



# Buechner Institute for Governance

An Analysis of Local Government  
Finance

By Christine R. Martell and  
Adam Greenwade



School of Public Affairs  
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## **An Analysis of Local Government Finance**

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### **About this Series:**

The Buechner Institute for Governance is located in the School of Public Affairs at the University of Colorado Denver. The purpose of the *Policy Research Brief* series is to translate academic research into a format that is of greater use and value to practitioner communities. This is consistent with the Buechner Institute's mission, which is to facilitate the creation of a bridge between the expertise and knowledge of the academic community with the expertise and knowledge of practitioner and policy-making communities.

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## **Acknowledgments:**

This policy brief report presents a summary of major findings and the policy implications of Dr. Martell's and Mr. Greenwade's work on the subject of local government finance. Interested readers can find a full, published article on the same topic:

Martell, C. R. & Greenwade, A. (2012). Profiles of local government finance. In R. D. Ebel & J. E. Petersen (Eds.), *The Oxford handbook of state and local government finance* (pp. 176-197). New York, NY: Oxford University Press, Inc.

Jennifer Kagan, Buechner Institute Policy Research Fellow, MPA 2013, School of Public Affairs, is the lead editor of the *Policy Research Brief* series.

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# **An Analysis of Local Government Finance. By Christine R. Martell and Adam Greenwade.**

*Policy Domain: Local Government*

## **I. Introduction**

This is an overview of major issues related to local government finance. The local government sector is one of the most important features of fiscal federalism in the United States. It underlies citizens' daily interactions with public services and is the largest part of the federal-state-local system of governance, with 89,526 local governments in 2007 (US Census Bureau, 2007). It also an extremely diverse sector with no one standard case of political or fiscal arrangements (Wallace, 2012).

Here, we examine local government finance by looking at the legal structure and organization of local government, the composition of local government finance, current issues facing local government finance, and the future of local government finance.

## **II. Research Question**

The purpose of this paper is to profile the structure and diversity of local government finance. The primary questions presented include the following:

- 1) What is the legal structure and organization of local government?
- 2) What is the composition of local government finance?
- 3) What are the current issues facing local government finance?
- 4) Where is local government finance headed?

## **III. Background and Prior Research**

This paper builds on existing research regarding local government finance and incorporates current statistics and trends in local government finance. It also considers recent economic issues, such as the recession, and explores policy reactions and impacts for local government finance.

## **IV. Methodological Approach and Evidence**

Here, we profile the structure and diversity of local government finance. The first section looks at the legal structure and organization of local government finance. The second section focuses on the composition of and trends in local government finance, specifically expenditures, revenue resources, and intergovernmental transfers. The third section explores current issues in local government finance, including issues related to the recession, changes in municipal debt finance, unfunded employee pensions, and variations in local government autonomy. We conclude by considering the future of local government finance and offering some policy suggestions.

## V. Major Findings

### 1. What is the legal structure and organization of local government?

#### a. Forms of local government

Local governments are typically either general-purpose or special-purpose. General-purpose governments have general taxing powers and offer an array of services, and special-purpose governments have limited revenue sources and typically serve a single function.

There are two major types of general-purpose governments: county governments and municipal governments (Miller, 2002). County governments are subdivisions of the state and their roles vary regionally. For example, in the Northeast, counties serve a limited role, while in the South and West, counties are the primary unit of local government. Municipal governments are typically considered corporate entities and are brought into existence by the state. Based on the concept of home rule, which is “the power of a local government to conduct its own affairs” (ACIR, 1987), municipal governments are self-governing. The limits of their self-governance, however, vary by state.

Municipal governments include townships, towns, and cities. Townships are governed by elected commissioners, towns by voters, and cities by an elected council. There are two major forms of municipal government structures: mayor-council and council-manager. In the mayor-council form, mayors are elected officials who serve as the head of the local government, and, in the council-manager form, the council is in charge

of setting policy mandates and the manager oversees policy implementation. There are many variations on these governance structures.

Special-purpose governments, or special districts, on the other hand, are another form of local government that are authorized by the state and levy taxes or charges on residents in a particular area to provide services not provided by general-purpose governments (US Census Bureau, 2009). They are especially common in the western United States. Services commonly provided include water, sanitation, fire protection, library services, and business improvement (Scott & Bollens, 1950; Bollens, 1961). Special districts are the most common form of government in the United States, and the number of special districts increased by 203% between 1952 and 2007 (US Census Bureau, 2007).

#### b. Fiscal autonomy

Local governments’ revenue sources and expenditures vary. States determine the types of revenues that local governments can raise themselves (called own-source revenue), and local governments can then usually set rates and exemptions. Own-source revenue can come from property taxes, sales taxes, income taxes, and user fees and charges. Local governments also receive intergovernmental monies from state and federal governments.

Property tax accounts for 75% of local governments’ own-source tax revenue and is the most important source of revenue for local governments (Bell, 2012). Local governments also often offer tax incentives to attract business and stimulate economic

development in their communities. Expenditure assignments vary among local governments, but may include items like general government, public safety, K-12 public education, community colleges, public works, planning, parks and recreation, economic development, and public health and welfare (Yilmaz, Vaillancourt, & Dafflon, 2012).

## **2. What is the composition of local government finance?**

### **a. Local government expenditures**

The largest spending priority of local governments is education, with 39% of local government expenditures going toward education. Other significant categories of spending include public welfare services (such as medical assistance and public hospitals, aid for needy families, and social safety-net programs), environmental services (natural resource management, parks and recreation, sewers, and solid-waste management), public safety services (police and fire protection and corrections), and transportation (road maintenance and local transit). Over the last thirty years, proportions of local government spending devoted to each major category have remained relatively constant.

### **b. Growth in local government expenditures**

On a per capita basis, local government expenditures are growing slowly but steadily (Brunori et al., 2005). Between 1980 and 2008, inflation-adjusted spending per capita increased 72%. Over the same period, local government spending grew slightly

faster than personal income, increasing from approximately 11% of percent of income to just over 13%.

Spending in the major categories of local government grew at similar rates between 1980 and 2008 (US Census Bureau, 2008). Education is responsible for the largest share (39%) of growth in local government spending, and the fastest growing portion of public welfare spending is health care, which has a five percent annual growth rate. While there is some variation in local government spending by state and region, overall, local government expenditures are similar across the U.S.

### **c. Local government revenues**

As mentioned, there are two major categories of local government revenue sources: own-source revenue and intergovernmental revenue (Fisher & Bristle, 2012). Most local government revenue is own-source, and local government taxes make up 13% of U.S. taxes (NCSL, 2009). While federal taxes are directed primarily at income, local taxes are usually directed at wealth and consumption (property and retail sales, respectively). Property tax is the largest component of local government own-source revenue, accounting for 29% of total local government revenue. State and federal transfers account for 38% of local government revenue.

Per capita local government revenue grew 70% between 1980 and 2008. The majority of this growth reflects a growth in own-source revenue. Two notable trends in local government finance during this period are a decrease in the share of revenue derived from property tax and an associated increase in the share of revenue derived from charges and fees

(Sjoquist & Stoycheva, 2012). These trends are explained by the rising popularity of tax and expenditure limits, such as Proposition 13 in California and the Taxpayer's Bill of Rights (TABOR) in Colorado (Brunori, Green, Bell, Choi, & Yuan, 2006).

Reliance on particular types of revenue sources varies by type of local government (city, counties, or special districts) and by region of the country. For example, special districts do not generate any revenue from income tax and generate the majority of their revenue from charges for services such as water and fire protection. Counties have the highest levels of intergovernmental revenue as a result of their responsibility for implementing state health and human services programs. Across regions of the country, there is considerable variation in the extent to which localities derive their revenues from property taxes and sales taxes.

#### d. Intergovernmental revenues

Local governments receive intergovernmental revenues in three ways: 1) directly from the federal government, 2) indirectly from the federal government through states, and 3) directly from state governments. These revenues are primarily used to subsidize health expenditures, welfare and safety programs, transportation capital, and education.

Although there continues to be growth in intergovernmental revenue, its share of local government revenue decreased from about 44% in 1980 to 37% in 2008. Between 1980 and 2008, the relative share of intergovernmental revenue coming directly from the federal government decreased from nine

percent to four percent, and the share coming directly from state governments decreased from 35% to 33%. As a result of the American Recovery and Reinvestment Act (ARRA), however, the share of local government revenues attributed directly or indirectly to the federal government was expected to increase between 2009 and 2011.

State transfers are responsible for the dollar volume growth in local governments' intergovernmental revenue since 1980 (Fisher & Bristle, 2012), but with states' budget gaps growing, states are cutting aid to local governments. For example, in 2011, 14 states introduced or enacted legislation to reduce aid to local governments (NCSL, 2009; Greenblatt, 2010).

### **3. What are the current issues facing local government finance?**

#### a. The recession and retrenchment

The housing and subprime mortgage crisis of 2008 led to a recession, which slowed consumer spending, increased unemployment, and restricted credit markets. These events affected local governments in three ways: 1) They reduced the property-tax base and associated revenues; 2) they reduced other types of tax revenues; and 3) they altered local governments' means of borrowing.

The housing crisis caused lower revenues from sales and property transfer taxes, decreased fees associated with construction activity, and reduced property taxes. There were also increased costs associated with monitoring vacant lots and issuing insured debt (Urban Institute, 2008). Other problems plaguing local governments include other revenue

declines, high unemployment, and poor fiscal conditions. Furthermore, poor fiscal management decisions, including unfunded pension liabilities and tax abatements for economic development, compounded existing problems (Honadle, 2009; Bullock, 2010; Pew Center on the States, 2010). Local governments that rely on revenue from property and sales taxes were affected more than those that rely on income-tax revenue. On the expenditure side, during the same period, expenses increased as a result of increases in the costs of employee health benefits, pensions, infrastructure, and public safety.

Improvement in local government finances was expected to lag behind the national economy, with the fiscal condition of cities remaining weak through at least 2012 (Hoene & Pagano, 2010). Local conditions, however, have national implications, particularly due to the large number of people employed by local governments (Muro & Hoene, 2009).

Local governments have employed a number of strategies in response to the economic climate (Hoene & Pagano, 2010). Governments have attempted to raise revenues by increasing fees levels, adding new fees and taxes, increasing property or sales tax rates, and broadening the tax base. Governments have also attempted to reduce expenditures through hiring freezes, lay-offs, canceled or delayed infrastructure investments, abandoned services, modified health-care benefits, spending cuts on public safety and human services, salary freezes, elimination of travel and development budgets, furloughs, and reduced pension benefits (Hoene & Pagano). The federal government provided some

relief to local education needs through State Fiscal Stabilization Funds, authorized by the ARRA, but the ARRA required a rapid spend-down, leading to a drastic drop in federal aid in 2011.

#### b. Municipal debt finance

Local governments typically finance capital investments by selling bonds to investors, which the governments will then repay. There are two types of bonds: 1) general obligation bonds, which are secured with the full faith and credit of the issuing jurisdiction, and 2) revenue bonds, which are secured with a specific revenue source (Mikesell, 2009). General obligation bonds are the most secure and thus have the lowest interest rates. The municipal bond market includes borrowing done by states and local governments. The interest on bonds in the municipal bond market is generally exempt from federal and state income taxes, thus allowing state and local governments to borrow at lower interest rates.

As a result of the housing crisis, a number of changes affected the structure of the municipal credit markets, leading to a restricted credit environment and an increase in local government borrowing costs (Martell & Kravchuk, 2010). As a result, many local governments decided to wait for more market stability and lower interest rates before borrowing for capital investment needs (Honadle, 2009; Stone & Youngberg, 2009), and municipal debt issuance levels fell about 14% between September 2008 and September 2009.

In light of the recession, unemployment, and low wage growth, municipal credit quality was seen as



stressed, and there were concerns that municipalities were taking on too much debt (Temple-West, 2010). Concerns were due in part to increased municipal bond issuance activity through Build America Bonds (BABs), a new federally subsidized instrument. There was also a risk that stimulus funds, which kept spending levels from dramatic drops, would dry up before economies recovered enough to generate their own revenues to replace them (McGee, 2010). The BABs program also temporarily altered how the federal government treated the subsidization of local government investment costs (Martell & Kravchuk, 2010). Funds from the BABs program were not tax exempt, but state and local governments that agreed to sell bonds on a taxable basis received a direct subsidy. The program ended in December 2010.

c. Pensions and liabilities

Unfunded pension benefits have strained local governments due to increased demand, resulting from an aging population and rising health care costs, and to investment losses as a result of the financial crisis (Honadle, 2009). Local governments are used to rising economies and increasing revenues, and, thus, have not had the management foresight or political will to bring their unfunded liabilities under financial control. Local governments also have limited abilities to make changes because of state rules or because they are members of state-managed systems.

d. Fiscal autonomy

Local government fiscal autonomy refers to a local government's

ability to decide how to fund its residents' needs, or to make its own financial decisions. Among other things, local governments with more autonomy have more control over the local tax rate and have discretion to decide how to use revenues (Hoene & Pagano, 2008). Recent research has looked at the effects of fiscal autonomy on fiscal outcomes. It is thought that state limits on local government autonomy may have unintended consequences like increased special purpose governments, but the research is mixed regarding whether this is, in fact, the case (Carr, 2006; Bollens, 1986; Feiock & Carr, 2001; Foster, 1997; McCabe, 2000; Lewis, 2000; Bowler & Donovan, 2004).

## POLICY IMPLICATIONS FOR PRACTICE

- **Improve fiscal management.** Local governments need to be particularly transparent and careful about decisions that may erode tax bases (namely, through granting tax abatements and exemptions) and expanding pension benefits.
- **Create a stronger federal-state-local partnership.** The federal government might consider assuming a stronger role in assisting cities with various programs, stabilizing the housing market, and enhancing the municipal credit market (Muro & Hoene, 2009). Improved fiscal management might be a condition for federal assistance (Honadle, 2009).
- **Improve the social compact between citizens and government.** Increasing dissatisfaction with government suggests that local governments should redefine their role in the social compact. This might be accomplished by shifting local government focus from jobs to innovation, by restructuring public sector compensation to attract talent, by increasing public conversations, and by emphasizing the value of leadership (Honadle, 2009; Muro & Hoene, 2009).

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