states—or how the fiscal capacity of all 50 states changed over time. In addition, the index does not explicitly reflect the effects of policy choices or the performance of public officials in delivering the services they provide. This is because expenditure needs and taxable resources are largely determined by underlying socioeconomic factors that are, in the short run, largely beyond the control of decisionmakers.[2]

We computed fiscal capacity indices for the 50 states and 56 largest cities. We did not perform a full-fledged analysis of fiscal capacity for counties because the methodologies we used do not yield explicit results for that level of government.[3] Fiscal capacity indices were computed for 1970, 1980, and 1990, the years for which Decennial Census data were available.[4] Moreover, we thought it important to take a 20-year look at fiscal capacity

[2]In the long-term, local government officials could have the ability to alter socioeconomic characteristics that affect fiscal capacity. For example, through economic development strategies, a jurisdiction may improve its prospects for employment and business opportunities, thus potentially increasing its per capita income and decreasing poverty levels.

[3]In analyzing the relationship between fiscal capacity and budgetary condition, however, we used per capita income as a proxy indicator of fiscal capacity for counties (see app. VIII for more details on this analysis).

[4]For our 1990 analysis, we used the original (that is, unadjusted) estimates from the 1990 Decennial Census.

because differences in per capita income and other socioeconomic factors change gradually.

Since no single approach was available that could be used to analyze the fiscal capacity of both states and large cities, we selected different approaches to construct fiscal capacity indices for states and for large cities. Furthermore, because of time and data constraints, we used our adaptations of these approaches and, where possible, made efforts to refine them. A discussion of these methods follows.

Calculating State Fiscal Capacity

In developing the fiscal capacity index for the 50 states, we combined two separate measures. One measure approximates the level at which a state would have to spend to finance services at average expenditure levels, considering local cost factors, and the other measure estimates the state's taxable resources. By computing the difference between these components, we were able to measure fiscal capacity for each state.

Average Expenditure Levels

To identify the level of spending that a jurisdiction would have to make to finance services at average levels, we relied on the 1990 version of the "Representative Expenditure System" (RES), an economic model developed for the U.S. Advisory Commission on Intergovernmental Relations.[5] This 1990 version was an update of the original RES developed in 1987. The RES, in effect, identifies a hypothetical spending total for each state that summarizes what the state would have to spend to finance services at average levels in seven functional categories: Elementary and Secondary Education, Higher Education, Public Welfare, Health and Hospitals, Highways, Police and Corrections, and All Other Direct General Expenditures.[6]

For each category, the model identifies workload factors thought to influence the level of expenditures. For example, in Elementary and Secondary Education, the number of school-age children is a factor. In the Public Welfare category, the number of people in poverty is used. The model requires a computation of the national average expenditures per workload unit—for example, average expenditures per school-age child. Once this is known, the expenditures needed in a given state to finance

[5]Dr. Robert W. Rafuse, Jr. (U.S. Department of the Treasury) developed the 1987 RES for the Advisory Commission.

[6]The RES takes into account public service needs for all governments within a state, including counties and special districts.

services at average levels is computed by multiplying the national average amount (e.g., average expenditures per school-age child across the nation) by the state's workload units (e.g., number of school-age children in the state). Similar computations are made in the other functional categories.[7]

Additionally, under the RES approach, the average level of expenditures in each functional category is adjusted by a factor that accounts for differences in prices governments pay to provide public services. Generally, this cost factor reflects each state's average labor costs relative to the national average.

We made certain adjustments to the RES model in an effort to improve our estimates of national average expenditure levels. These adjustments included modifying the poverty rates used in the categories of Public Welfare, Elementary and Secondary Education, and Health and Hospitals to reflect the interstate differences in cost-of-living. This adjustment accounts for the differing spending levels for high and low cost states in the expenditures needed to provide assistance to persons in poverty. Additionally, we conducted analyses to better define the socioeconomic factors that influence the All Other Direct General Expenditures category.[8] In the process of developing these adjustments, we conferred with experts knowledgeable about the RES, including officials at Treasury and the Office of Management and Budget.

We also performed regression analysis on the 1990 RES to isolate the few significant socioeconomic factors that influence the various categories of public service expenditures. This gave us an abbreviated and easy-to-use RES model, into which we could input Census data for the years of our fiscal capacity analysis. The regression results revealed that a state's poverty rate, percentage of population ages 5 through 17, and amount of nonfederal land area were statistically significant variables that account for interstate differences in expenditure needs (see table VII.1).[9]

[7]For further details on the Representative Expenditure System, see Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity, Advisory Commission on Intergovernmental Relations (Dec. 1990). Also, the 1990 version of the RES, currently unpublished, builds on its predecessor as seen in its methodological refinements and use of more recently available information, such as data from the 1990 Decennial Census.

[8]Using regression analysis, we identified urban population, nonfederal land area, and poverty rates as significant socioeconomic factors for this category. The RES uses only total population.

[9]We did not conduct a full-fledged statistical analysis on our abbreviated version of the 1990 RES to gauge the stability over time of the regression coefficients for each explanatory variable.

Table VII.1: Regression Analysis of the Representative Expenditure System

Variable	Coefficient	t-statistic
Poverty	0.182	18.4
Children, ages 5 to 17	0.239	7.3
Non-federal land area	0.006	6.5
Constant	0.573	19.0

Adjusted R square = .9460

Notes:

1. These regression results exclude the District of Columbia.

2. The data used in the regression analysis were in index form. The shares of a variable were divided by the population shares. For example, the poverty variable was constructed by calculating each state's share of the U.S. poverty population and dividing by each state's share of the nation's total population.

We used the abbreviated RES to compute what each state would have to spend to finance public services at average spending levels. To do this, we multiplied Census data for each explanatory variable by its regression coefficient. Separate computations were performed for 1970, 1980, and 1990. For each year, we then adjusted these results by a cost index which reflects differences in the amount that each state pays to provide public services. In deriving this cost index for a particular state, we measured its average annual wages earned by private sector employees against a national average.[10]

Taxable Resources

To gauge the amount of revenues a jurisdiction could raise to finance an average level of public service spending, we used each state's total taxable resources (TTR) for the study years. As defined and compiled by the Department of Treasury, TTR is the average of a state's per capita personal income (PCPI) and per capita gross state product (GSP). GSP measures all income produced within a state, whether received by residents, nonresidents, or retained by business corporations.

We consider TTR to be a more comprehensive indicator of taxable resources than other indicators, such as PCPI alone, partly because it encompasses income subject to tax exporting, which arises when jurisdictions tax in various ways the resources of nonresidents. In

[10]We computed separate cost indexes for 1970, 1980, and 1990 because such calculations for all 3 years were not made in the 1990 version of the RES. For our computations, we used average annual wages for private sector employees because comparable wage information for public-sector employees was not available for the years we studied. We obtained data on private-sector wage levels from surveys published by the U.S. Bureau of Labor Statistics.

addition, TTR has demonstrated technical and policy acceptance, as evidenced by its current use in certain block grant formulas—for example, in the Alcohol, Drug Abuse and Mental Capacity block grant program.

To develop the fiscal capacity index for each state, we computed the difference between its TTR and the cost-adjusted RES factor. States with above-average fiscal capacity had positive indices, indicating that they could finance public services at nationwide average levels and have discretionary taxable resources left over to finance an additional level or quality of public services. Alternatively, states with below-average fiscal capacity had negative indices. Their taxable resources fell short of being able to finance services at average levels. Consequently, these states would require help from outside sources, such as intergovernmental aid, to finance an average level of services with an average tax burden on state residents.

Calculating City Fiscal Capacity

To measure fiscal capacity for the 56 largest cities, we drew upon an economic model developed by Drs. Helen Ladd (Sanford Institute of Public Policy, Duke University) and John Yinger (Maxwell School of Public Administration, Syracuse University). The Ladd/Yinger model produces a fiscal capacity score for each jurisdiction, reflecting the degree to which a jurisdiction can finance an average level of expenditures on services with an average tax burden.[11] The researchers define taxable resources as the amount of revenue a unit of government could raise from broad-based taxes at a nationwide average tax burden on its residents. To measure taxable resources, Ladd and Yinger start with the income of city residents. They then calculate how much a city could raise by applying a standard tax burden using three common taxes: a property tax, a sales tax, and an earnings (or income) tax. To account for the tax-paying ability of nonresidents, the model contains a measure for tax exportation.

Ladd and Yinger define expenditure needs as the amount a city must spend per capita to obtain a national average level of public services. To compute this, the researchers use two different types of variables: (1) indicators of need for public services, such as the number of disadvantaged residents, the number of commuters, and the quality of a

[11]The Ladd/Yinger model considers the level and cost of public services delivered within a city. The model produces results that may reflect public services provided by overlying counties as well as central cities. Ladd and Yinger refer to their research as an analysis of "fiscal health." For more information on the Ladd/Yinger model, see America's Ailing Cities: Fiscal Health and the Design of Urban Policy (The Johns Hopkins University Press, 1989).

city's infrastructure and (2) a public service cost factor, reflecting the wages of workers and general price indexes.

In our judgment, the Ladd/Yinger model represents the best available approach to measuring cities' fiscal capacity, primarily because it uses regression analysis to isolate significant explanatory factors and incorporates a measure of a jurisdiction's ability to tax nonresident incomes (tax exportation).

Ladd and Yinger also present a "simplified" version of their full model. This approach identifies socioeconomic factors that are correlated with scores for a jurisdiction using the more complete and complex model. These socioeconomic factors pertain to both the expenditure needs side as well as the taxable resource side. According to this simplified model, the following seven factors are significant to fiscal capacity: population, per capita income, poverty rate, old housing, central city share of metropolitan population, unemployment rate, and the change in population over the period under study.[12] For each factor, the researchers identified a coefficient. A city's fiscal capacity is then derived by multiplying the data for each factor by the coefficient.

We decided to use the Ladd/Yinger simplified model, believing it to be well-suited for our purposes. Calculating fiscal capacity from the simplified Ladd/Yinger model involved a three-step approach. First, we incorporated relevant Census data for 1970, 1980, and 1990 into the model to produce an index for each of the 56 cities. Second, for each year we computed an average index for all 56 cities and scaled the results so that the fiscal capacity of the average city equaled zero. Finally, indices for 1980 and 1990 were compared against 1970 to provide a common base for determining whether a city's relative fiscal capacity improved, declined, or remained constant over time.

This index shows the fiscal capacity for each city relative to the national average for the 56 largest cities. Hence, cities with below average fiscal capacity had negative indices, while positive indices depicted cities with above-average capacity. As with the index for states, a positive or negative

[12]The simplified version of the model explains nearly 80 percent of the variation in the complete model's fiscal health results. The regression coefficients for the seven factors are as follows: population (in millions) –10.6; per capita income (in thousands) +4.9; poverty rate (in percentages) –1.2; old housing (in percentages) –0.2; share of metropolitan population (in percentages) –0.5; unemployment rate (in percentages) –2.2; change in population (in percentages) +0.2. The coefficient of the constant term was not reported. According to Ladd and Yinger, all the coefficients are statistically significant.

value reflects each city's ability to finance an average level of public services with its taxable resources.

Analysis Results

We measured the extent of and change in fiscal disparities among the 50 states and 56 largest cities. To examine differences between the strongest and weakest jurisdictions for 1970, 1980, and 1990, for each year we arrayed indices from highest to lowest and then divided the distribution into quartiles. Jurisdictions with indices in the top quartile were referred to as having the strongest fiscal capacity, while those in the bottom quartile were considered to be the fiscally weakest (see table VII.2). We also examined regional differences in fiscal capacity for states and large cities.

We examined trends in various socioeconomic factors associated with fiscal capacity that were included in our calculations. This analysis is intended to demonstrate the interrelationship between the patterns in disparities existing between the fiscally strongest and weakest jurisdictions and changing demographics.

Reduced Fiscal Disparities for States

Our analysis showed a 32 percentage point gap in fiscal capacity between strongest and weakest states in 1990. On average, the fiscally strongest, if they had used average tax rates, could have financed services at average levels and had discretionary resources left for other uses equal to 18 percent of their total tax revenues. In contrast, states with the weakest fiscal capacity, if they had applied average tax rates, would have needed outside revenue equal to about 14 percent of their total revenues in order to finance an average level of public services.

Figure VII.1 shows regional patterns for 1990. States in the Southwest and Southeast comprised a major portion of the fiscally weakest states, while the Northeast states were dominant among the fiscally strongest.

Figure VII.1: State Fiscal Capacity, 1990

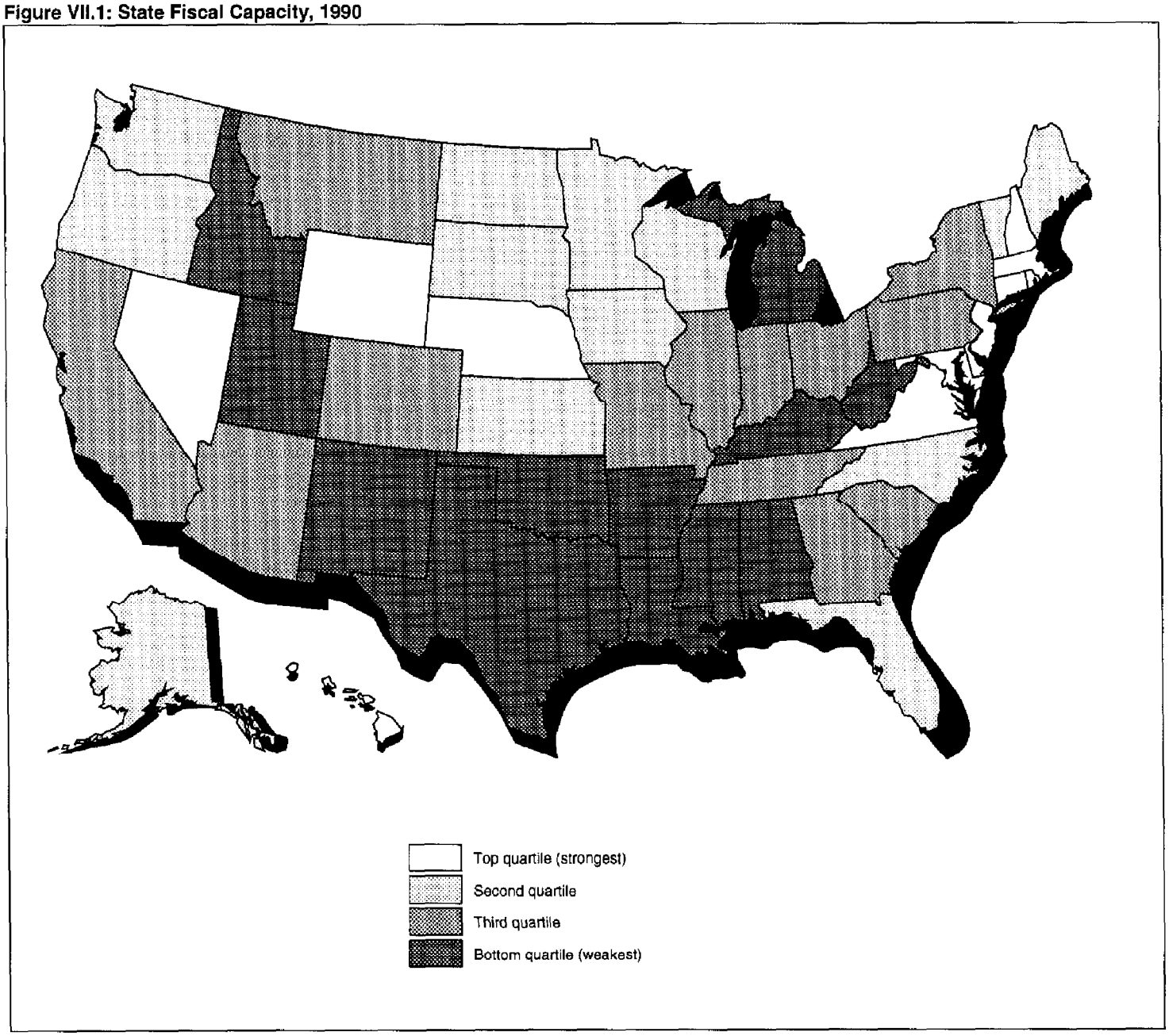
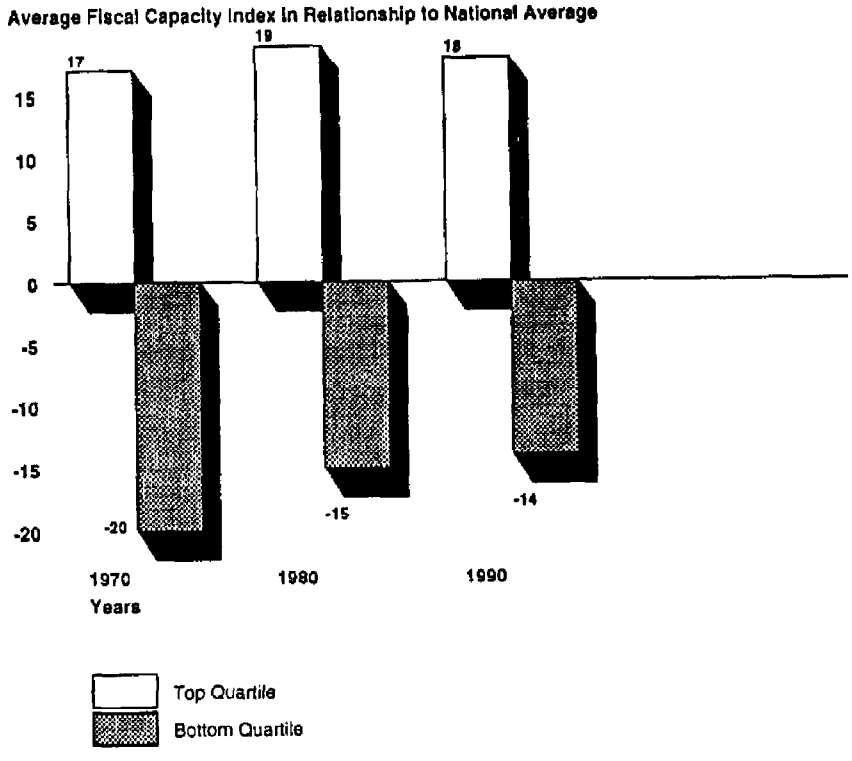


Figure VII.2 shows the narrowed gap between the fiscally strongest and weakest states between 1970 and 1990. Fiscal capacity indexes for the two

groups differed by 37 percentage points in 1970, 34 points in 1980, and 32 points in 1990. The reduced disparity was due primarily to an overall improvement by the weakest states, while the fiscal capacity of the strongest states remained relatively constant. Specifically, the fiscally weakest states rose from roughly 20 to 14 percentage points below average in 1970 and 1990, respectively. Meanwhile, states with the strongest fiscal capacity sustained a level at about 17 percentage points above the national average for each of the 3 years.

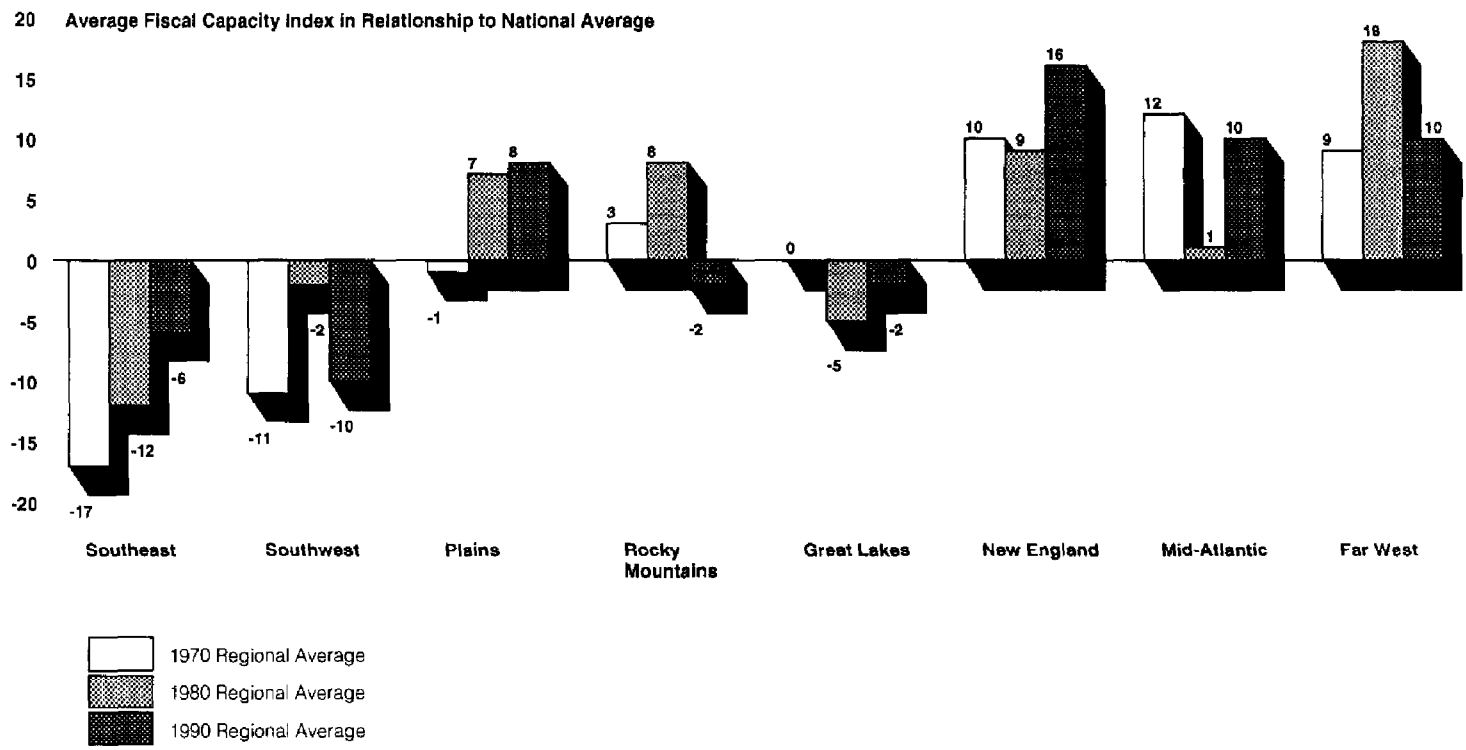
Figure VII.2: Changes in State Fiscal Disparities (1970, 1980, 1990)



Regarding changing disparities among geographic regions, the Plains and Southeast states experienced the greatest improvement in fiscal capacity. The Plains states rose from 1 percentage point below the national average in 1970 to 8 percentage points above in 1990. Meanwhile, Southeast states

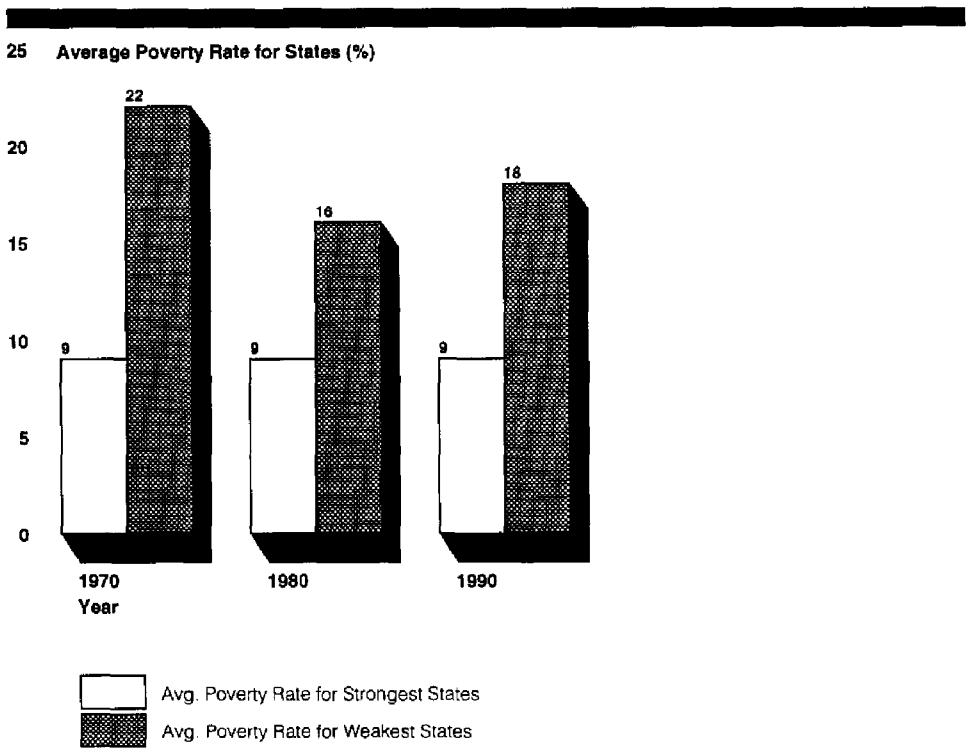
improved in their fiscal capacity from 17 to 6 percentage points below the national average (see fig. VII.3).

Figure VII.3: State Fiscal Capacity by Region (1970, 1980, and 1990)



Changes in socioeconomic factors accounted for the declining fiscal disparities for states. Notably, although the taxable resources for the fiscally weakest states remained stable at about 20 percent below the national average for the years we studied, their poverty rates decreased from 22 percent in 1970 to 18 percent in 1990. Poverty rates for the strongest states remained stable at about 9 percent (see fig. VII.4).

Figure VII.4: Disparities in Poverty Rate Between Bottom Quartile States and Top Quartile States (1970, 1980, and 1990)

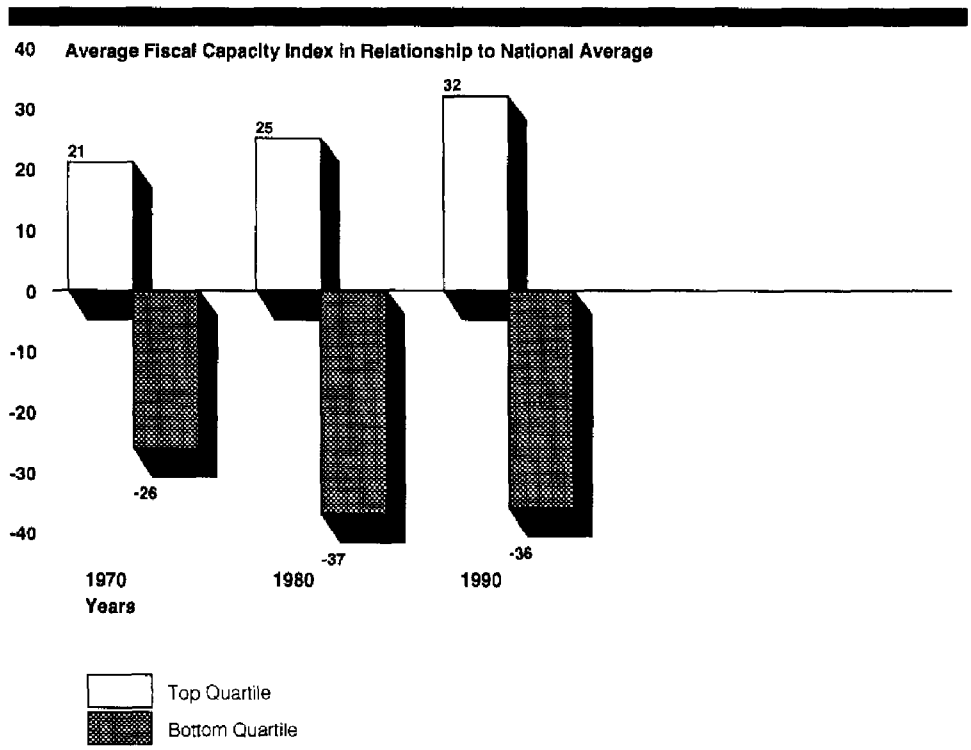


Fiscal Disparities Grew for the Nation's Largest Cities

As with states, our results for the 56 largest cities showed substantial disparities between the fiscally strongest and weakest jurisdictions. In 1990, the gap between the two groups equaled 68 percentage points (+32 versus –36).

Fiscal disparities among the largest cities increased between 1970 and 1990. The gap between the average fiscal capacity indices of cities in the top and bottom quartiles rose 21 percentage points (47 to 68) during this time period, with most of this increase occurring between 1970 and 1980 (see fig. VII.5). The widened fiscal gap over the 20-year period can be attributed to an 11 percentage point improvement in fiscal capacity for the top quartile cities as bottom quartile cities fell by 10 percentage points.

Figure VII.5: Changes in City Fiscal Disparities (1970, 1980, and 1990)



Analysis of cities with populations of 300,000 or more in 1990.

Cities in the Far West, generally a region with fiscally strong large cities, experienced the greatest increase in fiscal capacity from 1970 to 1990. Cities in the Plains states also improved over the 20-year period. In contrast, Midwestern cities, generally among the fiscally weakest, were the only group of cities that experienced a decline in fiscal capacity.

The widened disparities between the fiscally strong and weakest largest cities are associated with changes in per capita income and other socioeconomic factors. Between 1970 and 1990, top quartile cities on average experienced a 44-percent growth in real per capita income, over twice that for cities in the bottom quartile (see fig. VII.6). Meanwhile, the fiscally weakest cities (i.e., bottom quartile) were hurt by significant rises in their unemployment and poverty rates. For these cities, average unemployment increased from 5.3 to 11.5 percent, while the average poverty rate rose from 18.7 to 24.9 percent.

Figure VII.6: Growth In Per Capita Income for Fiscally Strongest and Weakest Large Cities (1970-1990)

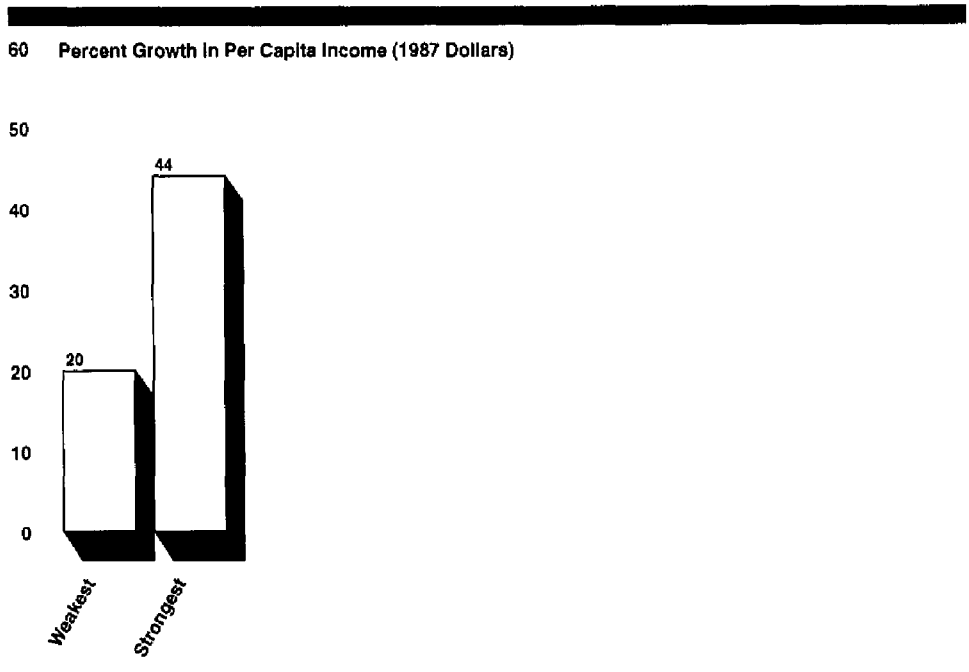


Table VII.2: 1990 Fiscal Capacity Quartiles of States, Large Cities, and Large Counties Based on GAO's Measures

States	Quartile	Cities	Quartile	Counties	Quartile[a]
Alabama	4	Albuquerque, NM	3	Alameda, CA	2
Alaska	2	Atlanta, GA	2	Allegheny, PA	3
Arizona	3	Austin, TX	2	Baltimore, MD	1
Arkansas	4	Baltimore, MD	3	Bergen, NJ	1
California	3	Birmingham, AL	3	Bexar, TX	4
Colorado	3	Boston, MA	2	Broward, FL	2
Connecticut	1	Buffalo, NY	4	Bucks, PA	2
Delaware	1	Charlotte, NC	1	Camden, NJ	2
Florida	2	Chicago, IL	4	Clark, NV	3
Georgia	3	Cincinnati, OH	3	Contra Costa, CA	1
Hawaii	1	Cleveland, OH	4	Cook, IL	3
Idaho	4	Columbus, OH	3	Cuyahoga, OH	3
Illinois	3	Dallas, TX	2	Dade, FL	4
Indiana	3	Denver, CO	1	Dallas, TX	2
Iowa	2	Detroit, MI	4	De Kalb, GA	2
Kansas	2	El Paso, TX	4	Delaware, PA	2
Kentucky	4	Fort Worth, TX	2	Du Page, IL	1
Louisiana	4	Fresno, CA	3	El Paso, TX	4
Maine	2	Honolulu, HI	1	Erie, NY	4
Maryland	1	Houston, TX	3	Essex, MA	2
Massachusetts	1	Indianapolis, IN	2	Esses, NJ	2
Michigan	4	Jacksonville, FL	3	Fairfax, VA	1
Minnesota	2	Kansas City, MO	2	Franklin, OH	3
Mississippi	4	Long Beach, CA	1	Fresno, CA	4
Missouri	3	Los Angeles, CA	3	Fulton, GA	2
Montana	3	Louisville, KY	3	Hamilton, OH	3
Nebraska	1	Memphis, TN	4	Harris, TX	3
Nevada	1	Miami, FL	4	Hennepin, MN	2
New Hampshire	1	Milwaukee, WI	4	Hillsborough, FL	4
New Jersey	1	Minneapolis, MN	1	Hudson, NJ	3

(continued)

States	Quartile	Cities	Quartile	Counties	Quartile[a]
New Mexico	4	Nashville, TN	2	Jackson, MO	4
New York	3	New Orleans, LA	4	Jefferson, AL	4
North Carolina	2	New York, NY	4	Jefferson, KY	4
North Dakota	2	Newark, NJ	4	Kern, CA	4
Ohio	3	Norfolk, VA	3	King, WA	2
Oklahoma	4	Oakland, CA	2	Los Angeles, CA	2
Oregon	2	Oklahoma City, OK	2	Macomb, MI	2
Pennsylvania	3	Omaha, NE	2	Maricopa, AZ	3
Rhode Island	1	Philadelphia, PA	4	Middlesex, MA	1
South Carolina	3	Phoenix, AZ	2	Middlesex, NJ	1
South Dakota	2	Pittsburgh, PA	3	Milwaukee, WI	4
Tennessee	3	Portland, OR	1	Monmouth, NJ	1
Texas	4	Sacramento, CA	1	Monroe, NY	2
Utah	4	San Antonio, TX	4	Montgomery, MD	1
Vermont	2	San Diego, CA	1	Montgomery, OH	3
Virginia	1	San Francisco, CA	1	Montgomery, PA	1
Washington	2	San Jose, CA	1	Multnomah, OR	3
West Virginia	4	Seattle, WA	1	Nassau, NY	1
Wisconsin	2	St. Louis, MO	3	Norfolk, MA	1
Wyoming	1	St. Paul, MN	1	Oakland, MI	1
		Toledo, OH	4	Oklahoma, OK	4
		Tucson, AZ	3	Orange, CA	1
		Tulsa, OK	2	Orange, FL	3
		Virginia Beach, VA	1	Palm Beach, FL	1
		Washington, DC	1	Pierce, WA	4
		Wichita, KS	2	Pima, AZ	4
				Pinellas, FL	3
				Prince George's, MD	2
				Riverside, CA	3

(continued)

States	Quartile	Cities	Quartile	Counties	Quartile[a]
				Sacramento, CA	3
				Salt Lake, UT	4
				San Bernardino, CA	4
				San Diego, CA	2
				San Mateo, CA	1
				Santa Clara, CA	1
				Shelby, TN	4
				St. Louis, MO	1
				Suffolk, NY	2
				Summit, OH	4
				Tarrant, TX	3
				Travis, TX	3
				Tulsa, OK	3
				Union, NJ	1
				Ventura, CA	2
				Wayne, MI	4
				Westchester, NY	1
				Worcester, MA	3

[a]Based on per capita income.

Correlations Between State and Local Government Fiscal Capacity and Short-Term Financial Condition

Our analysis of correlations between state and local government fiscal capacity and short-term financial condition found that large cities with weaker fiscal capacities tended to be in weaker positions on two of four budget indicators we examined. The weaker cities averaged small deficits during the period 1989 to 1991, whereas cities with the strongest fiscal capacities had surpluses that averaged about 9 percent of operating expenditures. Similarly, cities with the weakest capacities had on average significantly smaller cash and security holdings than the strongest cities. However, we found no significant relationship between fiscal capacity and short-term financial condition at the state or large county levels.

We conducted this analysis to test the commonly held assumption that jurisdictions with weaker fiscal capacities tend also to have weaker short-term financial conditions. One might expect this relationship to occur as weaker jurisdictions attempt to finance their relatively high service needs with their lower tax bases. Conversely, jurisdictions with stronger fiscal capacities and higher tax bases may be expected to have less difficulty in financing more moderate service needs. Our results, however, generally did not confirm the assumed relationships between fiscal capacity and short-term financial condition.

Approach

We compared the fiscal capacities of states, large cities, and large counties[1] with their short-term financial conditions, as indicated by the magnitude of their surpluses or deficits, cash and security holdings, and short- and long-term debt outstanding. To make these comparisons, we analyzed average budget indicator values for jurisdictions in the highest and lowest quartiles of fiscal capacity as of 1990 and conducted correlations and statistical tests to identify significant relationships between fiscal capacity and each budget indicator. Budget indicator values for each jurisdiction were based on a 3-year average for the 1989 through 1991 period. Although we identified the statistical significance of each relationship, it was beyond the scope of this review to explain the reasons for the degree of

[1]Absent a readily available model to estimate total taxable resources and representative expenditures for counties, we used per capita money income as an approximation for county fiscal capacity. The Census Bureau defines money income as wages and salaries, earnings from self-employment, Social Security payments, public assistance, and other regularly received income such as pension benefits, interest, and dividends. Receipts from "lump sum" payments, such as capital gains or inheritances, are not included as money income.

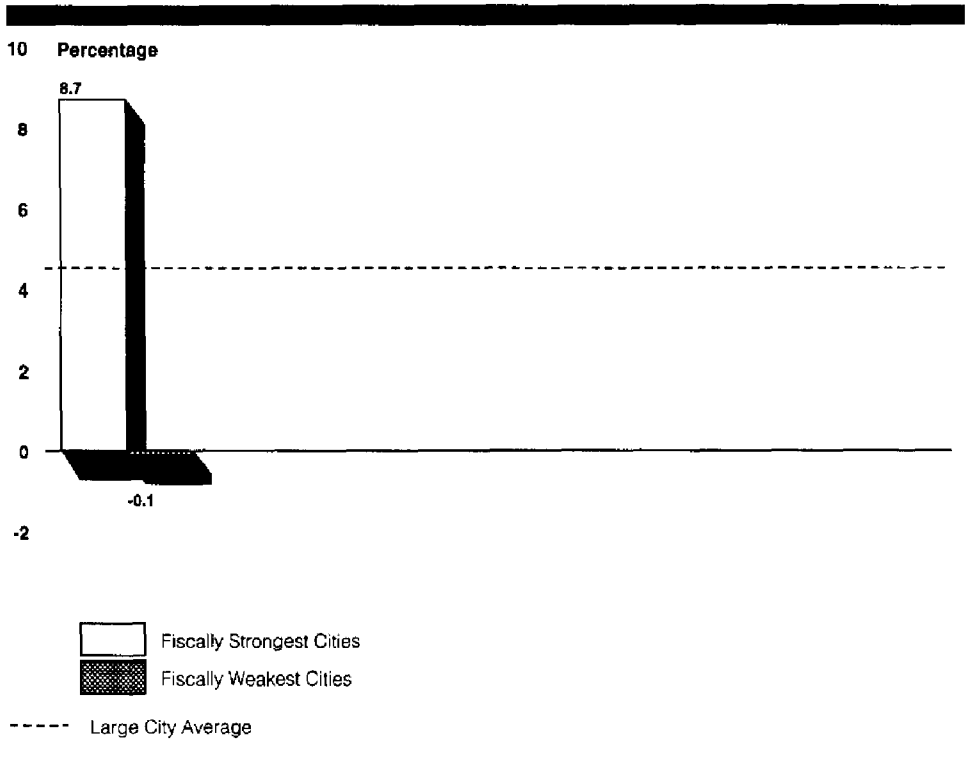
Econometric models, such as those used in this report, include income as a variable that correlates strongly with fiscal capacity. While our approximations do not include a measure of public service need, we believe analytical precedent provides sufficient rationale for using per capita money income as a gross estimate for fiscal capacity in our statistical analyses for large counties

correlation we identified between fiscal capacity and short-term financial condition.

Weaker Fiscal Capacity Compounded by Poorer Short-Term Financial Conditions Among Large Cities

Large cities with the weakest fiscal capacity in 1990 averaged a budget deficit equal to 0.1 percent of operating expenditures over the 1989 through 1991 period (see fig. VIII.1). Conversely, large cities with the strongest fiscal capacity had budget surpluses that averaged nearly 9 percent of operating expenditures, about twice the average of 4.5 percent for all 56 cities included in our review. However, the correlation between city fiscal capacity and operating surpluses or deficits was fairly weak, explaining only 9 percent of the variance in surpluses or deficits.

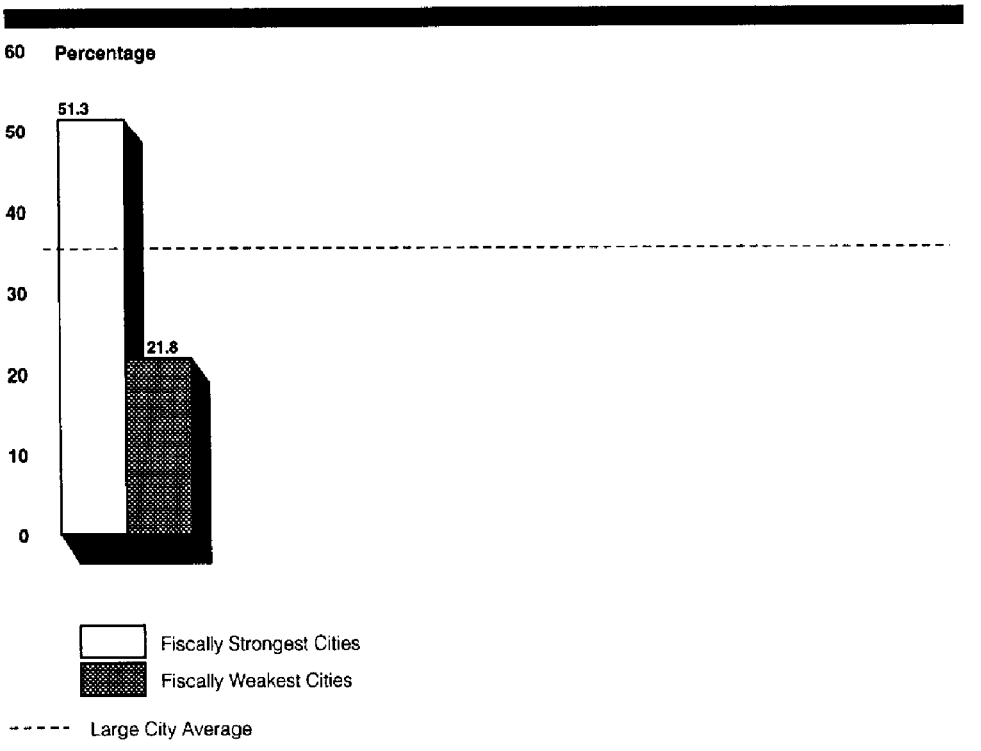
Figure VIII.1: Average Surplus/Deficit Values as a Percentage of Operating Expenditures for the Fiscally Strongest and Weakest Large Cities, 1990



Note: Surplus/deficit percentages are calculated as a 3-year average for the 1989-91 period.

Similarly, the same weaker cities averaged less than half the cash and security holdings (expressed as a percentage of operating expenditures) held by cities with the strongest fiscal capacity (see fig. VIII.2). These stronger cities had cash and security holdings that covered about 51 percent of their operating expenditures. Moreover, such holdings exceeded the average for all large cities by about 16 percentage points. Fiscal capacity explained 13 percent of the variance in cash and security holdings.

Figure VIII.2: Average Cash and Security Holdings as a Percentage of Operating Expenditures for the Fiscally Strongest and Weakest Large Cities, 1990



Note: Cash and security holding percentages are calculated as a 3-year average for the 1989-91 period.

The relationship between fiscal capacity and short-term financial condition was less significant among other budget indicators and levels of government we tested. While the fiscally weakest large cities tended to be in relatively weak positions on two budgetary measures—operating surplus/deficit and cash and security holdings—they were not in

significantly weaker positions on the other indicators of budgetary condition, namely short- and long-term debt. (See table VIII.1.) Among states and large counties, there was no significant relationship between fiscal capacity and any of the budgetary measures we used. In sum, fiscal capacity of large cities is weakly correlated with operating surpluses or deficits and cash and security holdings, whereas there is no correlation among these measures among states and large counties.

Table VIII.1: Summary of Fiscal Capacity and Budget Indicator Relationships

	Bottom quartile[a]	Group average[a]	Top quartile[a]	Pearson correlation coefficient	Probability level of t-statistic[b]	R-squared[c]
Large cities						
Operating surplus/deficit	-0.1%	4.5%	8.7%	**0.29306**	**0.0284**	0.0859
Cash & security holdings	21.8%	35.4%	51.3%	**0.36117**	**0.0062**	0.1304
Short-term debt	5.4%	3.4%	2.2%	-0.10724	0.4315	0.0115
Long-term debt (-PAB)	88.5%	100.5%	87.0%	0.07634	0.5760	0.0058
Large counties						
Operating surplus/deficit	8.8%	3.3%	2.0%	-0.20541	0.0731	0.0422
Cash & security holdings	26.4%	25.3%	26.0%	-0.07218	0.5328	0.0052
Short-term debt	1.9%	2.9%	3.0%	0.03778	0.7442	0.0014
Long-term debt (-PAB)	55.8%	54.7%	47.8%	-0.07587	0.5120	0.0058
State governments						
Operating surplus/deficit	4.4%	4.2%	6.1%	0.13175	0.3617	0.0174
Cash & security holdings	40.0%	38.3%	40.0%	0.01957	0.8927	0.0004
Short-term debt	0.2%	0.5%	0.9%	0.24880	0.0815	0.0619
Long-term debt (-PAB)	23.7%	26.2%	36.0%	0.21534	0.1331	0.0464

[a]Budget indicators are 3-year averages for the period 1989 to 1991.

[b]The probability is using the one-tail t-statistic. It should be .05 or less for significance at the 5 percent level and .01 or less for the 1 percent level.

[c]The R-squared represents the proportion of the budget indicator variance that is explained by the fiscal capacity measure and can also be defined as the R-squared of the simple bivariate regression.

Table VIII.1 contains the average budget indicator scores for the fiscally strongest and weakest jurisdictions. The table also shows the results of tests we applied to determine how significant the differences were between the budget scores of the strongest and weakest jurisdictions. As indicated by the first row of entries (operating surplus/deficit for the large cities), the R-squared value shows that fiscal capacity explains about

9 percent (.0859) of the variation in operating surplus/deficit between the fiscally weakest and strongest cities. The t-statistic indicates that there is only a 3-percent (.0284) probability that this relationship between fiscal capacity and operating surplus/deficit outcomes is due to chance factors. A similar, statistically significant relationship is seen between city fiscal capacities and cash and security holdings.

The tests show a different picture, however, for the other budgetary outcomes seen in the table. For example, fiscal capacity explains only 1 percent (.0115) of the differences in the short-term debt holdings of the fiscally strongest and weakest large cities, and there is a 43-percent chance (.4315) that this relationship is due to chance factors.

Trends in State and Local Government Bond Ratings

Recent trends in state and local government general obligation bond ratings approximate changes in short-term financial condition and fiscal capacity identified at each level of government. While rating downgrades in certain governments reflected significant budgetary and/or economic stress, overall ratings for states, large cities, and large counties paralleled relatively stable trends in certain of our indicators of short-term financial condition, such as cash and security holdings. Investor services (known also as rating agencies) more frequently assigned lower ratings to bond issuances from large cities with the weakest short-term financial conditions and fiscal capacities.

General Obligation Bond Ratings Provide a Composite Indicator of Short-Term Financial Condition and Fiscal Capacity

Bond ratings are a widely used tool for assessing the short-term financial condition and fiscal capacity of state and local governments. Rating systems rely on well-established criteria and assessment practices and include criteria similar to the definitions used in our calculations of short-term financial condition and fiscal capacity. For these reasons, we analyzed bond ratings and compared them to state and local short-term financial and fiscal capacity trends we identified in our other work.

We selected general obligation bond ratings for analysis because they are backed by the full faith and credit[1] of the issuing government and as such are tied to the general credit and taxing power of the issuer. Bond ratings indicate a government's willingness and ability to meet its debt obligations and also affect bond market pricing structures. For example, lower bond ratings usually mean an issuer's borrowing costs will be higher.

For our analysis of rating trends and profiles, we considered several rating sources and found that ratings for state and local government debt were similar or identical across all investor services we considered. We used Moody's Investors Service as the primary source of information on which to base our bond rating analysis and comparisons with the results of our analyses of short-term financial condition and longer-term fiscal capacity. (See fig. IX.1 for an explanation of Moody's rating categories.)

[1]Debt backed by the full faith and credit of the issuer refers to bonds that are secured by a pledge of the issuer's taxing power that is typically not subject to constitutional limits. In the event of default, the holders of general obligation bonds have the right to compel a tax levy or legislative appropriation in order to satisfy the issuer's obligation on the defaulted bonds.

Figure IX.1: Moody's Municipal Bond Rating Definitions

Rating	Definition
Aaa	Best quality: carry the smallest degree of investment risk.
Aal, Aa	High quality: margins of protection not quite as large as the Aaa bonds.
Al, A	Upper medium grade: security adequate but could be susceptible to impairment.
Baal, Baa	Medium grade: neither highly protected nor poorly secured; lack outstanding investment characteristics and sensitive to changes in economic circumstances.
Bal, Ba	Speculative: protection is very moderate.
Bl, B	Not desirable investment: sensitive to day-to-day economic circumstances.
Caa	Poor standing: may be in default with a workout plan.
Ca	Highly speculative: may be in default with nominal workout plan.
C	Lowest rated class of bonds: extremely poor prospects of ever attaining any real investment standing.

Sources: Moody's Investors Service and The Municipal Bond Handbook.

Bond rating criteria include factors related to both short-term financial condition and fiscal capcity. In assigning ratings to bond issues, investment analysts consider factors such as operating position and the local economy as well as others such as debt management. We used bond ratings to test or validate the trends we identified in our other work.

Unlike our short-term financial and fiscal capacity data, however, bond ratings do not embody a statistical degree of precision. Rating systems generally do not include numerical measurements of a bond issue's strength or weakness, precluding precise calculation of rating values or changes over time. Given this, we adjusted our analysis to reflect the less

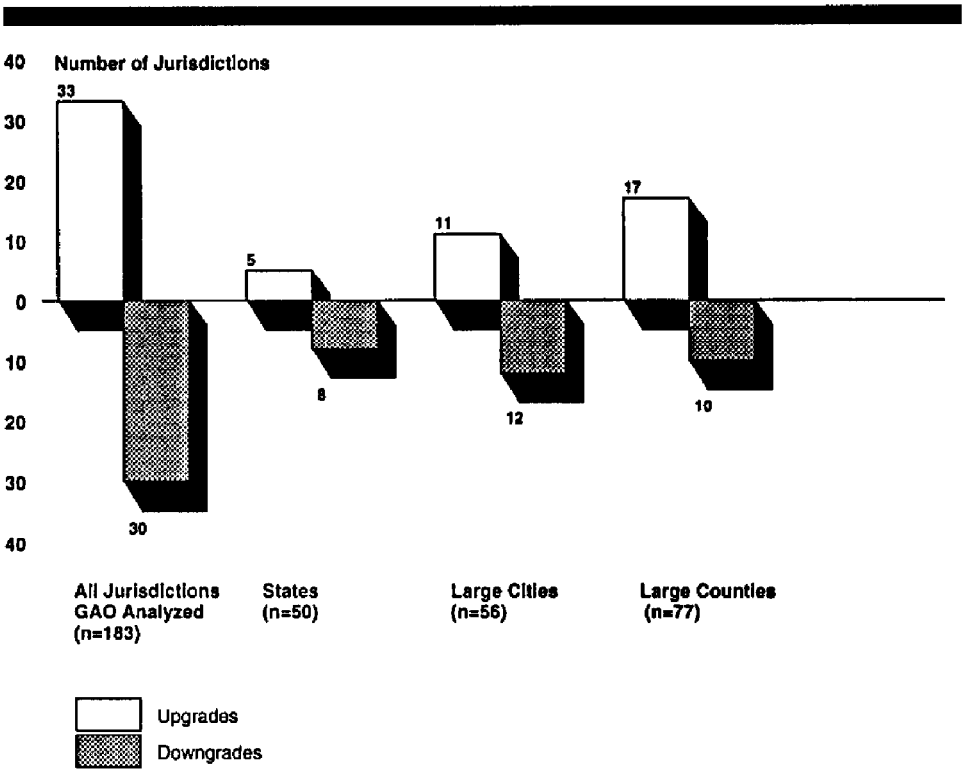
precise nature of bond ratings by using broad rating categories to assess relative rating quality. To coincide with the period covered by our short-term financial condition and fiscal capacity analyses, we included bond ratings for general obligation debt issued by all states, large cities, and large counties between 1985 and 1992, or the most recent year for which a rating was available.

Overall Rating Trends Remained Stable, States Maintained Most Favorable Profile

Bond ratings paralleled short-term financial condition and fiscal capacity trends in two respects. First, ratings remained relatively stable during this period for all levels of government, reflecting the same lack of deterioration we identified in certain of our indicators of short-term financial condition, such as cash and security holdings and trends in short-and long-term debt outstanding. Second, large cities that had the weakest fiscal capacity and the least favorable short-term financial conditions received among the lowest bond ratings for any of the jurisdictions we examined.

While general obligation bond ratings of most states, large cities, and large counties did not change between 1985 and 1992, the number of jurisdictions that did experience change varied among the three levels of government during this period (see fig. IX.2). States experienced more frequent downgrades (eight), relative to the number of upgrades (five), than either large cities or large counties. Large cities experienced about an equal number of rating upgrades and downgrades, 11 and 12 respectively. By contrast, 17 large counties experienced upgrades during this period and 10 experienced downgrades—the only level of government among the three for which upgrades exceeded downgrades.

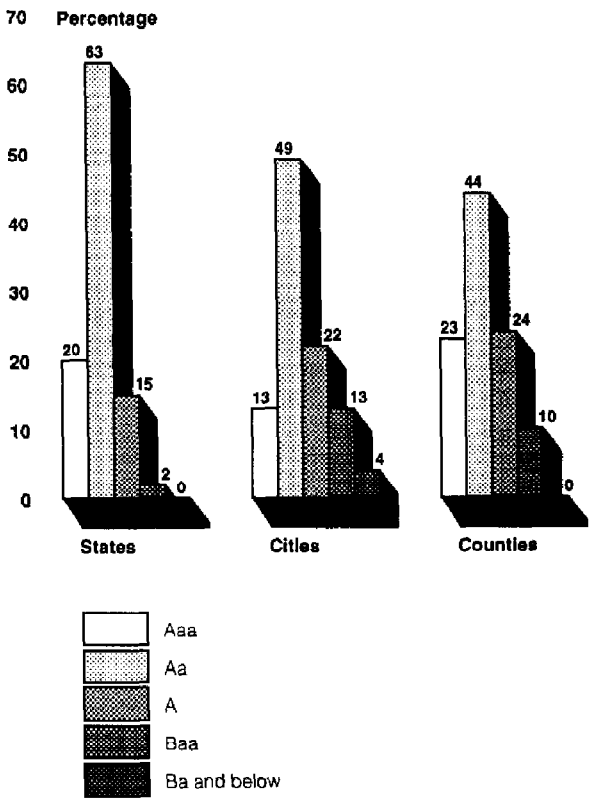
Figure IX.2: Total Number of States, Large Cities, and Large Counties With Upgrades or Downgrades in Bond Ratings, 1985-92



Source: Moody's Investors Service.

As of September 1992, states maintained a more favorable rating profile than either large cities or counties, indicated by the relative proportion of Aaa or Aa ratings (83 percent) assigned to their general obligation bond issuances (see fig. IX.3). Sixty-seven percent of large counties and 62 percent of large cities received ratings in these categories for their general obligation debt. Large cities had the least favorable rating profile, with 39 percent of the bond issuances assigned a rating of A or below. Large counties received 34 percent of their bond ratings in these lower categories compared to 17 percent for states.

Figure IX.3: Percentage of States, Large Cities, and Large Counties by Bond Rating Category, 1992



Source: Moody's Investors Service.

Notes: Municipal bond ratings of Ba and below are not considered to be of investment-grade quality.

Percentages may not add to 100 due to rounding.

A more detailed listing of 1992 general obligation bond ratings for states, large cities, and large counties can be found in figures IX.4 through IX.6.

Figure IX.4: Moody's General Obligation Bond Ratings for States, 1992

Aaa(8)	Georgia North Carolina Utah	Maryland South Carolina Virginia	Missouri Tennessee
Aa1(2)	Maine	New Jersey	
Aa(24)	Alabama California Florida Kentucky Montana New Mexico Oklahoma Vermont	Alaska Connecticut Hawaii Minnesota Nevada North Dakota Oregon Washington	Arkansas Delaware Illinois Mississippi New Hampshire Ohio Texas Wisconsin
A1(4)	Michigan West Virginia	Pennsylvania	Rhode Island
A (2)	Massachusetts	New York	
Baa1(1)	Louisiana		
Not rated (9)	Arizona Indiana Nebraska	Colorado Iowa South Dakota	Idaho Kansas Wyoming

Figure IX.5: Moody's General Obligation Bond Ratings for Large Cities, 1992

Aaa(7)	Charlotte, NC Minneapolis, MN San Diego, CA	Indianapolis, IN Omaha, NE	Los Angeles, CA Portland, OR
Aal(4)	Columbus, OH Seattle, WA	Dallas, TX	Sacramento, CA
Aa(23)	Albuquerque, NM Denver, CO Honolulu, HI Long Beach, CA Nashville, TN Phoenix, AZ San Jose, CA Witchita, KS	Atlanta, GA Fort Worth, TX Houston, TX Memphis, TN Norfolk, VA San Antonio, TX St. Paul, MN Tulsa, OK	Cincinnati, OH Fresno, CA Kansas City, MO Milwaukee, WI Oklahoma City, OK San Francisco, CA Virginia Beach, VA
Al(8)	Austin, TX El Paso, TX Oakland, CA	Baltimore, MD Jacksonville, FL Tuscon, AX	Birmingham, AL Louisville, KY
A (4)	Boston, MA Pittsburgh, PA	Chicago, IL	Miami, FL
Baal(4)	Cleveland, OH Toledo, OH	New York, NY	Newark, NJ
Baa(3)	Buffalo, NY	New Orleans, LA	St. Louis, MO
Bal(1)	Detroit, MI		
B(1)	Philadelphia, PA		
Not rated (1)	Washington, DC		

Figure IX.6: Moody's General Obligation Bond Ratings for Large Counties, 1992

Aaa (16)	Baltimore, MD	Bergen, NJ	Dallas, TX
	Du Page, IL	Essex, MA	Fairfax, VA
	Franklin, OH	Fresno, CA	Hamilton, OH
	Hennepin, MN	Middlesex, NJ	Montgomery, MD
	Montgomery, PA	Salt Lake, UT	Union, NJ
	Westchester, NY		
Aa1(9)	De Kalb, GA	King, WA	Los Angeles, CA
	Mericopa, AZ	Monmouth, NJ	Multnomah, OR
	Orange, CA	St. Louis, MO	Tarrante, TX
Aa (22)	Bexar, TX	Broward, FL	Bucks, PA
	Contra Costa, CA	Cuyahoga, OH	Delaware, PA
	Fulton, GA	Harris, TX	Hillsborough, FL
	Jackson, MO	Middlesex, MA	Montgomery, OH
	Palm Beach, FL	Pima, AZ	Riverside, CA
	Sacramento, CA	San Diego, CA	San Mateo, CA
	Santa Clara, CA	Shelby, TN	Tulsa, OK
	Ventura, CA		
A1(15)	Allegheny, PA	Camden, NJ	Clark, NV
	Cook, IL	Dade (Metro.), FL	Essex, NJ
	Jefferson, AL	Milwaukee, WI	Monroe, NY
	Norfolk, MA	Oakland, MI	Oklahoma, OK
	Pierce, WA	Prince George's, MD	Travis, TX
A(2)	El Paso, TX	Kern, CA	
Baa1(4)	Erie, NY	Hudson, NJ	Suffolk, NY
	Summit, OH		
Baa(3)	Nassau, NY	Wayne, MI	Worcester, MA
Not Rated (6)	Alameda, CA	Jefferson, KY	Macomb, MI
	Orange, FL	Pinellas, FL	San Bernardino, CA

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Bibliography

Intergovernmental Relations: Changing Patterns in State-Local Finances (GAO/HRD-92-87FS, Mar. 31, 1992).

The major trends GAO found were that (1) the state-local sector is running a deficit in financing its current service operations. This deficit is approaching a record high for the period from 1961 to 1990 and (2) deficits have been growing because expenditures have risen even faster than revenues.

GAO found that while both the federal and state-local governments continue to share the financing of "safety-net" programs like Medicaid, state-local governments have assumed a greater portion of the burden for other types of public consumption and investment. Also, health care spending is the most rapidly growing area in state-local budgets.

The growth in intergovernmental revenues by state-local governments from the federal government leveled off in the late 1970s after adjusting for inflation, and such revenues have declined as a percentage of both gross national product and state-local revenues. Since the 1970s intergovernmental revenues have shifted toward Medicaid and away from most other areas. Revenues from personal income and general sales taxes have been the most rapidly growing state-local own-source revenues.

Maternal and Child Health: Block Grant Funds Should Be Distributed More Equitably (GAO/HRD-92-5, Apr. 2, 1992).

GAO determined that it is possible to develop a formula for distributing maternal and child health funds that would meet either the beneficiary equity standard or the taxpayer equity standard. No formula could completely satisfy both standards simultaneously. GAO believes, however, that through the adoption of a formula that strikes a balance between the two standards, the overall equity of the program could be improved substantially. GAO developed one such formula that would redistribute $80.4 million, or 17.7 percent of the fiscal year 1990 appropriation, increase grants for 26 states, and decrease grants for the remaining states.

Federal Aid: Programs Available to State and Local Governments (GAO/HRD-91-93FS, May 22, 1991).

This fact sheet identifies and presents information on 606 federal financial assistance programs for which state and local governments are eligible applicants. The fact sheet includes the Catalog of Federal Domestic

Assistance number identifying the federal funding agency, program name, types of financial assistance, eligibility, budget function, and estimated funds obligated. An estimated obligation of $155.3 billion was available to state and local governments in fiscal year 1990.

Drug Treatment: Targeting Aid to States Using Urban Population as Indicator of Drug Use (GAO/HRD-91-17, Nov. 27, 1990).

GAO found that the urban population factor is an appropriate indicator of the prevalence of drug use. However, its influence in the apportionment formula overstates the magnitude of drug use in urban as compared with rural areas. Under the formula, the number of 18- to 24-year-olds is used to represent the population at high risk of drug abuse. In addition, total urban population is used to reflect a higher urban drug abuse incidence rate in this high-risk group. Using the entire urban population to represent urban-rural differences in the incidence of drug abuse among 18- to 24-year-olds significantly overstates these differences.

Federal Formula Programs: Outdated Population Data Used to Allocate Most Funds (GAO/HRD-90-145, Sept. 27, 1990).

In fiscal year 1989, 93 federal formula programs used Census Bureau population data to determine program eligibility or distribute funds to state and local governments. Of these 93 programs, 48 used current population estimates to distribute $10.1 billion, and 45 used 1980 decennial census population data to distribute $17.4 billion. For 33 of the 45 programs, the decennial population data were the most current available. These consisted primarily of data on the populations living in urban and rural areas and below the poverty level. These data are not estimated between decennial censuses.

Distressed Communities: Public Services Decline in New Jersey Despite Targeted State Aid (GAO/HRD-90-96, July 9, 1990).

New Jersey experienced large and growing disparities between poor and wealthier communities in the 1980s. Poorer communities faced more difficulties in coping with the loss of funds and in 1986, the expiration of general revenue sharing. To reduce the negative impact of the loss of general revenue sharing funds, New Jersey expanded a program of fiscal assistance targeted to its poorest communities. State funding more than offset general revenue sharing losses. However, public services declined

despite local efforts and state aid, suggesting that problems were increasing at a faster rate than state aid.

Communities in Fiscal Distress: State Grant Targeting Provides Limited Help (GAO/HRD-90-69, Apr. 13, 1990).

We found that disparities between fiscally distressed communities and better-off communities existed in all states. States provided $10.9 billion in general purpose fiscal assistance to local governments in 1985 and federal revenue-sharing added another $4.6 billion. Combined, this aid reduced disparities by approximately 18 percent. But when separately analyzed, federal revenue-sharing was targeted more to distressed communities than was state aid. As a consequence, although the federal program had less than half the funding of state general fiscal assistance, it reduced disparities more than did most state programs.

Federal-State-Local Relations: Trends of the Past Decade and Emerging Issues (GAO/HRD-90-34, Mar. 22, 1990).

GAO found that during the decade of the 1980s, changing federalism policies and federal budgetary retrenchment resulted in an increase in the role of the states in the intergovernmental system. Subsidies to local governments were reduced and state authority over some kinds of federal aid was increased. States became more prominent over the decade as a result, but not without some adverse effects. We identified three emerging issues: (1) the fiscal gap between wealthier and poorer communities became larger over the decade, (2) while regulation is an important mechanism for the federal government to use to attain statutory objectives, its success often depends on the goodwill and cooperation of state and local governments to implement these federal regulatory programs, and (3) the combination of federal budgetary retrenchment and expanding regulation could place too much fiscal pressure and program responsibility on states, especially during periods when national or regional economies are weak.

Legislative Mandates: State Experiences Offer Insights for Federal Action (GAO/HRD-88-75, Sept. 27, 1988).

Requirements that state and/or local costs be estimated or that local costs be reimbursed had only a limited impact on the burden of mandates. When coupled with strong legislative concern about restraining costs to subordinate levels of government, these processes appeared to have some

success in deterring, modifying, or providing funding for mandates. But in the absence of strong legislative concern, they appeared to have little impact.

At the state level, cost estimation seems to have a greater impact when the estimates are prepared early in the legislative process or for important amendments to proposed legislation. Adopting these changes could enhance the impact of the federal process.

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