MEASURING AND MODELING DETERMINANTS
OF FISCAL DISTRESS IN US MUNICIPALITIES

The recession of 2007–2009 negatively affected many cities and counties across the United States, causing them to resort to extreme fiscal practices in order to respond to new budget pressures. Many localities were forced to declare fiscal emergencies, lay off or furlough workers, and sometimes even default on debt. Extreme cases of fiscal stress took place at the local level in California, Michigan, and Pennsylvania. Researchers can learn from these states' responses about what causes fiscal stress and how policymakers can better respond in order to meet financial obligations.

In "Measuring and Modeling Determinants of Fiscal Stress in US Municipalities," Evgenia Gorina and Craig Maher propose a new way of measuring municipal fiscal distress and developing a deeper understanding of the different factors that lead to it. Results indicate that higher debt, lower reserves, and an underreliance on property taxes are all associated with higher fiscal stress.

STUDY DESIGN

This study takes a novel approach to the measurement and prediction of fiscal condition, meaning the ability to meet financial obligations. Rather than trying to define fiscal stress through a set of fiscal and environmental indicators, it looks at actions taken by governmental officials that signal their inability to meet operating needs and service requirements. Examples of poor financial practices include reducing public-employee salaries, deferring pension payments, cutting services, and declaring bankruptcy.

Local government officials that make harmful fiscal decisions are usually under pressure from a variety of factors including a worsening cash position, insufficient revenues, growing debt, or a combination of these. The study examines how each of these factors affects fiscal stress, and it breaks them down into the following categories:

- *Cash solvency*. Higher cash reserves can allow for more liquidity for a government to meet its short-term obligations.

- *Budget solvency*. Raising enough revenues to cover its expenses can allow a government to meet its annual obligations.

- *Long-term solvency*. Keeping debt low and maintaining annual contributions to pension plans can ensure a government's ability to meet obligations over the long term.

- *Revenue structure*. How much a local government relies on various sources of revenue, including taxes on income, sales, or property, can significantly impact its fiscal health.

FINDINGS

Of the 300 city and county governments examined between 2007 and 2012, 32 percent experienced fiscal distress—which, on its own, sheds light on the magnitude of the Great Recession. The empirical models developed in this study show a relatively more pronounced role of fiscal reserves, debt, and revenue structure in the prediction of local fiscal stress than do previous studies. After controlling for government type, population, and socioeconomic factors, the main results indicate that local officials can take specific actions to decrease the likelihood of experiencing fiscal distress in their area.

- *Increasing reserves*. Local governments with higher general fund balances as a percentage of general expenditures are less likely to experience fiscal distress.

- *Lowering debt*. Local governments with lower levels of debt as a share of total revenue are less likely to experience fiscal distress.

- *Reliance on property tax revenues*. Increasing reliance on property tax revenues can decrease the likelihood of fiscal distress. During the Great Recession, local governments that relied on property taxes weathered the recession better than governments that relied on other revenue sources.

CONCLUSION

This study highlights the importance of local fiscal policy that builds and uses adequate reserves to weather fiscal shocks. Increasing revenues, managing debt, and moving toward a reliance on property taxes can decrease the likelihood of experiencing fiscal stress. This latter policy is even more salient today than in previous decades because of the state-level initiatives to limit local taxing authority. This is especially so for property taxes like California's Proposition 13 and efforts to impose limits on revenue growth in the vein of Colorado's Taxpayer Bill of Rights, which by definition limit a community's ability to grow reserves.

There are tradeoffs to weigh when choosing how to structure tax systems, but when diversification is paired with sound fiscal management of reserves, local officials can improve their government's fiscal condition. This can help prevent worst-case scenarios, and policymakers will not have to make such difficult choices in times of fiscal stress.