Navigating the Fiscal Crisis
Tested Strategies for Local Leaders
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Can local government leaders formulate strategies that will actually – rather than hopefully -- stimulate their local economies? Has history any record of such successes?

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Abstract: Can local governments contribute to the recovery-directly and indirectly? Directly, local governments need to spend money. A banker who is a council member in an Alliance city is reported to have argued that if local governments stop spending, the recession will be worse and deeper. Local governments should utilize the bond authority they already have to get projects underway. Furthermore, it seems likely that the stimulus package will include public works funding that will rely on local governments to organize.

Federal policymakers have used fiscal policy tools on a massive scale to address the current economic crisis. For local governments, these interventions beg the question of what, if anything, can local government leaders do to stimulate their local economies?

The answer, according to traditional public finance theory (Fisher 2008; Musgrave 1980), is nothing. The main reason is that successful economic stimulus requires more resources than most local governments can leverage within the constraints of a balanced budget requirement. The components of a typical stimulus – tax cuts or rebates, infrastructure spending, temporary loans, and others –must take place on a large scale to have any meaningful economic impact, even at the local level. Most municipalities do not have the fiscal capacity to undertake those types of initiatives without reducing spending in other areas or increasing taxes, both of which are counterproductive to a stimulus effort. A related concern, as suggested by another theory of public finance (Tiebout 1956; Tiebout and Houston 1962), is that citizens and businesses that do not support a local government's stimulus effort might leave the jurisdiction.

But for many jurisdictions the political pressure to "do something" will likely overshadow the prescriptions of economic theory. To that end, municipalities have at their disposal three main stimulus-type tools: 1) drawing down financial reserves to maintain or expand local government expenditures, 2) expanding or accelerating local capital projects, and 3) tax policy changes to encourage spending by local taxpayers. Here I briefly review evidence on the effectiveness of each.

An extensive body of research shows that spending on public services is good for overall economic condition, and for economic development in particular (see, for instance, Fisher 1997). As such, perhaps the most important thing local governments can do to stimulate their local economies is maintain current expenditure levels. The challenge do doing so, of course, is that revenues typically decline during an economic downturn. Many municipalities try to address this challenge by keeping financial reserves. These reserves range from formal mechanisms like governing board-approved rainy day funds to informal resources like unreserved general fund balance. In many cases they are substantial; recent research (Marlowe 2006; Hendrick 2006; Gianakis and Snow 2007) shows a typical municipality maintains reserves equal to 30-50% of annual expenditures.

Public finance experts have studied these reserves at length to determine whether those resources can, in fact, help manage fiscal stress and in turn bolster the local economy. So far the answer is no, mostly because slack resources appear to have only a limited effect with expenditure levels during downturn periods. For instance, a recent study of Minnesota municipalities showed that for a typical jurisdiction, a one percent increase in reserve funds (as a percent of annual general fund expenditures) associated with less than a one-quarter percent increase in annual expenditures during downturn periods (Marlowe 2005). In effect, reserves can help to prop up spending when revenues decline, but the effect is minimal. This is not to suggest that financial reserves are ineffective fiscal policy; rather, in most jurisdictions they are simply not a powerful catalyst for economic recovery.

A second option is to accelerate or expand infrastructure spending. The previously mentioned positive effect of public spending is especially strong for public services that have a direct relationship with business and industry, like roads, bridges, stormwater treatment, and other basic infrastructure (Fisher1997). Low interest rates for the foreseeable future, coupled with the likelihood of substantial federal support for infrastructure, could create the ideal conditions for local economic stimulus through capital improvements.

A third stimulus option is to modify local tax rates. For example, many jurisdictions have rich traditions of "sales tax holidays" where state and local sales taxes are suspended for some short time period. The logic is simple – by lowering the price of goods, consumers will likely purchase more. Reductions to property tax rates or assessments follow the same logic.

Research in this area shows that temporary tax reductions are "politically expedient, but poor tax policy" (see Mikesell 2006). There is little evidence that sales tax holidays encourage new consumer spending. Rather, most spending during those periods is money consumers planned to spend anyway. Although there is no research on similar types of property tax exemptions, the same lessons from sales tax holidays likely apply there, too.

Therefore, ironically enough, the best option for local governments asked to do something to stimulate their local economies is to stay the course. Maintain current expenditure levels, expand capital improvements if possible, and maintain the capacity to respond to local idiosyncratic fiscal problems.

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