EPI Issue Brief

Issue Brief #181 | Economic Policy Institute | June 13, 2002

U.S. CITIES FACE FISCAL CRUNCH

Federal and state policies exacerbate local governments' budget shortfalls

by Max B. Sawicky

The budgets of local governments have been hit hard by both the economy's downturn in the third quarter of 2001 and the costs of extraordinary security measures in the wake of September 11. Inadequate fiscal backup from federal and state governments is resulting in needless disruption of basic public services and ill-advised deferral of capital expenditures. Even though gross domestic product began to grow at the end of last year, the effects of the third-quarter slump will linger in state and local government budgets. To date, federal and state governments have worsened the plight of U.S. cities by reducing aid and implementing tax cuts that trigger revenue losses for local governments.

City budgets in the lurch

As early as July 2001 a majority of cities, particularly the larger ones, expected to be in worse financial shape in 2002 (Pagano 2001). Factors cited included rising costs of employee health benefits, public safety needs, and capital spending. In October, driven by new public safety concerns and declines in revenues from sales tax, tourism, and state aid, a majority of cities needed to draw down reserves (Hoene and Bishop 2001).

The added security concerns in the aftermath of September 11 didn't help these already strained local budgets. As of February 2002, the National League of Cities (2002) estimated that added security expenditures had cost municipalities an additional $2 billion since September 11. An important component has been overtime pay for police and fire fighters (Hoene and Reinemer 2002), with some city governments responsible for protecting airports and water supplies.

Numerous cities are projecting budget shortfalls for what remains of FY2002 and are expecting gaps for FY2003. And though major metropolitan areas are particularly burdened, the problems afflict cities of all sizes, in all parts of the country. Cities have responded by instituting hiring freezes, dipping into reserve funds, and raising local taxes and fees.

In Atlanta, Georgia, an $82 million budget shortfall led the mayor to reduce her own salary and personal staff, as well as raise property taxes. The city of Detroit, Michigan, was faced with a $94 million deficit for FY2003 due to revenue reductions and overtime costs for police and fire fighters. Chatham County, North Carolina was looking at deficits for FY2002 and FY2003; it is dealing with them by instituting a hiring freeze and postponing capital expenditures. New York City faces a projected deficit of $6 billion for FY2003 that it has yet to resolve. **Table 1** reports the actual and projected budget shortfalls faced by a variety of U.S. metropolitan areas in 2002 and 2003.[1]

Cities' revenue sources are drying up

Many current indicators suggest that revenue growth for state and local governments will be extremely weak. A major revenue source – the individual income tax – decreased in absolute terms. Corporate profit tax proceeds are also expected to fall. Federal corporate income tax revenues have decreased in every quarter since the third quarter of 2000.

Cities depend on federal and state revenues, so when aid proves inadequate, the implications are serious. In 1998, over 39% of local government general revenue came from federal and state governments (Census of Governments 2002).

The modest increase of $8 billion in federal grants-in-aid expected in the first quarter of 2002 is not sufficient to revive the state-local sector. The National Governors Association reports that state governments faced an aggregate budget shortfall of about $50 billion for FY2002, which for most states ends in the summer (NGA 2002). The National Conference of State Legislatures (2002) expects that, in light of shrinking revenue projections, there will be further problems for states in devising budgets for FY2003.

Neglect and fiscal restraint at the federal and state level translates to reduced state government aid and the creation of budget shortfalls at the local level. After FY2002 budgets were passed, most states reduced aid to local governments as part of their across-the-board cuts. In fact, seven states targeted their cuts on aid to local governments (NGA/NASBO 2002). Some states will reduce aid because their aid program depends on a fixed share of a statewide revenue source. The drop in Michigan sales tax proceeds, for example, will mean an automatic reduction in aid to local governments. In California, the Vehicle License Fee funds designated for local governments could be tapped by the state to fix its own projected budget shortfall.

Direct federal aid to local governments is also stagnating. One of the most important federal programs to cities—the Community Development Block Grant (CDBG)—is cut by 46% in the Bush budget compared to FY2002. CDBG serves over 1,000 communities (NCSL 2002) and is a key program that provides fiscal flexibility to local officials.

Congress turns a blind eye as state spending responsibilities mount

State governments typically resort to cuts in aid to local governments as partial solutions to their own fiscal problems. Such cuts might be fueled by cuts in state taxes or simply by erosion of tax revenues. Insofar as such problems are remedied by cuts in aid, the result will be higher local taxes or cuts in local spending. Typically a state's economy is better served by absorbing such costs at the state level. Local tax increases or spending cuts tend to be concentrated where the economy is weakest.

TABLE 1
A sample of budget shortfalls in U.S. city governments
(Dollars in millions except where otherwise indicated)

	Population	Budget shortfall Actual FY2002	Budget shortfall Projected FY2003	Budget shortfall (as percent of budget) Actual FY2002	Budget shortfall (as percent of budget) Projected FY2003
Population over 500,000					
New York, NY	7,428,162		6000	0.0%	14.6%
Los Angeles, CA	3,633,591		250		5.2%
Chicago, IL	2,799,050	80		1.7%	
Houston, TX	1,845,967		16		1.1%
Philadelphia, PA	1,417,601		16.7		0.5%
San Diego, CA	1,238,974	15.6			
San Antonio, TX	1,147,213	18		1.3%	
Detroit, MI	965,084	75	94	2.9%	3.7%
San Francisco, CA	746,777		130		2.5%
Baltimore, MD	632,681	8		0.5%	
Boston, MA	555,249		100		5.6%
Seattle, WA	537,150		50		8.0%
Population 100,000 to 500,000					
Oklahoma City, OK	475,322		6.6		2.5%
Albuquerque, NM	420,578	19	18	5.8%	5.6%
Atlanta, GA	401,726	82		18.8%	
Arlington, TX	311,962		10		
Buffalo, NY	295,619	9	28	3.0%	
Raleigh, NC	261,205		14.2		5.1%
Durham, NC	179,212	8.5	5.38	1.7%	
Worcester, MA	167,132	5	25		1.1%
Hollywood, FL	131,828		7.5		
Flint, MI	130,853	38			
Hartford, CT	128,367		47		
Allentown, PA	100,160	3.7			
Population under 100,000					
Clearwater, FL	99,936	1		0.4%	
Roanoke, VA	93,357	1.8	3.5	0.9%	1.8%
Gresham, OR	87,106		2.1		11.0%
High Point, NC	76,955	3.1	7.2	1.3%	3.2%
Cranston, RI	75,009		5		2.9%
Portland, ME	61,925		11.6		7.9%
Schenectady, NY	60,784	1.86			
San Luis Obispo, CA	42,891	2.6		7.9%	
Medina, OH	23,012	1			
Northboro, MA	13,509		0.4		

Sources: U.S. Department of Commerce, Census Bureau, and author's analysis. See http://eire.census.gov/popest/archivesfor population estimates for cities with populations of 10,000 and greater, counties, and minor civil areas.

State governments are often tempted to reduce taxes in the face of a recession. The benefits of such a move are likely to be lacking for three reasons: state economies are porous, which means the benefits of a tax cut spill out of the state; service cuts tend to offset the benefits of a tax cut, since business firms rely on public services to function; and excessive instability in a state's tax code or its service provision are not conducive to a healthy economy.

A particularly serious problem for the states is the growth of Medicaid costs. Growth rates for FY2001 and 2002 exceeded 10%, well above the pace of all other state expenditures and revenues (NASBO 2002). Costs have grown due to rising caseloads and increasing prices for prescription drugs (NASBO/NGA 2002). Proposals for a change in the federal formula that would alleviate the states' expenses have failed to pass Congress thus far.

The rising Medicaid caseload suggests that welfare reform has failed to improve the ability of low-income families to finance their own health insurance (Sawicky 2002). The reduction in the national welfare caseload has slowed to a crawl. In fact, the fourth quarter of 2001 saw the number of families on the welfare caseload actually increase by a tiny margin of 498 families (U.S. DHHS 2002). The urban concentration of the welfare caseload is well-known. Some cities, notably New York and San Francisco, share in responsibility for financing Temporary Assistance for Needy Families (TANF) and Medicaid.

The likelihood that some states will face heavier burdens than others in financing TANF points to the need to replace the block grant approach with a formula that is sensitive to such local conditions as poverty, unemployment, and state fiscal capacity, among other factors (Sawicky 2000).

The low levels of aid proposed in President Bush's budget won't help states much, further suggesting the need for general fiscal assistance to state and local governments (Sawicky 2002). For instance, the President proposed a 26% cut in aid for law enforcement (FFIS 2002). And Congress is notorious for increasing spending in other areas and reducing federal taxes. These federal tax cuts automatically reduce revenues in the states, since state and local income taxes and estate and gift taxes are often "piggybacked" onto the federal system. Repeal of the Federal Estate and Gift Tax in the 2001 tax cut, for instance, is projected to reduce annual state government revenues by $9 billion (McNichol, Lav, and Tenny 2002).

While the Congress has moved to provide some aid to state and local governments, there has been no serious assessment of national needs. The adequacy of present efforts is at least an open question. The actual mechanism for distributing new funds to local governments has yet to be established (NASBO 2002).

Congress has enacted some emergency aid programs, but the bulk of the funds go to state governments. An example of pending legislation is the President's proposal of $3.5 billion to "first responders" (police, fire fighters, and emergency medical technicians), which goes primarily to states, not to the local governments that employ most of these personnel. By contrast, knowledge of potential security vulnerabilities, and the responsibility to react immediately, is partly vested in local government. There is little rationale for filtering all federal aid through state capitals, as the U.S. Conference of Mayors has pointed out (USCM 2002).

Federal policies also affect funding for security measures in our transportation systems. There is new money for the airline industry, on top of questionable levels of bailout funds to the industry, but a gaping silence with respect to rail, sea, highway, and mass transit systems. This seems like a particularly strange oversight when considering that the World Trade Center, after all, was built by the Port Authority of New York and New Jersey, a governing body for regional, land-based transportation systems.

Policy priorities

What the nation's cities need right now is more focus on the following policy remedies:

- The federal government should provide general fiscal assistance to state and local governments;
- The Medicaid formula should be adjusted to ease the cost burden on grantees;
- The TANF grant should be made sensitive to business cycle downturns, poverty, and state fiscal capacity;
- Federal tax cuts that reduce state and local tax revenues should be rolled back;
- More aid for homeland security should flow directly to local governments;
- State governments should not resort to tax cuts for purposes of economic stimulation.
- State governments should not balance their budgets on the backs of local governments by passing along the costs of tax cuts through reduced aid.

Neglect of the plight of America's cities needlessly inhibits U.S. economic growth, disrupts the provision of basic services, and weakens the common defense against terrorist threats to civilian public safety.

Endnote

1. The results in Table 1 represent a preliminary scan of newspapers done through the use of Lexis-Nexis. More comprehensive data are now being collected through a survey by the National League of Cities, which expects to report its findings in summer 2002.

References

Federal Funds Information for States. 2002. *Major Discretionary and Mandatory Program Funding.*

Hoene, Chris, and Kyan Bishop. 2002. *State of America's Cities Survey, Summary Results*.

Hoene, Chris, and Mike Reinemer. 2002. *Police and Fire Personnel Expenditures Dominate Post-9/11 City Spending.* Washington, D.C.: National League of Cities.

League of California Cities. 2002. *State Budget Alert.*

McNichol, Elizabeth C., Iris J. Lav, and Daniel Tenny. 2002. States Can Retain Their Estate Tax Even as the Federal Tax Is Phased Out. Washington, D.C.: Center on Budget and Policy Priorities.

National Association of State Budget Officers (NASBO). 2002. *NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003.*

National Association of State Budget Officers (NASBO). 2002. *Special Report: State Funding for Homeland Security*.

National Conference of State Legislatures (NCSL). 2002. "State Budget Shortfalls at $27 Billion; 40 States Project Budget Cuts This Year." *NCSL News*, April 16.

National Governors Association (NGA). 2002. *State Fiscal Woes Continue*. Washington, D.C.: NGA.

National Governors Association and National Association of State Budget Officers. 2002. *The Fiscal Survey of States*.

National Governors Association and National Association of State Budget Officers. 2002. *Medicaid and Other State Healthcare Issues: The Current Situation*.

National League of Cities (NLC). 2002. *Hot Issues 2002: Community Development Block Grant Funding.* Washington, D.C.: Center for Policy and Federal Relations.

National League of Cities (NLC). 2002. *Hot Issues 2002: Local Priorities for Homeland Security.* Washington, D.C.: Center for Policy and Federal Relations.

Pagano, Michael A. 2001. *City Fiscal Conditions in 2001.* Washington, D.C.: National League of Cities.

Sawicky, Max B. 2001. *An Idea Whose Time Has Returned: Anti-Recession Fiscal Assistance for State and Local Governments*. Washington, D.C.: Economic Policy Institute.

Sawicky, Max B. 2002. *Budgeting Beyond the Beltway.* Washington, D.C.: Economic Policy Institute.

Sawicky, Max B. Forthcoming. *U.S. Welfare Reform: Learning Experience or Exercise in Self Delusion?* Working Paper. Washington, D.C.: Economic Policy Institute.

Sawicky, Max B. (ed). 2000. *The End of Welfare? Consequences of Federal Devolution for the Nation.* Armonk, N.Y.: M.E. Sharpe.

U.S. Census Bureau. 2002. *State and Local Government Finances.* < http://www.census.gov/govs/estimate/99stlss1.xls. >

U.S. Conference of Mayors. 2002. *Mayors Ask Congress to Help Cities With Security Costs.* Washington, D.C.: U.S. Conference of Mayors.

U.S. Department of Health and Human Services. 2002. *No Increase in National Welfare Caseload, HHS Reports* . < http://www.acf.dhhs.gov/news/press/2002/tanf_521.html >