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Fiscal Health of Local Governments: The Community Economic Development Connection with Implications for Local and State Government Roles

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The fiscal health of local governments and community development are inextricably intertwined. In times of fiscal stress local governments cut back on "nonessential" services. In so doing they may harm community economic development. Some local governments include community economic development among these expendable services and eliminate positions and programs aimed at economic development. On the other hand, one strategy in a comprehensive approach to securing a local government's fiscal well-being is to expand the tax base. In fact, many policies local governments pursue affect local fiscal health positively or negatively and sometimes in ways that were not intended. Cutting back on arts and recreational programs might be considered prudent cost-saving, but it might have the unintended consequence of actually hurting revenues in the long-run because the area is a less attractive place to live and work.

A recent study looked at the role that states play in dealing with the most serious forms of local government financial problems – fiscal crises. A 50-state telephone survey administered to members listed on the roster of the National Association of State Auditors, Comptrollers and Treasurers explored what states do to try to *predict*, *avert*, *mitigate*, or *prevent the recurrence of* local government fiscal crises in their respective states.[1]

> The following eight strategies comprise a balanced approach to local fiscal health:
>
> (1) Be more efficient
> (2) Expand the tax base
> (3) Reduce the demand for services
> (4) Shift costs to nonresidents
> (5) Secure new sources of revenue
> (6) Increase spending flexibility
> (7) Improve management of existing resources
> (8) Diversify revenue sources
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> Source: Chapter 8, "Practical Strategies for Local Fiscal Health," in Honadle, B.W., J. M Costa, and B. A. Cigler, *Fiscal Health For Local Governments: An Introduction To Concepts, Practical Analysis, And Strategies*, Boston: Academic Press/Elsevier, 2004.

This is an important question for several reasons. First, as the axiom goes, local governments are "creatures of the state". Local governments are beholden to their states for their very existence and the states set up the rules of the game by which local governments must manage their finances. States tell local governments what services they can provide or can mandate services that local governments have to pay for. States are responsible for institutional arrangements such as the assignment of functions among the different types of local governments within their borders. They may set expenditure limits, debt limits, levy limits and they may determine what kinds of taxes local governments are allowed to have. They may have elaborate reporting requirements for local governments, or they may not. In short, in the United States' federated system of government, states have a lot of discretion in how they relate to local governments in ways that affect the localities' finances. This issue is even more important now than it was just a few years ago when states were boasting healthy surpluses and were in a better position than they are now to bail out local governments.

This study found that only ten states had formal definitions of local government fiscal crises, while the balance varied between having a working definition, having no definition, or leaving it to local

authorities to define a crisis for themselves. Despite this general lack of a formal definition of a fiscal crisis, 36 states reported that they had experienced such a local government fiscal crisis (or crises) in recent history. So, states apparently have less trouble recognizing a local government fiscal crisis when they see one than in defining one.

Seven overlapping categories of state approaches emerged: the directive approach, the proactive approach, the *ad hoc* approach, the special legislation approach, the reform approach, the takeover approach, and the responsive approach. As the descriptive labels for the different approaches are meant to suggest, states have widely differing ways of dealing with local government fiscal crises. An example of a directive approach is Virginia's intercept program in which the state can literally force a local government out of crisis by diverting local government funds directly to venders and bondholders. The proactive approach is illustrated by the state of New Mexico's early warnings to counties that were heading for financial disaster nine months to two years in advance of the emergency and repeatedly thereafter. The exemplar of the *ad hoc* approach is New York State where the state has no governing fiscal crisis statute, but has responded to each major local government fiscal crisis with different special legislation. An example of a state that has used special legislation to deal with a crisis is when the Wisconsin legislature accepted a recommendation of the Menomonie County Management Review Task Force to spend $500,000 annually on the county's infrastructure. The reform approach is illustrated by the state of California passing new regulations restricting the amount of leveraging and purchasing of risky investments in the aftermath of the Orange County financial debacle. The takeover approach (a most unpopular remedy for most local governments) is illustrated by the states such as Michigan that have usurped local authority and put local government finances under state control.[2] Pennsylvania is among the responsive states because the state is usually brought in to help with a crisis at the request of the governing body itself.

In general, states tended to get involved after a crisis rather than before one occurred. States tended to get involved when there was a threat to essential public services affecting the health and safety of citizens or where the state had a financial interest in the local government's fiscal health. For example, if state officials perceived that the state's bond rating was in jeopardy, the state might step in to protect the state's bond rating. Or, if the state was investing increasing resources in local government functions, the state might be more interested in seeing to it that those funds were spent appropriately.

One state official who responded to the survey might have hit the nail on the head in explaining why states do not have formal definitions of local government fiscal crises. To have a definition might imply that the state had some responsibility to deal with the problem if a certain trigger were met.

Communities and their vitality have a large impact on local government fiscal health. As any community that has lost a major employer knows all too well, local government revenues are adversely affected at precisely the time when people might need more services from those local governments. When that happens, is there a role for the state to step into the breach and help resolve the problem?

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[1] The material about this survey and results are discussed in detail in Beth Walter Honadle, "The States' Role in U.S. Local Government Fiscal Crises: A Theoretical Model and Results of a National Survey," *International Journal of Public Administration*, Vol. 26 (13), 1431-1472, 2003. For a reprint of this article, please contact the author at honadle@bgnet.bgsu.edu or 1-866-562-7277.

[2] For an interesting article on this topic, see Elizabeth Carvlin, "The Art of Saving Cities," *The Bond Buyer*, Wednesday, December 18, 2002.

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