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Municipal Finance in Ohio

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The financial condition of state and local governments has been strained in recent years by inflation, a growing demand for public services, and a generally unresponsive tax structure. With prudent management, Ohio's state and local governments generally have struggled through these problems, yet signs of financial strain have begun to surface. Within the last two years, schools have closed from lack of funds, cities have been threatened with default, and the rating accorded to the state of Ohio's general-obligation bonds has been downgraded from AAA to AA. Viewed against this background, the current budget problems, though not really a surprise, have become quite painful. The recession has seriously eroded state and local government revenues. The state's 1979-81 biennial budget is now threatened with a large potential deficit. Recent estimates suggest that state income has fallen more than $300 million below projections, and payments to welfare recipients have risen by more than $100 million above previously budgeted levels. The state imposed a 3 percent spending cut in June 1980, and further outlay cutbacks and a tax hike are being considered. To provide a better perspective of recent budget adjustments, this *Economic Commentary* examines the budget performance of Ohio's state and local governments between 1962 and 1978.

Budget Adjustments by State and Local Governments

In any given year, state and local government budgets are constrained by the tax base, the tax-rate structure, and legal restrictions prohibiting deficits. Relatively slow regional economic growth constrains the expansion of the local tax base, limiting the growth of both revenues and demand for some government services. Even more difficult are the budget adjustments that are required because of short-term fluctuations in revenues associated with cyclical movements in business activity. State and local governments have some flexibility, especially through the use of accumulated surpluses, the issuance of short-term debt, and even the postponement of capital projects.

The severity of short-term budget adjustments is affected by the income elasticity of the tax structure. Revenues from a graduated income tax, for example, are more responsive or sensitive to fluctuations in income than a fixed-rate tax, such as a property tax. The more income-elastic the tax revenues are, the faster the growth of revenues will be during a cyclical expansion, and the sharper the decline of revenues during a recession. However, high rates of inflation may cushion the impact on nominal tax revenues during a recession. The ability to adjust budgets is also affected by specific constraints, varying from earmarking revenues for specific functions to constitutional prohibitions on operating-budget deficits.

Typically, state and local governments enter a recession with financial reserves. By depleting reserves to maintain spending (even if not at pre-recession rates of growth), state and local governments alleviate the impact of a recession. When recessions turn out to be deeper or longer than expected, the alternatives are: offsetting the revenue decline with tax-rate increases or new taxes, cutting operating or capital outlays where legally possible, and financing through debt. As a rule, only the most severe recessions force state and local governments actually to reduce expenditures.

Reliance on funds derived from debt issues to cover operating expenditures has been a particularly important causal factor underlying past financial crises.[1] Long-term

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1. For a comprehensive discussion of the past misuse of short-term indebtedness, see Advisory Commission on Intergovernmental Relations, *City Financial Emergencies— The Intergovernmental Dimension* (U.S. Government Printing Office, July 1973, A-42).

debt is a proper instrument for financing long-term capital programs. Indeed, roughly 60 percent of all state and local capital expenditures is financed with bonds. Short-term debt issued in anticipation of tax revenues that have not yet been received frequently is used to provide a smooth cash flow or to provide flexibility in the timing of long-term debt offerings. Experience suggests that additional borrowing to meet current operating expenses, without making proper provisions for repayment, postpones adjustments and often leads to the need for even more severe adjustments in the future.

Financial Performance during Recessions

Fiscal stress among state and local governments obviously is greatest during periods of recession. On average, revenue of the state government of Ohio has been far more sensitive to recession than that of state and local governments nationwide (see table 1). The state's revenue represents roughly one-half of total state and local government revenues in Ohio. During the economic slowdown in 1966-67 and the recessions in 1970-71 and 1973-75, general revenues in the state declined in real terms; nationally, states experienced declines only during the relatively severe 1973-75 recession. (General revenues and expenditures include all revenues and expenditures except those from utilities, liquor stores, and insurance trust funds.) In the 1973-75 recession, Ohio's revenue decline was twice as great as the national average (−1.2 percent vs. −0.6 percent, respectively). The similar pattern of tax revenues indicates that the cyclical sensitivity of general revenues was concentrated in the tax base.

Table 1 Percentage Changes in Revenue and Expenditure during Recessions

Percentages based on constant 1972 dollars

	Ohio		U.S. state and local
	State	Local	total
General revenues			
1966-67	−0.6	−2.1	4.7
1970-71	−0.5	4.1	4.2
1973-75	−1.2	0.2	−0.6
Tax revenues			
1966-67	−2.7	−1.1	1.9
1970-71	−2.7	2.7	2.2
1973-75	−6.1[a]	−7.9[a]	−3.4[a]
General expenditures			
1966-67	−5.7	−1.5[a]	6.7
1970-71	0.5	3.1	7.2
1973-75	−3.7	1.3	−0.4

a. Peak to trough percentage declines using annual data span a two-year period, beginning with the first year of the recession. All other percentage changes were limited to the last year of the recession. The 1966-67 period is technically referred to as a business slowdown.

SOURCES: *Governmental Finances* and Federal Reserve Bank of Cleveland.

The greater cyclical sensitivity of Ohio revenues stems both from the industrial makeup and a tax structure that has become more flexible.[2] The concentration of such cyclically vulnerable industries as steel, automotives, and machinery in Ohio produces greater peak-to-trough percentage declines in employment, taxable income, and state revenue than in the nation as a whole. In addition, since 1972, state and local governments in Ohio have shifted toward a greater reliance on personal and corporate income taxes, making the state's tax system more progressive and more responsive to changing economic conditions.

In past recessions, the state usually has responded to revenue losses with substantial cutbacks in general expenditures (although real spending remained virtually stable during the 1970-71 recession). Nationwide, state and local governments reduced expenditures when necessary, but expenditure cutbacks tended to parallel revenue losses (−0.4 percent and −0.6 percent, respectively, during the 1973-75 recession). In contrast, state expenditure reductions in Ohio were at least three times greater than revenue losses during the 1973-75 recession.

General revenues in Ohio's local governments have tended to be less cyclically sensitive than those of the state government and, in some cases, even of the national sector. This has occurred largely because a sharp expansion in state aid has greatly cushioned local budgets from cyclical fluctuations. Although general revenues for local governments fell sharply during the 1966-67 slowdown, general revenues increased slightly (0.2 percent) during the relatively severe

2. See Steven A. Monzel and Robert H. Schnorbus, "Industrial Structure and Recession in Ohio," *Economic Commentary*, Federal Reserve Bank of Cleveland, June 30, 1980.

1973-75 recession. Tax revenues declined during both the 1966-67 and 1973-75 periods, but only the 1973-75 recession produced greater losses at the local level than at the state level. As a result, Ohio's local governments were able to maintain general expenditures in real terms except for the 1966-67 slowdown. While local governments on average cut back spending during the 1973-75 recession, Ohio's local governments increased spending by 1.3 percent. Although local governments could have supported their expenditures during the 1970-71 and 1973-75 recessions, state government transfers to local governments continued to expand. The only cutback in local government expenditures in Ohio occurred in 1967, when revenue transfers from the state were cut 10.3 percent. New sources of state revenue since then have enabled the state to absorb some of the impact of recessions on local governmental budgets. Without these transfers, local governments would have experienced greater fiscal strain.

Trends in State and Local Budgets

Since World War II, state and local governments have steadily increased their share of the nation's output—from 5.3 percent of real GNP in 1946 to 14.8 percent in 1975. The momentum of this expansion helped limit the impact of recessions on the budgets of state and local governments, at least until the 1973-75 recession. Since 1974, relative growth in state and local government spending has leveled off, and real wages and capital outlays have declined. To illustrate the adjustments made by Ohio's state and local governments, six ratios were constructed to analyze trends in revenues, expenditures, surpluses, and debt (see Description of Budget Ratios). By comparing Ohio's state and local government ratios with the total state and local government sector, a set of indexes were developed that focus on the relative trends of Ohio's state and local governments (see table 2).

State Financial Trends. In addition to providing a buffer for local governments,

Description of Budget Ratios

Per-capita Expenses:[1] total noncapital general expenditures less intergovernmental revenue transfers per person. This ratio is an overall measure of the expenses that state and local governments must support by taxation.

Tax Burden:[1] property, income, sales, and other taxes divided by total personal income. This ratio measures the local revenue demands placed on the population relative to its ability to pay.

Aid Dependence:[1] intergovernmental revenues relative to general revenues (excluding utility revenue and employment retirement revenue). This ratio measures the degree to which state and local governments depend on outside sources of revenue.

Per-capita Surpluses: current operating surpluses per person from state and local governments, including the difference between general revenues and general expenditures plus the difference between capital outlays and long-term debt retirement. This ratio measures the budget surplus available to state and local governments on a short-term basis by postponing capital outlays.

Debt Burden:[2] sum of long-term debt retirement plus total annual interest payments, divided by revenues from own sources. This ratio measures long-term debt service payments relative to the debt-carrying capacity of state and local governments.

Short-term Debt to Cash Holdings:[2] short-term debt outstanding divided by cash and securities holdings. (Since budget deficits can be handled by increasing short-term debt and/or by drawing down cash balances, a high and rising ratio over time may indicate fiscal stress.) This ratio is a rough measure of the short-term solvency of state and local governments.

1. See Touche Ross & Co. and The First National Bank of Boston, *Urban Fiscal Stress: A Comparative Analysis of 66 U.S. Cities* (New York: Touche Ross & Co., 1979).
2. See J. Richard Aronson and Arthur E. King, "Is There a Fiscal Crisis Outside of New York?", *National Tax Journal*, vol. XXXI, pp. 153-63.

Table 2 Budget Indexes for Ohio's State and Local Governments[a]

Year	Per-capita expenses		Tax burden		Aid dependence		Per-capita surplus		Debt burden		Short-term liquidity	
	State	Local	State	Local	State	Local	State	Local	State	Local	State	Local
1962	9	60	40	48	207	244	139	23	89	181	4	102
1963	7	58	39	49	220	250	134	29	106	165	6	115
1964	5	58	39	46	211	229	145	20	72	166	28	161
1965	7	71	38	52	187	218	126	20	70	174	132	155
1966	5	54	36	45	199	223	129	27	77	171	176	220
1967	8	42	35	43	186	190	121	25	85	167	229	241
1968	13	52	38	43	177	185	119	24	82	180	326	247
1969	12	67	40	46	182	183	129	20	85	171	213	223
1970	12	42	39	45	168	180	121	21	84	164	213	269
1971	14	53	38	46	161	168	129	24	91	157	139	256
1972	14	40	43	45	131	145	115	24	78	134	15	243
1973	16	40	48	44	133	176	112	22	78	161	4	269
1974	15	36	45	43	147	194	117	31	74	159	22	260
1975	16	33	45	41	136	186	135	42	78	145	19	248
1976	15	34	47	41	152	208	142	29	76	148	21	318
1977	14	34	45	42	152	221	127	31	80	142	84	424
1978	16	38	49	40	146	226	135	39	71	131	1	447

a. Index values were constructed by dividing the ratios for Ohio's state and local governments by the comparable ratios for the national sector and multiplying by 100. Thus, values greater than 100 are above the national average, and values less than 100 are below the national average.

SOURCES: *Governmental Finances* and Federal Reserve Bank of Cleveland.

the state government has maintained tight control over its finances. Although spending on a per-capita basis has been rising at a faster rate than the national sector (indicated by a rise in the per-capita-expense index from 1962 to 1978), state spending and taxes on a per-capita basis have been considerably below the average national level. Indeed, the index of tax burden continues to be less than half the average tax burden of the national sector. However, the percentage of general revenue received by the state from federal sources has been well above the national average (aid dependence was 26 percent of general revenues in 1978). The impact of the 1971-72 tax increases was clearly evident in the revenue and expenditure measures (the tax burden index jumped from 38 to 43 in 1972) and contributed to a marked reduction in dependence on federal sources (the index fell from 161 to 131 in 1972). Since 1972, spending relative to the nation tended to stabilize, while dependence on federal revenues began to rise again. Although the overall dependence on outside sources of revenue has been declining (from over twice the national level to about 50 percent higher between 1962 and 1978), the three indexes strongly suggest that the state depends heavily on federal aid. Loss of federal aid would force changes in the tax structure or reduce the state's ability to respond to the needs of local governments.

The state government's budget has shown little evidence of fiscal strain over the 16-year period studied. The state has achieved above-average per-capita surpluses in its funds available over the short term to meet current operations. In addition, both long-term and short-term debt have remained substantially below national levels. The state thus has avoided accumulating burdensome interest payments. Indeed, by 1978 the state had a relatively high surplus of cash holdings to redeem its total short-term debt. Only in the late 1960s did short-term debt approach troublesome levels (the ratio of short-term debt to cash holdings tripled in 1965 and was three times the national average). However, new sources of revenue in 1972 apparently eased the pressure by allowing drastic reduction of the state's short-term debt position (the index of short-term debt to cash holdings was 1 in 1978).

Local Financial Trends. While Ohio's local governments have followed the state's example in keeping revenue and expenditure levels below the national average, local governments have become even more dependent than the state on outside sources of revenue. Most of the intergovernmental revenue received by local governments (about 80 percent in 1978) came from the state government of Ohio. The aid-dependence index reached its lowest level in 1972; since then, aid to Ohio's local governments expanded faster than the national average. Local government spending has fallen steadily behind the national average (the per-capita-expenses index dropped from 60 to 38 between 1962 and 1978), perhaps reflecting a deliberate decision of taxpayers to hold down government expenditures. While local government tax rates have increased, the increases have fallen behind the national average. As a result, local governments have shifted toward greater financial reliance on the state and federal governments.

Although local governments have been affected less by recession than the state, they clearly have operated with far fewer reserves to fall back on in a fiscal emergency. Per-capita surpluses were roughly one-third the national average in 1978. Perhaps local governments could risk having extremely tight budgets if the state were prepared to intervene when deficits threaten. Indeed, high aid dependence and relatively low taxes have not limited the ability of either state or local governments to adjust their budgets to avoid short-run budget deficits. (The notable exception, of course, was the city of Cleveland.)

Local governments in Ohio appear to rely heavily on long-term and even short-term debt for capital formation and other financial needs. In contrast to the state, local government debt is well above the average national levels. While this debt burden has been declining relative to the nation, local governments have become more dependent on state and federal aid to service debts. Consequently, any loss of that aid would result in greater pressure on Ohio's local governments to reduce current expenditures, rather than risk defaulting on long-term debt service payments.

While long-term debt among Ohio's local governments is a matter of concern, short-term debt levels appear to be troublesome. About half of the short-term debt in Ohio's local governmental structures has been issued by municipalities, with the remainder being evenly divided between school and special districts. While starting at the national average in 1962, the short-term liquidity position deteriorated until the ratio of short-term debt to cash holdings for local governments was over four times the national average in 1978. Unlike the state, local governments apparently have continued to rely on short-term debt, even as new sources of revenue have become available. Of course, a low level of cash holdings may simply reflect more efficient cash management. Local governments could still claim to have their short-term debt outstanding covered by their cash holdings; however, the relatively high and rising levels of short-term debt to cash holdings, compared with the national average, suggest budget procedures that may prove to be troublesome in the future.

Concluding Remarks

While exacerbated by the sudden and deep contraction in economic activity in the second quarter of 1980, the current financial problems confronting state and local governments in Ohio are neither unexpected nor without precedent. Indeed, they parallel past experience in periods of recession. These problems should not represent insurmountable obstacles to preserving the financial health of individual governments. In past recessions, fiscal problems caused by loss of revenues have been relieved by cuts in expenditures and other temporary budget adjustments. To help insulate budgets from cyclical revenue losses, state and local governments in Ohio have placed greater emphasis than the national sector on outside sources of revenue. While consistent with acceptable budget management, such practices would appear to make budgets vulnerable to cutbacks in federal aid, such as revenue sharing, and to climbing interest rates. Indeed, the most disturbing trend has been the steady accumulation of short-term debt among local governments in Ohio. The growing reliance on short-term debt, more so than the cyclical loss of revenue, suggests the development of significant financial strains in Ohio's local governments.