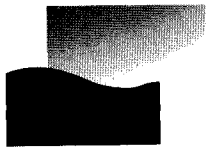


The going gets tough: State and local governments confront the nineties

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Fear of recessionary fallout is everywhere. All levels of government are scrambling to shore up revenues and limit spending, especially in hard

hit regions such as the Northeast and California. This fiscal storm comes in the wake of a prosperous period for many state and local economies. Despite dwindling aid from the federal government, eight years of national economic growth enabled most state and local governments to expand programs for education, public welfare, infrastructure, and the environment. As revenues picked up, some states found themselves facing an enviable choice of options, from accelerating spending to reducing taxes or rebuilding reserves.

Options were much more limited for the Seventh District states of Illinois, Indiana, Iowa, Michigan, and Wisconsin. The Seventh District has traditionally relied on its large manufacturing and farm base for growth, two sectors that did not perform particularly well in the early 1980s. Because of unrelenting fiscal stress, District budgets were forced to maintain slow to moderate growth.

This article begins by presenting evidence of the current fiscal pressure on state and local governments nationwide. Trends in state and local revenues and expenditures are examined, as well as the role that declining federal aid has had in leading to the current fiscal pinch.

The focus then turns to why the Seventh District's fiscal track record has followed a different pattern from the rest of the U.S. The answer lies in the District's economic perform-

ance in the 1980s, in conjunction with discretionary measures taken by District governments to maintain balanced budgets in response to the District's slower revenue growth.

Led by manufacturing and agriculture, the District's economy enjoyed a resurgence in the latter half of the 1980s. Combined with prudent budgeting practices which were carried over from the leaner times of the early 1980s, District governments were able to rebuild their formerly strong fiscal positions by 1989.

Prudent budget management will help the District during the 1990s, but it will be a limited tool during an era in which state and local governments continue to become more reliant on their own source revenues. As District governments confront the challenges of the 1990s—rising service needs and federal turnbacks—governments will first need to shore up budget balances which are now eroding under the weight of economic recession.

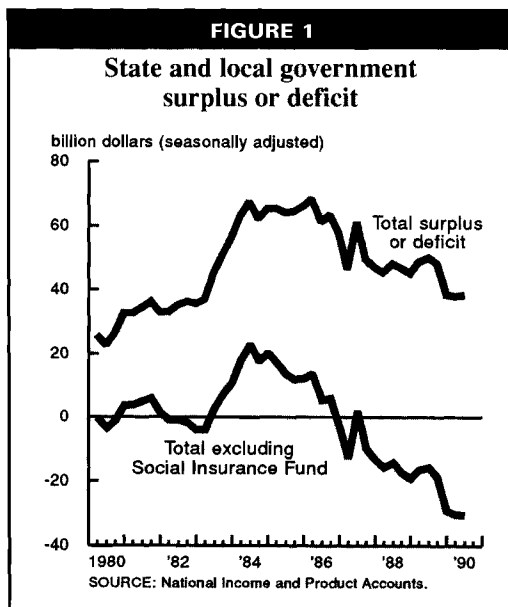
Evidence of nationwide fiscal pressure

One common measure of a state's fiscal soundness is its ability to end the year with a surplus of general funds.¹ The larger the state government's surplus as a percentage of expenditures, the greater the cushion with which to respond to economic shocks and spending pressures. Most experts cite either a 3 percent or 5 percent surplus as evidence of prudent

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budget management. Over the 1978-1989 period, the U.S. average general fund ending balance as a percentage of expenditures for state governments (excluding local governments) ranged from as high as 9 percent in 1980, to an estimated low of 1.1 percent in 1989.²

A more comprehensive measure of fiscal soundness is the size of the state and local government sector's budget surplus or deficit (see Figure 1). This figure, a product of the National Income and Product Accounts (NIPA), is the net of receipts and expenditures for all state and local governments, including cities, towns, counties, school districts, and special purpose districts.³ In the early to mid-1980s, when the economy was recovering from the back-to-back recessions of 1980 and 1981-1982, the state and local surplus grew from \$25.7 billion in the first quarter of 1980 to \$68.5 billion in the first quarter of 1986. Since then, with only a few quarterly aberrations, the surplus has been decreasing. As a measure of fiscal soundness, this surplus must be viewed with some caution because it includes the states' social insurance funds (SIF). Social insurance funds include employee pension funds and unemployment insurance, which are not part of current operating funds. Since the beginning of 1987, the surplus excluding SIF actually fell into the red and, during the first two quarters of 1990, the deficit exceeded \$30 billion.



Evidence of deteriorating financial condition has also emerged for municipal governments. As reported in a 1990 survey of city financial conditions,⁴ 54 percent of the cities surveyed reported expenditures outpacing revenues in fiscal year 1990 (FY90). Twenty-two percent of the cities in the U.S. expected general fund revenues to decline, compared to 11 percent in 1989 (see Table 1). Although budgetary woes have been widely-reported to be centered in the Northeast region—especially Philadelphia, New York City, and the state of Massachusetts—the recent municipal survey shows a geographically dispersed pattern of fiscal stress, with every region expecting similar declines in revenues in FY90 over FY89.

As shown in Table 1, declines in city expenditures are less dramatic, reflecting the reluctance to make expenditure cuts even in the face of declining revenues. However, even here the fiscal pressure on the South and Northeast is shown by the increase from FY88-89 to FY89-90 in the percentage of cities reporting reduced spending. In contrast, the percentage of cities reporting reduced spending fell in the Midwest and West.

The current fiscal pressure on state and local governments obviously has a great deal to do with the slowing national economy. However, the pattern of revenue and expenditure growth that occurred in the 1980s, along with changes in federal aid, are also primary contributors to the current situation.

Causes of spending and revenue pressure

Much of the decade saw a significant gain in virtually all state and local revenue sources, especially in those tax sources that move in tandem with swings in state and local economies. But since 1987, state revenue gains have slowed while demands for government services have continued to grow.

Why was revenue growth strong up until 1987? The early 1980s found the nation in a recession. Faced with slumping revenues and reduced federal aid, states acted, often with a lag, to boost many of their largest tax sources by raising tax rates and user fees and by expanding the legal bases of taxation. Increases in sales, individual income, and business taxes were particularly popular. From 1981 to 1983, 28 states from every region in the nation, in-

TABLE 1		
Cities with declining general revenue		
	Percent of cities	
	FY88 to 89	FY89 to 90
Total	11	22
Northeast	13	21
Midwest	9	22
South	10	22
West	12	21

Lower city spending by region		
	Percent of cities	
	FY88 to 89	FY89 to 90
Total	10	10
Northeast	3	10
Midwest	11	8
South	11	13
West	14	10

SOURCE: *City Fiscal Conditions in 1990*, National League of Cities.

cluding all of the District states except for Iowa, increased either their personal income tax rates or expanded their income tax base. Thirty states throughout the U.S. chose to increase their sales tax.⁵

As the economic recovery set in, those states that raised taxes were able to garner large revenue increases as higher personal incomes and expanding consumer confidence helped fuel growth in both of these tax bases. The east and west coast states benefited the most as their regional economies were particularly robust emerging from the recession. The combination of higher tax rates and rapid expansion in the underlying tax base led to impressive revenue growth on both coasts.

From 1982 to 1986, state and local receipts grew by 19 percent even after adjusting for inflation (see Table 2). Especially large gains were realized in sales and personal income tax revenues which represent the two largest revenue sources for most state governments. During this period, income tax revenues increased nearly 25 percent and sales tax revenues posted a 21 percent gain.

On the local level, property values increased rapidly during this period as new construction and higher market values for real

estate (particularly on the east coast) pushed local property tax revenues upward. Property tax revenues, which usually lag rising property values by several years, increased 18 percent during the period 1982 to 1986.

By the end of 1985, evidence of this improving fiscal health was apparent. Many states that had begun the decade in such difficult straits found themselves in exceptional fiscal shape. Only two states found it necessary to cut their budgets in 1985 as compared with 39 in 1983. Revenues had grown sufficiently to allow 14 states (seven on the east coast) to cut their income tax and four states to cut their sales tax.⁶

However, not all sources of state and local revenue were robust over this period. From 1982 to 1986, federal grants increased by only 6 percent—by far the smallest percentage increase of any of the principal revenue sources. A national policy of “New Federalism” was designed and implemented to decentralize government and to increase fiscal responsibility at the state and local levels. An important aspect of this policy was to reduce state and local government reliance on federal aid.

On top of the revenue pressures being exerted by falling federal aid throughout the decade, state and local own source revenues began to decelerate in 1986. As shown in Table 2, state and local revenues grew by 9 percent from 1986 to 1990, a sharp contrast from the 19 percent growth of the prior four years. By 1988, strains in state revenue systems were increasingly visible. Six states (California, Delaware, Kentucky, Massachusetts, New Jersey, and West Virginia) found that they had overestimated their personal income tax receipts. Twelve (Connecticut, Massachusetts, Michigan, Wisconsin, Missouri, North Dakota, South Carolina, Virginia, Arizona, Colorado, Utah, and Kentucky) found that sales tax forecasts had been optimistic.⁷ The sales tax and personal income tax, which had grown more than 20 percent during the earlier period, fell to growth rates of 10 percent and 18 percent respectively during the 1986-90 period. The property tax also began to falter. The growth rate in property taxes fell from 18 percent to 9 percent.⁸

The revenue bulge during the 1982-86 period was large enough to allow state and local governments in many sections of the

TABLE 2

State and local government receipts
(Billions of constant dollars)

	Year			Percent change	
	1982	1986	1990	1982-86	1986-90
Total*	434.1	516.8	565.1	19.1	9.4
Own source tax revenues					
Income	50.8	63.3	74.8	24.6	18.2
Sales	95.0	114.7	126.7	20.7	10.5
Property	81.8	96.9	106.2	18.4	9.6
Corporate	10.0	15.7	16.7	57.0	6.4
Federal grants-in-aid	85.0	90.4	93.9	6.4	3.9

*Total state and local government receipts.

NOTE: Figures adjusted to 1982\$ using the state and local government purchase deflator.

SOURCE: *Survey of Current Business*, second quarter data, U.S. Department of Commerce.

country to expand government services and programs, even though federal grant money was experiencing sluggish growth. As the growth rates in revenues slowed, states had to face the problem of spending commitments that had been taken on during periods of rapid revenue expansion.

Trends in state and local expenditures

State and local governments respond, albeit imperfectly, to the current needs and wants of their constituencies. In the 1980s a number of issues became increasingly important to citizens who pressured all levels of government to respond with additional spending. These issues include the betterment of the U.S. education system, regulation and enforcement of environmental laws relating to clean air and water, recycling, and reduced pesticide use, and demographic issues such as care for the elderly and the indigent and a burgeoning prison population.⁹

Despite reduced federal aid and volatile revenue flows, changing constituent needs, and federally-mandated program pressures, the composition of state and local spending by category remained fairly stable in the 1980s. Public welfare and health and hospital programs remained more or less constant, claiming 12 percent and 9 percent shares respectively. Over the 1980-1989 period, the share of state and local general expenditures used for education fell only slightly, from 36 percent in

1980 to 34 percent in 1989. Another program area with heavy federal participation, transportation (highway, air, water, etc.), also lost a small share, falling from 10 percent of total general expenditures in 1980 to less than 9 percent in 1989. The areas with increased shares include police and corrections, government administration, and interest on general debt. Police and corrections increased their share 1 percentage point, government administration .5 percent, and interest on general debt 2 percent.

State expenditure patterns may not remain so stable in the 1990s. As budgets become even tighter, states will be forced to focus their dollars on the most critical state- or region-specific program needs and trim back programs that are less essential.

The 1990s will find state and local governments facing increasing levels of federal mandates and turnbacks. States have accepted increased responsibility for several programs either because they have been required by mandates to do so, or in response to constituent pressures. Programs such as Medicaid, with recent expenditure growth of 15 to 20 percent per year, have proven to be particularly costly despite limited federal reimbursement. Further, in order to comply with court-mandated standards in areas like prison reform, states have undertaken expensive construction programs, often without the benefit of federal aid. These pressures come in addi-

tion to fulfilling their own long-standing service responsibilities.

Regional effects of the New Federalism

The 1980s saw a change in the direction and nature of federal funds flowing back to states and municipalities. Whether intentional or not, changes in federal spending policies in the 1980s exerted pressures that were uneven across regions. Federal spending by region of impact can be defined for our purposes to include state and local grants, salaries and wages of federal employees, procurement (mostly defense spending), and direct payments to individuals.

On the state and local level, the New Federalism meant that funding for discretionary grant programs (block-type grants that can be used for a variety of purposes) was sharply reduced in favor of categorical spending with a restricted or limited purpose, and direct payments to individuals. Federal spending increased for Medicaid and Aid to Families with Dependent Children throughout the decade. However, even this increased spending was not sufficient to forestall fiscal pressure when state caseloads grew faster than had been budgeted. In general, grant programs that focused on older, more urban regions of the country, suffered the biggest cuts. Among the programs affected were the Urban Development Action Grant Program (which was eliminated in 1988), the Community Development Block Grant Program (cut 25 percent from 1981 to 1988), General Revenue Sharing (eliminated for the states in 1980 and for municipalities in 1986), the Environmental Protection Agency wastewater treatment program (cut 36 percent), and the Urban Mass Transit Administration Program (cut 13 percent).¹⁰

Beginning in 1981, federal budget priorities were shifting away from federal grants altogether. Instead, spending on procurement comprised a growing share of the federal budget. In New England and California, the increase in procurement spending served as a significant economic stimulus, thereby helping to soften the blow from the reduction in discretionary aid. Both Connecticut and Massachusetts, two states widely hailed as among the strongest economic performers in the nation during the mid-1980s, benefitted substantially from the national build-up in defense spending. One report estimated that every federal

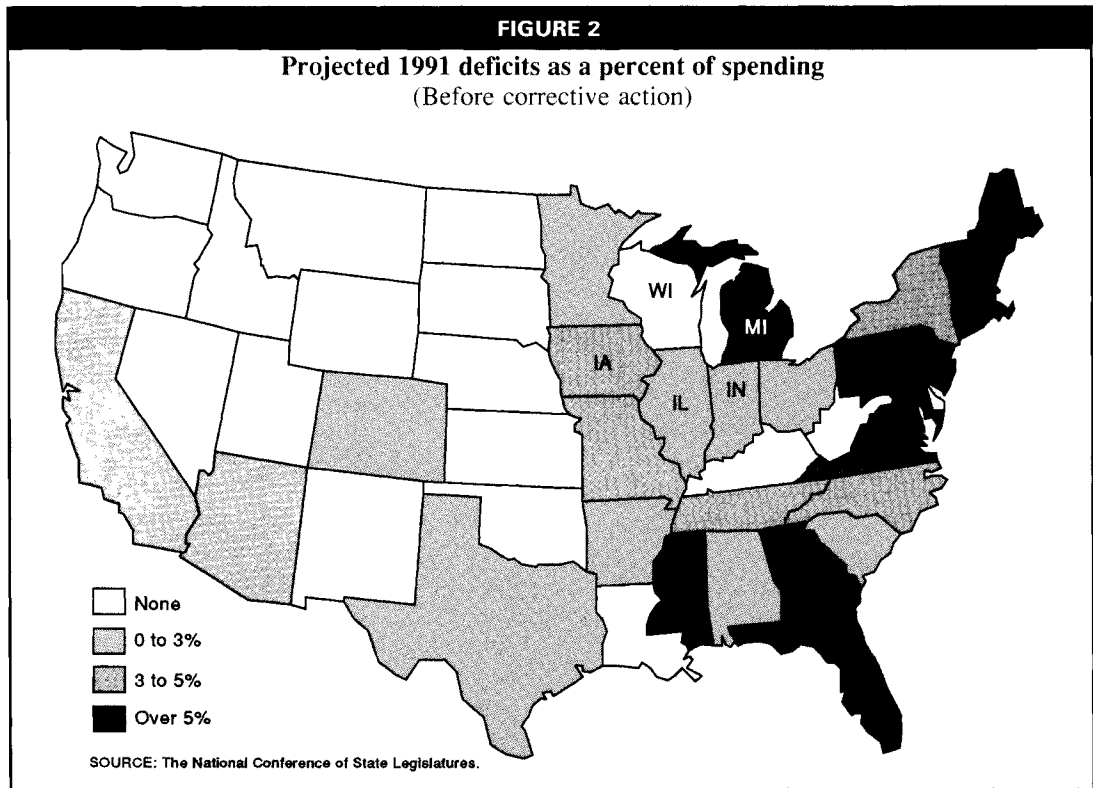
defense-related dollar of tax money originating in Connecticut and Massachusetts returned \$1.93 and \$1.66, respectively, in procurement. Similarly, California enjoyed a return of \$1.60. In contrast, the return for Seventh District states ranged from a high of \$.72 in Indiana to a low of \$.30 in Illinois. Partly as a result of the shift in federal spending toward procurement and the unequal distribution of benefits from this shift, cumulative federal spending (all sources) from 1981 to 1988 for the Midwest was \$19,537 per capita as compared with \$28,722 for New England.¹¹

Regional patterns: Seventh District focus

Seventh District states did not share in the same rapid revenue and expenditure growth that characterized the two coasts throughout much of the decade of the 1980s. However, the gap between District and national revenue and expenditure growth narrowed considerably during the second half of the decade due to more recent economic conditions favorable to the Seventh District.

Using ending year balances as an indicator of fiscal health, the Seventh District outperformed the U.S. average for FY87, FY88, and FY89.¹² While projections of year-end balances are highly imperfect,¹³ District states themselves had expected robust year-end balances for FY91 prior to the current economic slowdown. Revised figures indicate that while District states will not reach their optimistic projections, their fiscal condition is still stronger than that of most of the states on the two coasts (see Figure 2). As of early 1991, only Michigan appears to have been affected profoundly by the recession as reflected by the need for tax increases or significant budget cuts in order to end the current budget year in balance. However, evidence of increased fiscal pressure could be found in all District states. District states are experiencing increasing expenditure demands for programs that historically grow during recessions. Programs such as Medicaid are growing much faster than FY91 budgets had predicted. However when compared to the rest of the nation, District revenue growth estimates have held up reasonably well.

One of the underlying reasons for the District's fiscal strength relative to other districts through FY91 can be traced to a resur-



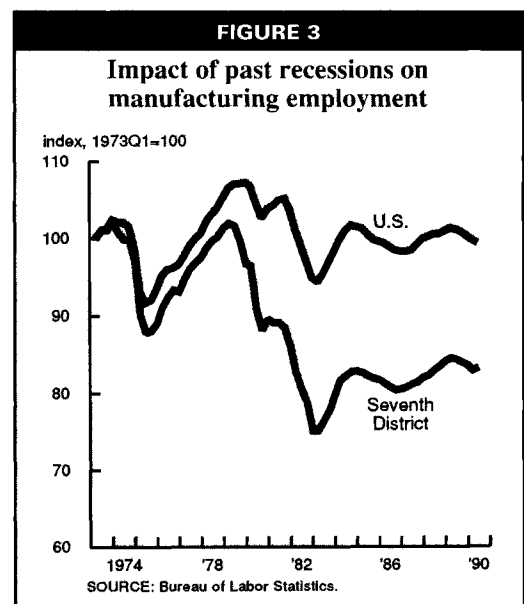
gent strength in economic conditions in the Seventh District, while other regional economies such as the Northeast and South have faltered. This development is a reversal of fortunes from the early 1980s when the District economy, and resulting fiscal conditions, were sorely strained.

Rebuilding the Seventh District economy

In the early 1980s, the bottom fell out of the District's economy. The twin pillars of the region's economic base, manufacturing and agriculture, experienced a deterioration of conditions the likes of which had not been seen in the post-war era. From peak-to-trough, one-quarter of the region's manufacturing jobs evaporated (see Figure 3), although some jobs were subsequently regained beginning in 1983 as the U.S. consumer led the nation and the world out of its economic doldrums. Still, District manufacturing was slow to recover from the one-time onslaught of overseas competition accompanied by a rising dollar. In contrast, many of the nation's coastal regions were gaining manufacturing jobs in high tech industries such as computers and electronics and in defense-related industries, many of

which were impervious to the rapidly escalating trade deficit.

District agricultural fortunes also experienced a downturn in the early 1980s that was both sharp and extended.¹⁴ Led by rising world demand for grains, District exports surged in the 1970s. The result was a specula-



tive boom by District farmers in both land values and capital spending. A decline in world demand in the early 1980s, accompanied by a rising U.S. dollar and several droughts, led to a severe shrinkage in farm exports and earnings. In turn, high debt levels and stagnant earnings in the farm sector contributed to the woes of District manufacturers of farm machinery and equipment.

Beginning in early 1985, the value of the dollar began to fall from its lofty heights. Still, the District's core manufacturing industries continued to stagnate in 1986. But by the end of 1986 and into 1987, two forces were igniting a District recovery. The falling value of the dollar finally began to stimulate foreign exports. Chemicals, industrial machinery, and equipment sales increased. At the same time, the extended U.S. expansion lent its force to domestic sales of capital goods as manufacturers here and abroad could no longer profitably delay expansions in their capacity. Real, gross nonresidential investment rose by 2.5 percent in 1987 followed by a whopping 8.3 percent rise in 1988. This resurgence was most apparent in capital goods states, such as Illinois, Iowa, and especially Wisconsin.

At the same time, economic growth in the coastal regions of the U.S. began to cool as defense spending on advanced weapons systems was curtailed and the once red-hot financial services industries began to experience difficulties. Overall, the nation's economic growth tapered off in 1989 and into the first half of 1990, but the engines of growth, and their regional impacts, remained much the same. As a result, and despite the problems of the domestic auto makers, District economic fortunes continued to improve. For the most part, revenue growth was responsive to economic expansion, affording the District's governments some slack in fiscal pressure.

Rebuilding the District's fiscal structure

In addition to a turnaround in the general economic environment, the District states also benefited from their governments' discretionary fiscal strategies and actions presumably undertaken to preserve fiscal balance and integrity. By FY87, three Seventh District states (Iowa, Indiana, and Michigan) had adopted budget stabilization funds. Wisconsin proposed establishing a budget stabilization

fund in its FY90 and FY91 budget proposal; Illinois alone has no budget stabilization fund.

Low debt levels can be another example of prudent fiscal policy. Government debt levels are an important gauge of fiscal soundness because debt reflects claims on the future revenue and income of the state. Often, states with declining tax revenues will turn to bonding and other debt instruments in order to sustain selected program initiatives. Increases in the amount of tax and other revenues being dedicated to retiring debt can often signal that a state is experiencing fiscal trouble. This is not to say that higher levels of bonding are necessarily an indicator of stress. Capital investment in assets with long lives and attendant economic benefit can be a rewarding use of taxpayer money.¹⁵ However, the use of debt to meet current expenditures rather than long-term capital projects during a rough economic period usually indicates fiscal stress.

In comparison to the rest of the U.S., the District has avoided this pitfall reasonably well. Despite revenue growth that ran below the U.S. average throughout most of the 1980s, District states were more restrained in expanding their use of debt than the rest of the U.S. From FY80 to FY88, total state and local debt in the District grew by 72 percent. By comparison total debt for the rest of the nation grew by 112 percent.

Even better evidence of the District's fiscal restraint is provided by the comparison between the rest of the nation and the District in terms of the change in per capita debt and in debt as a percentage of personal income over the 1981-88 period. By 1988, the District's per capita debt was over \$1000 less than the nation as a whole. Similarly in 1988, debt as a percentage of personal income stood at 13.6 percent for the District while the figure for the rest of the nation stood at 21.1 percent (see Table 3). These relatively low debt levels potentially position the District better for the 1990s in two ways. First the District is better positioned to use debt to withstand a budgetary shortfall. Second, District states may be able to use debt to invest in public projects such as transportation infrastructure, which could enhance the region's economic competitiveness in the 1990s.¹⁶

A review of the District's spending in the 1980s suggests that District states have acted, either by design or in reaction to adversity, to

TABLE 3

State and local government debt

	Percent change total debt	Debt per capita (in dollars)		Debt as a percent of income	
	FY80 vs. FY88	FY80	FY88	FY80	FY88
Illinois	70.6	1444.1	2423.4	13.7	14.8
Indiana	84.7	797.5	1455.4	8.9	10.5
Iowa	96.4	821.2	1658.8	8.8	11.7
Michigan	67.3	1264.9	2121.8	12.7	13.8
Wisconsin	67.0	1297.7	2100.3	13.8	14.4
District	72.1	1215.9	2074.4	12.3	13.6
Rest of U.S.	112.0	1674.7	3232.3	17.6	21.1

SOURCE: *Government Finance, 1979-80, 1987-88*, U.S. Department of Commerce Bureau of Census.

keep their spending within their ability to pay—so-called “fiscal capacity”.¹⁷

The personal income of state residents is an easily understood and broad-based measure of a region’s fiscal capacity. A government’s ability to spend should be closely related to the income level of its constituents. Of course the specific tax bases available to governments—property, sales, income, etc.—more directly relate to government revenues, and these often restrain revenue growth. Nonetheless, higher income states should be able to adjust their tax and revenue systems, subject to citizen approval, in order to generate public revenue.

“Expenditure effort” measures the extent to which state and local governments utilize or stress their underlying fiscal capacity (that is, economic base). Government spending per \$1000 of personal income is one such measure of expenditure effort. In most situations a low expenditure per \$1000 personal income is desirable, other things equal, because it means that government services put less strain on the tax base, and constituents have more discretionary income.

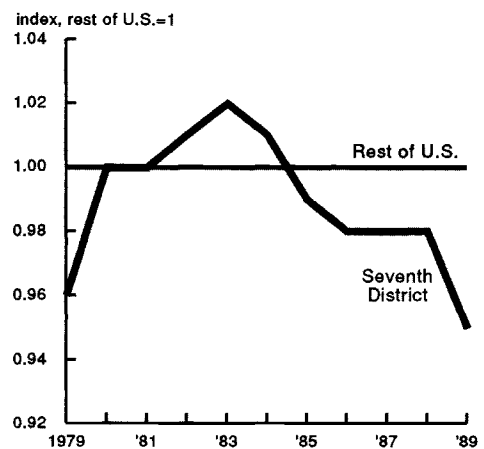
In 1979, the Seventh District had levels of expenditure effort equal to or slightly below the rest of the nation (see Figure 4). Expenditure effort began to rise during the 1981-82 recession and continued into 1983, pushing above the effort of the remainder of the nation by approximately two percentage points. In perspective, the District’s relative rise in expenditure effort was notably moderate in light

of its profound drop in economic conditions. During hard times, demands for income support programs and social welfare services rise sharply in tandem with the needs of unemployed and underemployed constituents. At the same time, the economic base for tax revenues slides in sync with the general economy. In this context, a much larger increase in the District’s government expenditure effort would not have been surprising.

The pattern of government spending behavior over the remainder of the decade (see Figure 4) shows that the District’s rising expenditure effort was cyclical and recession-related. As the District economy recovered

FIGURE 4

**Spending per \$1000 personal income
(Seventh District relative to the U.S.)**



SOURCE: Bureau of Economic Analysis and Bureau of the Census.

from its economic shock, expenditure effort relative to the remainder of the nation eased back below the nation by fiscal year 1985. By the late 1980s, when the District economy began to perform especially well under the influence of surging exports and capital spending, its expenditure effort had come full circle. In fiscal 1979, prior to the region's economic travails, District expenditure effort stood 4 percent below the rest of nation; by fiscal 1989, it rested at 5 percent below the nation.

The District's relative improvement in expenditure effort is explained in part by increased spending in other regions. From 1980 to 1989, District expenditures per \$1000 of personal income climbed by \$4.50 while, in the remainder of the nation, the climb exceeded \$11 (see Table 4).

Public finance enters the 1990s

The 1980s were a volatile decade for state and local government finance. The beginning of the decade found a nationwide recession creating severe fiscal pressure, accompanied by state and local budget deficits, and ultimately leading to tax rate hikes. Also, federal government aid to the states was restructured and significantly limited during the 1980s.

From a national perspective, the 1980s found states (particularly on the two coasts) emerging from the early years of budget deficits and tax increases with record surpluses by the middle of the decade. Fueled by economic expansion, state revenues grew while states responded by initiating new or reviving delayed program initiatives.

By the end of the decade the same stresses that characterized the earlier part of the decade returned. The slowing economy meant slower revenue growth while program commitments continued to grow. As a group, the states entered the 1990s on shaky ground.

The 1990s—issues facing all states

Most observers believe that the 1990s will be more challenging for the states than the 1980s. Expenditure pressures in the areas of health care, school finances, and corrections will continue to grow. Demographic changes, such as increases in the number of the elderly, will also increase spending demands. On the revenue side, short term prospects provide no relief. The forecast for slower personal income growth will cut into state revenue

TABLE 4

**State and local spending increase
(decrease) per \$1000 personal
income vs. rest of U.S.**

Type of expenditure	FY 80-89	
	Seventh District	Rest of U.S.
General expenditures:	4.51	11.82
Education	1.32	1.36
Public welfare	0.95	1.68
Health and hospital	0.35	1.36
Transportation:		
Highways	(2.40)	(1.31)
Air	0.44	0.16
Other	0.00	0.03
Police	(0.03)	0.43
Corrections	1.31	2.09
Environment:		
Natural resources*	0.06	0.17
Sewerage	(0.96)	(0.41)
Sanitation	(0.02)	0.60
Interest on general debt	2.41	4.35

*Includes parks and recreation.

SOURCE: *Government Finances*, U.S. Department of Commerce, various years.

growth unless economic expansion revives more forcefully. Neither can the federal government be expected to come to the rescue. The most recent five year financial plan for federal spending places the burden of dealing with issues such as education, infrastructure, home health care, drug abuse, and the homeless squarely on state and local governments.¹⁸ And federal aid is unlikely to increase in the midst of federal budget problems. Instead, it is more likely that the federal government will further hinder states by usurping potential revenue sources and increasing program mandates without accompanying financial support.

Increasing interest in offering a tax environment that is attractive to business development and expansion will put pressure on legislatures and local policy makers to limit or forego tax rate hikes. In the absence of higher tax rates, state and local governments may investigate ways to broaden the tax base, such as limiting tax exemptions or extending current taxes to new bases (for example, extending sales taxes to cover more services). These indicators point to a decade of difficult options

for state governments. State governments may respond to slow growth and fiscal pressure by reducing state aid to local government, thereby increasing fiscal pressure on local government.

Finally, reduced federal aid and increasing debt costs will force all states to take a hard look at their budgets and focus their dollars only on programs with paybacks specific to their needs. No longer will states try to please everyone with programs covering an array of services. States will be forced to scale back their program offerings and keep only programs that serve the greatest need.

The Seventh District faces the 1990s

Ironically, the District's slow economic performance throughout much of the 1980s may have helped improve the fiscal position of the District in the 1990s. As noted earlier, slower growth in District states constrained District policy makers, resulting in moderate spending increases, stabilized revenue, and lower debt.

However, this is not to say that the District enters the 1990s with any fewer challenges than the states as a whole. All of the above expenditure and revenue trends will affect District states to a certain degree. Clearly the current national economic slowdown is affecting District states as recession-related spending increases and revenue growth moderates. Further, there are some other issues that are especially important to District policy makers. The District's economy continues to specialize in durable goods manufacturing industries which means that the current recession will be felt more keenly here than in the remainder of the country. As the state government fiscal year draws to a close, a budget squeeze across District states is emerging.

Following a stressful beginning, there is good news and bad news concerning the District's prospects for economic and fiscal prosperity in the remainder of the 1990s. First the bad news. The outlook for the region's personal income growth, hence income and sales tax revenues, is not robust. The latest forecast from the Department of Commerce places personal income growth for the District below national levels. Personal income is projected to grow an average of 26.2 percent in the U.S. from 1988 to 2000; with District states' growth rates ranging from 24.4 percent in Indiana, 24 percent in Wisconsin, 23.7 percent in Iowa,

21.8 percent in Michigan, and 21.6 percent in Illinois. With income growing more slowly than the U.S. average, it is unlikely that District revenue performance will exceed national growth rates. Lower revenues will continue to restrain District expenditures.

Population growth also presents a challenge to the District. While the U.S. population grew by just over 10 percent from 1980 to 1990, growth in District states ranged from 4.3 percent in Wisconsin, 1.3 percent in Indiana, .72 percent in Michigan, and .35 percent in Illinois. Iowa's population actually declined 4.3 percent. Relatively low population growth will affect the District in two ways. First, the District's share of those federal funds that are driven by population formulas will decline. Second, it will reduce the District's political influence by reducing the number of congressional seats held by District states. Figures published by the Northeast-Midwest Institute¹⁹ indicate that District states will lose five seats in Congress when the results of the 1990 census are concluded. The effects are even more pronounced when the slower growth rate in District population is considered in a longer time frame. Since 1940, District states have relinquished 12 congressional seats to other parts of the country. This pattern of slow population growth is expected to hold through the 1990s. The Department of Commerce projects the District's population to grow by roughly 6 percent from 1988 to 2000, while the U.S. population as a whole will grow by 8.9 percent.

On a more encouraging note, the District's slow economic performance in the 1980s caused District states to adopt fiscal policies favoring moderate budget increases with less dependency on rapid revenue growth.

Further, a potential advantage exists in the District's low debt levels. District states have been slow to increase their bonding levels until recently. As a result, debt could be used to increase fiscal and economic capacity in two ways. First, investment in infrastructure can improve a state's economic attractiveness by creating the capacity for economic expansion. Second, prudent debt use can be an economic stimulus during slow economic times when other fiscal tools of government are constrained. More active but judicious use of debt capacity can pump state and local government dollars into the economy without having to

pay for the liability immediately. In the long run, total fiscal capacity can potentially be increased as the economy expands in response to better infrastructure. Moreover, the expense of the liability can be spread over future taxpayers who will also share in the returns from capital investment and enhanced public services in any case.

Conclusion

Prudent budget management has helped the District states. To cite Michigan, this state was running nearly an \$800 million deficit in 1982. By 1985, it had pulled itself out of the red and begun a \$419 million budget stabilization fund. But even prudent budget management has its limitations in the face of a slumping economy. Declines in the state's automotive industry are already being felt in the current fiscal year. FY91 finds Michigan back in the red, facing a potential \$650 million budget

deficit. Similarly, Illinois, despite tight budget practices, finds itself struggling to maintain a small monthly balance in its general fund and is looking to cut FY92 spending significantly.

Such volatility highlights the fact that the District states can still fall victim to the same ills they faced at the beginning of the 1980s—a still heavy reliance on manufacturing and the problems inherent in a cyclically-sensitive and industrially-mature economy.

No one can predict the future with complete accuracy, but efficient and effective budget management will be the key tools state and local governments will need to thrive (or survive) in the 1990s. As state and local governments grow more dependent on their own sources of revenues, budget management will require that governments respond quickly to local and regional economic conditions in order to preserve their fiscal health.

FOOTNOTES

¹A state's general fund normally includes only expenses and revenues associated with the operation of the state, that is, the administration of the state agencies such as Employment and Training, Human Services, etc. Many states have special funds that are single-purpose funds such as university or capital funds which are not considered general funds.

²National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States*, October 1988, p. 33.

³Specifically, this figure is comprised of general funds, own source receipts, plus contributions for social insurance and federal grants-in-aid, less purchases of goods and services, transfer payments to individuals, net interest paid (less dividends received), and subsidies.

⁴National League of Cities, *City Fiscal Conditions in 1990*.

⁵Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism 1985-1986*, Table 53, February 1986.

⁶Ibid.

⁷National Governors Association and National Association of State Budget Officers, *Fiscal Survey of the States*, October 1988.

⁸Slow growth in property tax figures also reflects national efforts to reduce reliance on the property tax by increasing state assistance for municipal programs such as education.

⁹For a more complete discussion, particularly of the impact of increased prison expenditures, see Laura Rubin, "The Current Fiscal Situation in State and Local Governments," *Federal Reserve Bulletin*, December 1990, pp. 1009-1018.

¹⁰Keith Laughlin, *The Flow of Federal Funds 1981-1988*, Northeast-Midwest Institute, March 1990.

¹¹Ibid.

¹²National Governors Association and the National Association of State Budget Officers, *Fiscal Survey of the States*, October 1988.

¹³Other surveys of state fiscal position include the National Conference of State Legislatures survey and the *State Budget and Tax News*, Tax Watch list.

¹⁴Gary L. Benjamin, "Agriculture and the Great Lakes Region," *The Great Lakes Economy Looking North and South*, Federal Reserve Bank of Chicago, Chapter 9 (forthcoming).

¹⁵Moreover, it can be argued that debt-financing of long term assets such as roads and bridges are appropriately and equitably financed through a mechanism that spreads the tax burden across the generations who ultimately consume public services.

¹⁶For more on this topic, see David Aschauer, "Is Public Expenditure Productive?" and "Is Government Spending Stimulative?," *Staff Memoranda*, SM-88-7 and SM-88-3, Federal Reserve Bank of Chicago, 1988.

¹⁷Many efforts have been undertaken to construct more expansive measures of state ability to tap revenues or spend. For example, the particular mix of economic base within a state reflects the extent to which a state can shift tax burdens to residents of other states, that is, so-called "tax exporting". For a discussion see Advisory Commission on Intergovernmental Relations, *Measuring State Fiscal Capacity: Alternative Methods and Their Uses*, M-150, Washington, D.C., 1986.

¹⁸*State Budget and Tax News*, Vol. 9, Issue 20, October 17, 1990, p. 5.

¹⁹Keith Laughlin, "Census Results Cast Shadow on Region's Funding Fights," *Northeast-Midwest Economic Review*, February 4, 1991, p. 11-13.

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