

Can Long-term Gain Come from Budgetary Pain?

Facing Years of Shortfalls, State and Local Governments May Find the Will to Reform

By Edward W. "Ned" Hill and Fran Stewart

Headlines trumpet the bad news: State and local governments have been forced to lay off workers and cut services to plug budgetary holes caused by the current economic crisis. Here's the worse news: The financial squeeze on state and local budgets is likely to get worse – even if optimistic projections that the economic recession will end by mid-2009 turn out to be true. Four experts in municipal finance assembled for a forum sponsored by the Urban University Program and Cleveland State University's Levin College of Urban Affairs in Columbus predicted shortfalls in state and local budgets as far out as 2012. Despite the dark clouds building on the fiscal horizon, all four panelists offered up a silver lining: This economic storm may spark needed political reform in Ohio.

If viewed strategically, this economic crisis may force state and local governments to improve efficiency, prioritize spending, form partnerships with private organizations and other government entities, restructure programs and embrace reforms. "The pressure systems have to build enough for us to change how we do business," said R. Gregory Browning, president of the Columbus-based public policy and management consulting firm Capital Partners and former director of the Ohio Office of Budget and Management. "The pain has to be enough to move us from the status quo."

If misery loves comfort, Ohio can take comfort in knowing it's not alone in its economic troubles. Brian Sigriz, with the National Association of State Budget Officers in Washington, D.C., noted that roughly 40 states are experiencing some degree of budgetary shortfall, with many facing significant losses in revenue and increasing demand for services. As bad as that is, many "haven't hit bottom yet," Sigriz said.

City budgets are faring no better. An annual survey by the National League of Cities on the fiscal status of cities found that, as of January 2009, 92 percent worried about their abilities to meet needs in 2010. Citing an 18- to 24-month lag between the end of a recession and an upturn in local tax revenues, Christopher Hoene, director of the Center for Policy and Research at the NLC, predicted rough road ahead: "We're looking at the low point as being late 2010 or early 2011. That means we're looking at a couple of pretty tough years."

What will make recovery from this recession particularly difficult for cities and states, Hoene said, is the dramatic loss in housing values, resulting in significant losses in property taxes for municipalities. Although property taxes are only one of three primary revenue streams that local governments have, with sales and local income taxes being the others, they represent a critical revenue source. Property tax collections that have declined because of falling housing values will take longer to turn around. "When there is a housing component of a recession," Hoene said, "we tend to come out of it pretty slowly."

This recession marks the first time in the history of the NLC survey that municipal property, sales and income tax collections have all been down at the same time. "The three revenue sources are more integrally linked than they used to be," Hoene said. In particular, sales and property taxes moved more closely together as housing prices soared. "What was driving spending was the wealth people had in their homes," he said.

In addition to lower revenues, the housing crisis is taxing city budgets by increasing the need for services. A March 2008 report by the NLC found that 53 percent of responding cities had experienced greater need for temporary assistance, 33 percent had seen an increase in vacant property, and 22 percent faced an increase in temporary housing.

Operating costs are also pressuring local governments. More than 90 percent of city finance officers reported that rising prices and inflation were negatively affecting city budgets. Nearly as many reported that employee wages (89 percent) and health benefits (84 percent) were budgetary concerns. Having funds necessary to meet infrastructure and public safety needs concerned 78 percent of city finance officers, and employee pension costs were seen as squeezing city budgets by 77 percent of those surveyed.

Local governments struggling to meet obligations despite declining tax collections will find little help from their state governments. Federal stimulus funds will help ease some of the budgetary pressure, but they will by no means erase the entire shortfall. There is no way for most state and local governments to avoid the looming fiscal pain, the panelists predicted.

NASBO's Sigriz noted that it has become increasingly difficult for states to cut spending. "Over the past 15 years, general funds have been declining as a percentage of state budgets, and other state funds have been growing. That limits what states can do with the general fund. They have less flexibility than 15 years ago." Education and Medicaid now make up nearly 63 percent of states' general fund expenditures. "When you count health care, it's probably about 75 percent," Sigriz said. "States are going to have to start looking at those areas because that's where the money is."

Sigriz cited California as an example of budgetary structural imbalance. Expenditures have kept going up even though revenues are down. State spending in California has outpaced revenues since 2006 and accelerated in 2008 to the point that expenditures exceed revenue in the 2009-2010 budget by \$30 billion. Sigriz said such budgetary imbalances occur when more and more spending becomes "programmed in."

Ohio faces budgetary problems – although Brian Perera, finance director for the Ohio Senate, added thankfully that Ohio's fiscal problems are nothing on the scale of California's shortfall. He said the state is estimating declines in personal income tax collections from 2009 to 2011 and drops in sales tax receipts for 2009 and 2010, with a modest increase projected for 2011. General fund receipts "have, for all memory, gone up, but now they're going down. People would not have believed that possible...." More than 80 percent of the current state budget is swallowed up by "non-discretionary spending" for requirements such as debt service, Medicaid, and primary and secondary education. Perera said that, without changes, that would lead to continued financial strain: "How do we deal with this, having all these spending pressures and less than stagnant revenue growth?"

"When things get this bad," Sigriz said, "you have the opportunity to consolidate programs, restructure, look at how you do things and why." Hoene echoed Sigriz's belief that the current economic crisis may spark budgetary reform. "Bad times provide political cover that you don't have at other times." He noted that, although states are not in a position to help local governments cover spending obligations, they could reform the structure of local government. One target is the number of local taxing jurisdictions. Perera pointed out that only Kansas has more local taxing districts than Ohio.

“Under pressure, we are going to have to change,” Browning said. “We have 3,000 political subdivisions in Ohio, and we’re just supposed to continue to fund them forever? Do we need that?”

Hoene agreed: “There are lots of states where there are far too many overlapping jurisdictions.” For them, the crisis may offer opportunity to reform their systems and encourage various taxing districts to collaborate. “That’s probably the right political calculus,” he said. “But it won’t necessarily solve the state’s budget shortfall.”

To address projected budget shortfalls in the short- and long-term, Ohio may need to adopt new perspectives. Gambling has been proposed as one option for improving the state’s fiscal outlook. But the panelists suggested that changing the state’s economic outlook might hinge more on Ohio placing better bets on competitiveness and sustainability. Instead of taking a “peanut butter” approach to spending by trying to spread a little funding everywhere, the state may be forced by the crisis to invest more strategically in areas that have better potential and greater impact and where there is incentive to promote local government consolidation.

“We have a permanent budget crisis in Ohio. How do you pivot, how do you change, in a state that is 47th or 48th in economic activity?” Browning asked. “Under pressure, we have to be strategic about something big and bold, and that’s a gamble. We have to be strategic ... in a way we haven’t wanted to be in the past.”

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