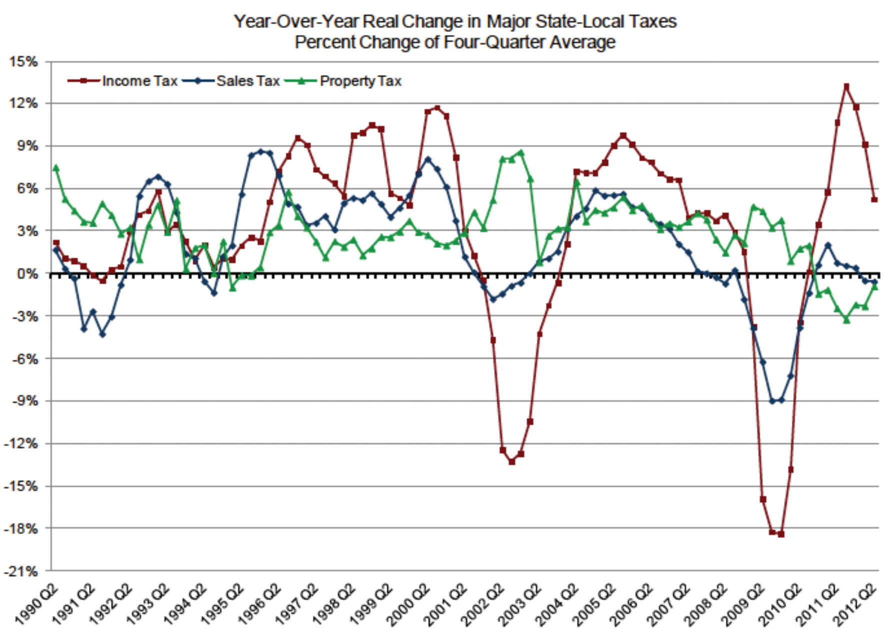
Session III: Impacts on State and Local Government Finances

Opening remarks (summarized) for panel III, "Impacts on State and Local Governments Finances."
Thomas Gais, *Director, Nelson A. Rockefeller Institute of Government, State University of New York*

The 2007-08 recession has not only been extraordinarily harsh on homeowners; it has been unusually challenging for local governments. Recent data have shown that the ARRA's substantial increase in intergovernmental assistance went largely to states and did not trickle down to local governments. In fact, states cut their aid to localities in 2010, according to a report by the Pew Center on the States.

At the same time, property taxes—which account for about three-fourths of total local tax collections—have stagnated or declined to a degree not seen since the early 1980s (see figure; from a report by the Rockefeller Institute). Perhaps as a consequence, local government employment has declined by about 3 percent since the end of 2007, a much larger drop than the 2 percent decline in state government jobs over the same period. Local employment in education has been hit especially hard.

How do these changes relate to the housing crisis? And how do they affect different local governments, including cities, and their budgets and services? And what can we expect in the future?



Sources: U.S. Census Bureau, Quarterly Summary of State & Local Government Tax Revenue and Bureau of Economic Analysis (GDP).
Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.

To help answer these questions, we have two superb researchers. Kim Rueben is a Senior Fellow at the Tax Policy Center of the Urban Institute and an expert on state and local public finance and the economics of education. Her current projects include work on state budget shortfalls, financing options for California, the fiscal health of cities, and higher education tax credits and grants. Kim will focus on the economic conditions of cities, drawing on (among other data sources) a recent survey of cities conducted by the National League of Cities.

Byron Lutz is a Senior Economist at the Board of Governors of the Federal Reserve System. Like Kim, Byron is a MIT-trained economist. Byron's research has also been wide-ranging, including work on school desegregation, intergovernmental grants, state and local finances and the macroeconomy, and the effects of taxes on wage inequality. His presentation today draws on his research in housing prices and housing markets and their effects on state and local government revenues.

Summary of "The Housing Crisis and State and Local Government Tax Revenue: Five Channels"
Talk given by Byron Lutz at the Distressed Residential Real Estate Conference, Oct. 5, 2012

- The talk reflects updated results based on Lutz, Byron, Raven Molloy and Hui Shan, "The Housing Crisis and State and Local Government Tax Revenue: Five Channels," Regional Science and UrbanEconomics, vol. 41, 2011

- The housing market recently experienced the sharpest contraction since the Great Depression.
  - House prices plunged by 30 percent from 2006 to 2011
  - New single family housing starts dropped by 70 percent

- Over the same period, state and local government tax revenues have been hit hard.
  - These revenues fell 4 percent in 2009, the first nominal decline since the Great Depression.

- We ask: How important is the impact of the housing market downturn on state and local tax revenues relative to the broader, more global, impact of the recession and sluggish recovery?
  - To answer this question we identify five channels through which the housing market may impact state and local government tax revenues:
    - Property taxes at the local government level (the primary channel)
    - Four channels at the state government level

- Analysis using historical data informs two aspects of the relationship between home values and property tax revenues
  - **Timing:** It takes three years for a change in house prices to be reflected in property tax collections The lengthy lag appears to reflect three factors:
    - The property tax is backward looking in that taxes paid today are based on assessments in the prior fiscal year.
    - In many states assessments lag market values at the time they are taken.
    - Property tax caps and limits prevent house price appreciation from moving into the tax base during periods of rapid house price appreciation. When house price growth falls below the caps/limits, the past house price appreciation begins to move into the tax base. This dynamic can create significant lags between house prices and property taxes.
  - **Magnitude:** The elasticity of property tax revenue with respect to home prices equals 0.4 (i.e. a 10 percent increase in house prices produces only a 4 percent increase in property tax collections).
    - The implication is that policy makers offset house price changes by adjusting rates.

- The above analysis uses historical data in which most of the house price changes were increases. Additional analysis focuses on historic episodes of house price decreases.
  - Historically, policy makers more than offset house price declines with increases in the effective tax rate. As a result, in states where house prices declined, property tax collections continued to increase.

- House price declines during the recent downturn in the housing market were significantly greater than those in the historical data. Thus, the historical data may not provide an accurate guide to the current situation. We therefore turn to case studies using data collected from individual state governments.
  - These case studies reveal that in many states:
    - Assessed values lag market values by several years and that, as a result, there was little downward pressure on property taxes in the initial years following the fall in house prices.
    - When assessed values eventually declined, policy makers made significant increases in the effective tax rate and property tax revenues fell only modestly.
- The four non-property tax channels through which the housing market may influence state tax revenues are
  - Real estate transfer tax
    - The tax is assessed at the time real estate changes hands and is based on the dollar value of the transaction. The sharp decline in real estate sales volumes decreased the collection of the tax.
  - Direct sales tax
    - Most builders pay sales or use tax on materials. The decline in construction activity therefore decreased sales tax receipts.
  - Indirect sales tax
    - The decline in housing equity likely caused many households to reduce their consumption expenditures. In turn, sales tax receipts likely fell.
  - Personal income tax
    - Aggregate payrolls in the construction and real estate sectors declined which caused a fall in income tax collections.
- From 2005-2009, these four channels collectively reduced total state tax revenues by around 3 percent
  - However, there is significant heterogeneity across states, e.g.:
    - Florida saw a 10 percent decline in revenues due to these channels
    - New York experienced only a 1 percent decline

Economic Condition of States and Cities

Kim Rueben Tax Policy Center – Based in part on the NLC “City Fiscal Conditions in 2012”

- Economic activity drives state and local governments’ fiscal health and revenue levels, with some areas doing better than others. State and local government actions can also help or hinder economic recovery. Government finances are largely pro-cyclical, so revenues fall and spending needs increase during recessions, typically lagged from when the economy falters.
- This recession far worse than past recessions.
  – Variables that drive revenue hit harder than broader economy
  – Real estate and construction sectors still weak
  – Consumer spending still low
  – Also highlights longer term pressures governments will face
- Governments mostly spend money on employees and people
- Understanding what long and short-term obligations are will be critical.
- Demographic changes (aging of the population) will also put pressure on budgets.
- State and local government actions also directly affect economic activity
  – State and local employment numbers are 600,000 lower than peak levels, and local employment is still falling. Thus current gains in employment are limited due to a lackluster public sector.

What does the outlook look like for states?

- For states, while revenue crisis is easing, fiscal crisis continues
  – State revenues are growing but so are spending pressures
  – Revenues still weaker (in real terms) than before recession
- According to the NASBO Fiscal Survey of the States Spring 2012, FY 2013 general fund revenues finally larger that pre-recession levels in nominal terms (690B in 2013 vs 680B in 2012)
- While most states passed balance budgets, some states will face shortfalls (CA budget uncertainty most stark)
  – Facing short term challenges ahead
- Medicaid growth – most of additional general fund spending going to Medicaid, in part making up for end of federal ARRA funds
- Many programs that were cut over the last four years, provided important services – Will some of these services be restored?
  – Most states, began rebuilding balances this year after facing shortfalls for the last few years
- However, states often balance budgets by cutting aid to local governments
- Many not back to pre-recession spending/revenue levels
  – Rules can make budgeting harder
- 30 states have state tax or expenditure limits
- 17 states require voter approval or supermajority of legislatures for tax increases
- Only 4 states don’t limit local property taxes
- State limits on property taxes vary and make harder for some local governments.

What does the outlook look like for cities? (City Fiscal Conditions in 2012)

- Nation’s city finance officers report that the fiscal conditions of cities in 2012 continue to reflect the prolonged effects of the economic downturn.
- Declines in city revenues largely driven by local and regional economies that are still experiencing struggling housing markets, slow consumer spending and high levels of unemployment.
- Cities facing sixth year in a row of year- over-year declining revenues.

- Continued decline in property tax revenues (which started falling in 2010), reflects the lagged impact of real estate market declines and is likely to continue going forward
- Yet in 2012 higher percentage of city finance officers (57%) felt better able to meet financial needs than in prior years. The percentage up starkly from 2009 and 2010 when only 12% and 13% of officers felt that they were better able to meet needs than prior year.
  – Cities that have a sales tax seem more optimistic, in part have less revenue decline
- Fiscal pressures on cities include declining local tax bases, cuts in state and federal aid, but increased employee-related costs for health care pensions and wages and growing infrastructure needs
- Cities are responding by raising fees, and cutting personnel, delaying infrastructure projects and cutting local services.

Beyond 2012

- Real estate markets slow recovery;
- Prolonged effects of unemployment and wage reductions will weigh heavily on income tax revenues and sales tax receipts;
- Underfunded pension and health care liabilities will persist as a challenge;
- State and Local governments likely to continue to operate with reduced workforces, cut services and infrastructure investment

However some opportunities in a crisis…

- Most governments realize need to change business as usual. Decisions hard, as most state and local spending is on workers and providing important services and moving to:
  – Shared service agreements, inter-local agreements and regionalization and cost-sharing;
  – Participatory budgeting and citizen engagement to reset/reevaluate priorities;
  – Redefinition of "core services;"
  – Outsourcing, privatization and "managed competition;" and,
  – New partnerships and volunteerism.
- Local bankruptcy very rare
  – Since 2010 (and as of early August 2012), only 27 municipalities have filed for Chapter 9 bankruptcy
  – Only 7 were general governments (Central Falls, RI; Jefferson County, Alabama; Stockton, CA; Mammoth Lakes, CA; and San Bernardino, CA. It also includes two filings (Harrisburg, PA and Boise County, ID) that were ultimately rejected.
  – Municipal bankruptcy as much about dysfunctional politics as finances:
- Bad earlier deals and on the hook for bonds for faulty investment (Scranton, Jefferson County)
- Inability to reach agreement
- Changes in economic conditions
- (Stockton felt would be experiencing extraordinary growth and built for it.)
- Changing demographics and difficulty meeting existing commitments (MI cities – Detroit, Flint) faced with local existing public sector pension obligations yet shrinking population and tax base
- But bankruptcy or restructuring can be an opportunity to try and help with large existing obligations (employee costs, existing debt), and can lead to adoption of rules to help going into the future.
  – Vallejo recovering and fiscal house in order
  – New York and Washington are still following rules set out under state and federal takeover