Local Level Fiscal Sustainability and Strategies

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At the state and local level, fiscal sustainability is the capability of a government to meet consistently its financial responsibilities. In the short run, this involves either reducing expectations of government's roles or tinkering with the tax system to raise additional revenues. In the long run, it means that financial decisions must be made to protect future generations' fiscal abilities. There is clearly a connection between short-run decision-making and long run outcomes; this white paper will therefore discuss both although it will ignore nuances and second-order problems.

Sustainability Problems

Through November 2008, the housing market continued to decline, with some forecasting problems for at least the next six to nine months. This decline will lead to a fall in property taxes that will extend beyond this horizon, because of assessment lags or the political inability of local governments to raise the tax rate. As the recession continues and unemployment increases, there is also likely to be a continuation of foreclosure trends, which will lead to continued declines in property tax receipts. As the housing market falls there will be a reduction in sales of both durable and non-durable goods (to furnish the house) as well as an impact of the wealth effect, which leaves consumers feeling poorer and encourages further cut-backs in their consumption. Therefore, there will also be a fall in sales tax receipts. The recession will cause a fall in state income tax collections (as well as a fall in local income tax collections in jurisdictions that have local income taxes). The recession will also cause an increase in health and welfare costs at the state and county levels, which can lead to a fall in any intergovernmental transfers from the state to local governments.

The long-run sustainability problems may be even more serious. Health care costs will continue to increase at above the rate of general inflation, the public sector's defined benefit pensions are in serious financial trouble, and public infrastructure is generally considered ill maintained and lacking in growing areas.

Short-run solutions

The short-run solutions involve tinkering with the present expenditures and tax rates of the jurisdiction. Because of hard budget constraints, and assuming that all of the rainy-day funds have been exhausted, some services will have to be cut. For fiscal sustainability reasons, these cuts should not affect future economic growth. However, virtually all economic analysis indicate that expenditure cuts are more detrimental to the overall fiscal health of the local economy that tax increases, so that tax increases should not be automatically ruled out.[1] As the recession promises to worsen, major tax increases or expenditure cuts may become necessary, although because of both potentially mobile capital and labor, these policies must be carefully analyzed.[2]

A note about the up-coming stimulus package of the Obama administration: Given the time frame of enactment, the strictures concerning earmarking, the intense debate about who should get the money—the state or local governments, the 90 day expectation of the flow of infrastructure finance, and the large amount dedicated to individual income tax relief, it will probably have minimal effect on FY 2009 budgets. FY 2010 budgets should be prepared incorporating the Obama stimulus recommendations.

Long Run Solutions

Without a budget debacle to force change, long run decisions will be more difficult because of the entrenched political power of special interest groups. In addition, residents feel entitled to expenditure programs—polls confirm that residents 1) want to cut spending in general; 2) do not want to raise taxes; and 3) a greater number want to spend more on education, mass transit, freeways, police services, university education and fire protection than want to spend less.[3] The most significant long-run change that must be made is to remove this "free lunch" mentality. This means that the potential long run solutions have to be carefully explained in the context of legitimate budget

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[1] [1] See, for example, Peter Orzag and Joseph Stiglitz, Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?

http://www.cbpp.org/10-30-01sfp.htm. Note that Orzag has been recently named to head President-Elect Obama's Office of Management and Budgeting and Stiglitz is a Nobel Laureate in economics. For a more technical analysis, see Iryna Ivaschenko. (2004), Will the State and Local Budget Crises Hinder Economic Growth? In Matin Muhleisen and Christopher Towe (eds.) *U. S. Fiscal Policies and Priorities for Long-Run Sustainability*. Washington D.C.: International Monetary Fund. 48-54.

[2] See Jacoby, Sanford M. and Finkin, Matthew W. Labor Mobility in a Federal System: The United States (March 2004). Available at SSRN: http://ssrn.com/abstract=514482 or DOI: 10.2139/ssrn.514482 or Lorz, Oliver. (2001). "On the effects of capital mobility on local infrastructure policy and rent-seeking." *Regional Science and Urban Economics*. 31:2-3. (April): 319-337 for more citations and technical work on labor and capital mobility.

[3] Michael O'Neil (2009). "What we wand depends on question." *The Arizona Republic*. January 4, 2009, B12. Interestingly enough, no questions were asked about social services.

constraints. It also means a move toward an increased use of user charges and benefit based taxes, where there is a clear connection between the benefits of a program and the financing mechanism for that program. Other parts of this White Paper suggest some solutions to ensure long term fiscal sustainability, but the particular solutions related to eliminating the free lunch mentality would involve more use of tolls and user charges for transportation finance, and the increased use of a land value tax as a benefit tax for local government capital improvements.

Public finance decisions will affect local government fiscal sustainability. It is too easy to make ad hoc decisions covering the next two years that can generate extremely negative effects for the long run. Because GASB is currently considering a position paper that will require an explicit consideration of the fiscal sustainability of a local government, it is necessary to be conscious of the long run consequences of short run decision making.