Domestic Credit by Richard Freeman

Fiscal crunch for states and localities

The recession, tax revisions, and federal cutbacks are having a dramatic, destructive effect.

Information reported in two recent bank newsletters confirms that state and local-level government finances are heading sharply into the red, with major negative consequences for financing urban infrastructure, for the capital markets, and for efforts to limit the effects of the current recession.

According to the *Morgan Guaranty Survey* for November, the operating balance of states and municipalities as a whole is headed for a $5 billion deficit in 1982, the first deficit since the 1975 recession. This follows five years of declining surpluses, which have shrunk from $10.1 billion in 1977, more than $9 billion in 1978, $3 billion in 1979, just over $2 billion in 1980 and almost $4 billion estimated for this year. Next year's shortfall results from the cutbacks in federal grants to cities, an adverse impact on state finances from the Economic Recovery Tax Act of 1981, and the shortfall in tax revenues.

The *Manufacturers Hanover Financial Digest* for Nov. 23 reported that, adding in revenues derived from retirement and disability contributions, states and localities reaped a cumulative surplus between 1977 and 1980 of $110 billion, of which $24 billion was in the operating balance account. This surplus has been cited to indicate that the cutbacks in federal aid will not create a crisis. But beginning with California's Proposition 13 in 1978, many states have seen tax and spending limitations reduce their available funds. Coupled with general economic stagnation, these factors would have reduced the surplus to nearly zero even without federal cutbacks.

According to the Morgan Guaranty letter, the congressional reconciliation bill is expected to reduce federal grants by $7 billion from the $94 billion recommended by President Carter. In real terms, this is a 14 percent fall (8 percent in current-dollar terms) during 1982. This contrasts with an annual 6 percent real rise during the past decade. Moreover, several provisions of the Economic Recovery Tax Act of 1981 may reduce state and local tax collections by $2.5 billion, because of the close linkage of state tax bases to federal income-tax returns. Many of the federal personal and corporate tax reductions will automatically lower state levies, unless tax rates and schedules are changed which is often impossible.

As the recession deepens, sales tax revenues fall with softening sales; income-tax levies decline with lowered incomes and ballooning unemployment rolls; and welfare and unemployment payments rise. Morgan estimates that even with new revenue-raising actions of some 30 states this year, state and local tax collections will grow at only 9 percent next year, down from 11 percent this year. But even this assumes a mild and short-lived recession.

This crisis is likely to affect the credit markets in several ways. According to Manufacturers Hanover, $50 billion of the $110 total surplus in the four years ending in 1980 went to purchase U.S. government securities. Some of these were purchased directly with the operating surpluses, which will certainly be sold when the deficit materializes next year. With cuts (or ceilings on increases) in various federally subsidized entitlement programs, social insurance funds will also be likely to sell U.S. government securities.

This means not only that the state and local contribution to net national savings (15 percent last year) will shrink, but that federal borrowing will now need to soak up even more funds from the private markets, including whatever the state and local governments sell plus what they would have normally bought, but will not be able to, this year. As Manufacturers Hanover points out, "astonishingly, in fiscal 1981, total federal and federally related borrowings were already just about equal to net private savings." So the added strain will simply "displace further private sector credit demands."

Note that even while running the nominal surpluses in recent years, most municipalities, especially the medium-sized and larger cities, have vastly underinvested in renewing their infrastructure, from bridges and roads to sewers, water supplies and mass transit. With historically sky-high borrowing rates for city bonds likely to continue indefinitely, combined with the expected deficits, infrastructure investment will be cut still further, portending a virtual collapse of many urban services.