

**GENERAL
SESSION**

FUNDAMENTAL TAX REFORM

Monday, November 11, 1996, 8:30 a.m.

Alvin C. Warren, *presiding*

**How a City Can Survive a Boom and Bust Cycle
Without Bankruptcy: The Case of Houston**

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This paper examines the revenue and expenditure choices of the City of Houston. The purpose is to understand the institutional context that allowed, in response to a massive economic downturn, the city government to reduce expenditure by 25 percent without resorting to some form of bankruptcy. I find Houston's first response was to ignore economic reality as long as possible. When the downturn proved severe, however, the key institutional feature appears to be the City Controller. The Controller must certify each city budget as balanced *ex ante*. This hurdle provides an important brake to the natural inclination of politicians to postpone hard decisions.

INTRODUCTION

Very few major cities have gone through economic swings as wild as those in the City of Houston. These economic swings allow a view of whether it is possible for political institutions and the politicians that inhabit them to survive the economic whipsaw of rapid change. This examination seems especially pertinent because there are many reasons to believe that cities respond poorly to a tightening of their revenue stream. The term urban fiscal crisis has been in virtually constant use over the last 30 years. As cities have coped with a variety of environmental and economic forces that have kept budgets tight, their governments have not always seemed very responsive to changes in their economic fortunes. For example, Inman (1992) has documented how Philadelphia, in the face of a relatively minor drop in public revenues, essentially went into bankruptcy.

This paper closely examines the institutions, as well as the revenue and expenditure choices, of the City of Houston to determine how the city has responded to the economic forces it faced. In particular, I will focus on the institutional aspects that allowed the city to reduce expenditure in the face of a massive revenue loss without a true fiscal crisis.

The 1970s and the first portion of the 1980s was a very prosperous period for Houston, resulting in a tremendous influx of people and capital. Houston's population grew from 1.22 million in 1969 to 1.65 million by 1981, a rate of 2.55 percent per year. During the same period, real per capita income of the Metropolitan Statistical Area (MSA) grew from \$15,082 to \$20,928, or 2.77 percent per year. Housing prices reflected the rapid growth, as real prices rose by almost three times (9.14 percent per year). This prosperous period was followed by a massive contrac

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tion when energy prices fell, and the housing market crashed, taking along the banking and savings and loan industries. Housing prices are just (1996) returning, on average, to their peak in 1982 in nominal dollars.

This cycle of boom followed by bust is fully reflected by the public sector's finances. The real residential property tax base in 1993 had fallen by over 35 percent to \$17,506 from its 1986 peak of \$26,990. City expenditures grew from \$402 per person in 1977 (in 1993 dollars) to almost \$600 in 1987. By 1989, they had fallen all the way back to \$450 per person. Despite a reduction in city expenditures of 23 percent in two years, the mayor in Houston did not even lose her job. This paper attempts to explain how the city government could respond to the massive loss in revenue without bankruptcy, state and/or federal intervention, or the massive bond defaults that have characterized some other cities' responses to economic downturns that were quite mild in comparison.

First, I examine the expenditure and revenue pattern of the city, and then discuss the institutional framework. Finally, I examine how the institutions shaped the city government response to the economic crisis.

THE REVENUE AND EXPENDITURE PATTERN FOR HOUSTON

Figure 1 shows real income per capita (1993 dollars) for the Houston MSA. After increasing steadily for over a decade, income peaked in 1981 at \$20,928 per capita, fell slightly in 1982, and plummeted by over 8.5 percent in real terms to \$19,147 in 1983. Not until 1989 did income surpass its 1981 peak. Houston's population, shown in Figure 2, exhibits essentially the identical pattern. Relative housing prices reflect these changes, as shown in Figure 3, rising in real terms

Figure 1



Figure 2

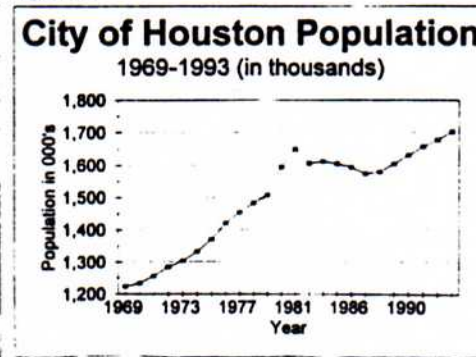


Figure 3



Figure 4

