

Causes of Fiscal Crises in State and Local Governments

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Abstract

Financial insolvency is a rare occurrence in American state and local governments. However, when it does happen, as in the case of Detroit's historical bankruptcy filing in 2013, the consequences for vital city services, public employees, and taxpayers can be devastating. This essay reviews existing and emerging research on the causes of government fiscal crises, paying particular attention to how social, economic, and legal constraints interact with the electoral incentives faced by public officials to create financial distress. It concludes by identifying a number of open questions that should guide future research, to help identify potential institutional and political reforms that can help avert future problems before they occur.

When the city of Detroit filed for bankruptcy protection in mid-July 2013, it became the largest municipal bankruptcy in US history, with outstanding debt of nearly \$20 billion. Although Detroit was by far the biggest city to go broke, it was far from alone. In the two years leading up to of its filing, two other major cities—Stockton and San Bernardino, both in California—filed for protection under the same section, Chapter 9, of the federal bankruptcy code. A few years earlier, another California city, Vallejo, announced that it could no longer pay its bills as they became due and sought protection of its creditors. Although it had emerged from the bankruptcy process in 2011, Vallejo again seemed poised on the precipice of a financial abyss at the time of Detroit's filing.

At first glance, the proximate causes of these high profile financial crises appear to be quite varied. Detroit succumbed to insolvency after decades of declining population, deindustrialization, and poor fiscal management. Stockton had bet heavily on the "infrastructure of play" (Judd, 2002), taking out substantial debt to finance the construction of minor league sports venues, revitalize its marina, refurbish its historic theater, and upgrade its

City Hall. The bet did not pay off. San Bernardino suffered disproportionately from the housing market collapse that accompanied the 2008 financial crisis, while Vallejo faced mounting bills for generous benefits promised to its city employees, a problem that caused another city, Central Falls in Rhode Island, to declare bankruptcy in 2011. Yet, the experiences of these cities share an underlying pattern: In each case, financial ruin came about as an unintended result of city leaders working within rigid social and economic constraints while trying to respond to the electoral pressures from their constituents and other political stakeholders.

This essay reviews the political economy of fiscal ruin, focusing on the causes of solvency crises in state and local governments. As will become clear, the research on the origins of public-sector financial stress is limited by the fact that truly catastrophic fiscal failures occur quite infrequently. Between 2008 and 2013, for example, less than 0.05% of municipalities filed for bankruptcy protection in federal court (Maciag, 2013). Because the traditional workhorses of empirical social science research—sophisticated multivariate econometric models—do not perform well in predicting such “rare events” (King & Zeng, 2001), much of the literature of government fiscal crises takes the form of individual case studies. While this literature has yielded important insights on the causes of these crises, which I review in the following section, it has also left open a number of important questions of interest to both scholars and policy practitioners, which I discuss at the conclusion of this essay.

FOUNDATIONAL RESEARCH

WHAT WE KNOW ABOUT FISCAL CRISES

Although municipal bankruptcies and government fiscal crises are extraordinary events, substantial budget deficits and episodes of fiscal stress occur with relative frequency at both the state and local levels and follow a predictable pattern. As a general rule, public finances track the economic business cycle, deteriorating during recessions and improving again as the economy recovers. The trend has a clear institutional explanation: Unlike the federal government, which can run large deficits during economic downturns to stimulate private demand, nearly every state and most local governments face a binding balanced-budget requirement (Poterba, 1995). This presents state and local officials with serious policy challenges. On the one hand, economic downturns generally increase demand for public services these governments provide. As workers lose their job and see their personal incomes decline, they become eligible for cash aid and Medicaid services, which are funded partly out of state coffers. Similarly, high unemployment has historically coincided with rising crime rates, requiring cities

to increase investment in law enforcement services during downturns. On the other hand, state and, to a lesser extent, local government revenues decline during recessions, as job losses translate to lower income and sales tax receipts. This is especially true for states, such as California, that rely on volatile capital gains taxes for a substantial share of their revenues. With service demands and revenues moving in opposite directions, elected officials must choose between cutting government programs and increasing tax rates—both politically unpopular options—in order to balance their budgets or find stealth ways to delay the day of fiscal reckoning, by using short-term loans to paper over deficits, deferring capital maintenance, or reducing payments into pension plans (Congressional Budget Office, 2010).

For these reasons, government fiscal crises often occur in waves, coinciding with broader economic shocks. The financial panics of the late 1830s, for example, triggered a series of state government defaults, which led to important state constitutional reforms in areas of government borrowing and corporate regulations (Wallis, 2005). During the Great Depression, both state and local governments were overwhelmed by public demand for welfare services, historically provided by lower level governments, which in part motivated the creation of the federal welfare state. Similarly, the period of economic stagflation during the 1970s contributed to financial troubles in some major cities, including Chicago and New York (Fuchs, 1992).

The close empirical relationship between the state of the economy and government balance sheets also explain the recent financial struggles faced by declining industrial cities, including Detroit. In the period since World War II, many urban centers in the industrial Northeast and the Midwest have experienced substantial population losses, as many upper- and middle-class residents left the central city for the surrounding suburbs. These population shifts had an undeniable racial dimension, with out-migration of wealthier whites exacerbating housing segregation and resulting in large swathes of concentrated poverty in many major cities (Beauregard, 2003). By the 1970s, some major employers began to follow their workers, moving their offices from the central city to outlying suburbs. Globalization, which disproportionately affected older industrial cities with a big manufacturing presence, further exacerbated these big-city employment losses, marking an era of deindustrialization and manufacturing decline that has continued through the first decade of the twenty-first century.

The loss of their wealthiest taxpayers and some of the largest employers dramatically reduced the tax base in many urban areas during this period (Ladd & Yinger, 1989). Between 1950 and 2012, for example, the population of the city of Detroit fell sharply from nearly 1.9 million people to about 700,000. However, declining population has usually not been matched by a proportional reduction in service demands or local government costs. In part, this

is due to the geographically diffuse nature of out-migration. As residents left the central city, but not any neighborhood in particular, the reduction in population density has required city agencies to continue to cover the same geographic footprint, reducing the efficiency of services. High rates of concentrated poverty and crime in many major cities have also required substantial government investment to improve living and working conditions of their residents and help avoid pushing even more city dwellers to safer, wealthier suburbs that do not face similar social and economic challenges.

Balanced-budget requirements and how these institutions interact with the broader economic and social context mean that elected officials often find themselves at the whim of forces beyond their direct control in the sphere of public finance. Even the most fiscally prudent public servants cannot escape the feast-and-famine cycle driven by macroeconomic ups and downs, although they might temper these impacts by setting aside generous budget reserves during good times to prepare for future economic slowdowns. Since the 1970s, moreover, government officials have faced even greater constraints in their fiscal authority and flexibility owing to the passage of tax and expenditure limitations (often referred to as TELs), often through mechanisms of direct democracy. This trend began with the passage of Proposition 13 in California but quickly spread across the country (Martin, 2008).

Individual TELs vary substantially but most set limits on overall tax rates, how much these rates can be increased over time, and how quickly property may be reassessed to reflect current market rates for the purpose of taxation. Some TELs also impose procedural requirements—such as voter approval or super-majority vote thresholds—before taxes can be raised. Although most TELs target local government taxing authority, others—such as Colorado’s recently weakened Taxpayers Bill of Rights (TABOR)—also have tremendous impact on state finances (Kousser, McCubbins, & Moule, 2008). California’s Proposition 13 appeared to play a pivotal role in the bankruptcy of Orange County (Baldassare, 1998), one of the largest local government defaults until Detroit, and in the decade-long fiscal crisis faced by San Diego (Erie, Kogan, & MacKenzie, 2011).

To say that external and exogenous forces constrain state and local policy options does not, however, let policymakers in these levels of government off the hook for allowing fiscal stress to turn into unmanageable crisis or default. Public officials can and do respond to similar cyclical and demographic challenges in different ways, with political factors serving an important moderating role. States with unified partisan control of government, for example, appear to react quicker to unanticipated economic shocks, adjusting policies accordingly (Alt & Lowry, 1994; Klarner, Phillips, & Muckler, 2012; Poterba, 1994). Elections, on the other hand, limit necessary but politically unpopular

adjustments, with incumbents fearful of upsetting voters in an election year (Poterba, 1995).

At the local level, the diffusion of authority between political and legal offices can raise the cost of coordination, resulting in undesirable policy choices and slow responses in the face of worsening fiscal conditions, while strong party organizations have been shown to lead to more responsible policy (Berry, 2009; Fuchs, 1992; Shefter, 1985). Some scholars also point to the role played by ordinary voters and the local “political culture” in laying the groundwork for poor fiscal outcomes (Clark & Ferguson, 1983; Erie *et al.*, 2011). When voters do not understand—or perhaps are convinced by political entrepreneurs to ignore—the reality that popular government services must be funded by unpopular taxes and instead demand “something for nothing” (Sears & Citrin, 1982), elected officials face tremendous political pressure to oblige, often resulting in unsustainable policy choices or obscure, off-budget spending that solves short-term political problems but increase the risk of long-term insolvency.

CUTTING-EDGE RESEARCH

EMERGING RESEARCH QUESTIONS AND AGENDAS

The research described in the previous section provides much important context and background for understanding the experience of fiscally stressed state and local governments during the twentieth century. In the new millennium, however, the types of fiscal challenges facing policymakers and the actors involved in responding to them appear to be changing, developments that are prompting new lines of scholarly research.

Although public-sector employees have long been recognized as important stakeholders and active participants in the public policy process, they have attracted renewed critical attention from many political observers in recent years. One reason is growing concern about the sustainability of public pensions and other post-employment benefits promised to government workers, together accounting for some of the largest unfunded long-term liabilities facing state and local governments (Kieweit & McCubbins, 2014). In recent years, almost every state has passed some form of pension-reform legislation, although financial experts project that these changes will do little to address the long-term solvency of public pension funds (Novy-Marx & Rauh, 2009).

When viewed in historical context, the salience of present-day pension woes are in many ways surprising: since the 1970s, public pension funds and their government sponsors have faced increasing accounting and funding rules, meaning that public pensions in the modern era are probably better funded than they’ve ever been before (Kogan, 2014). Indeed, until the 1970s-

and 1980s-era reforms, most pensions were funded on a pay-as-you-go basis, with no actuarial pre-funding, something even the worst-managed pension funds today dare not do.

One reason for why pension shortfalls have attracted so much political attention may be that the vast majority of pension assets today are invested in the stock market, exacerbating cyclical fiscal stress faced by their government sponsors. During good economic times, strong pension investment earnings reduce the amount state and local governments must contribute to pre-fund employee retirement benefits. During recessions, however, disappointing earnings mean that fund sponsors must increase contributions at exactly the moment they confront falling revenues and are forced to make cuts to other popular government programs, making public employee pensions a political albatross around the neck of elected officials (Kogan, 2014). In other words, public pension are as much a *political* problem as a policy problem, with government sponsors paying the least when they can most afford to and contributing the most when it is politically infeasible to do so (Kogan & McCubbins, 2010).

Thanks to high rates of unionization among public employees, another phenomenon that dates back only to the 1970s most states, government workers are also better organized than most other diffuse interest groups to fight off retrenchment in government spending (Anzia & Moe, 2013). Public employees can exercise their influence through a variety of channels. Some unionized workers, such as firefighters and police officers, can leverage their high esteem among regular voters to make endorsements contingent on candidate support for pro-labor policies. In many state and local contests, public employees also represent an important source of campaign resources, including monetary donations and volunteer man hours, which can help labor-aligned candidates win office. At the local level, low turnout among ordinary voters also means that the voices of government employees may be heard disproportionately at the ballot box (Anzia, 2011; Moe, 2006).

Given what some perceive to be overweening influence of public employees over government actors, many political reformers and some scholars have advocated reforms, such as the outsourcing the provision of public services to private contractors, meant to weaken organized labor. Such arguments suffer from two logical weaknesses, however. First, it is unclear why public employees—even politically influential and well-organized employees—have any reason to exacerbate financial challenges or precipitate fiscal crises for their employers. Since public employment opportunities and membership dues at the end of the day depend on the financial health of government employers, even self-interested unions have a clear interest in looking out for the long-term solvency of the agencies at which their members work. Second, there are few reasons to expect that private contractors

will be any less malevolent than their public-sector counterparts. Having won a contract to provide public services, these firms should be expected to fight just as hard, and make just as many campaign contributions, to avert budget cuts that reduce their profits. These reasons may explain why the empirical literature has generally found mixed evidence about the cost-effectiveness of government outsourcing efforts (e.g., Australia Industry Commission, 1996; International City-County Management Association, 2007).

Even as public employees have gained political influence, their traditional adversaries in the business community have taken on a lower profile, particularly in local government. Scholars have attributed the declining “corporate citizenship” and civic advocacy in political affairs to the consolidation of major local business into bigger multinational firms and their increasing global focus (Hanson, Wolman, Connolly, Pearson, & McManmon, 2010; Poterba 1994). With low level executives no longer expecting to spend most of their career in a single location and with business profits less tied to the health of their local economy, corporate leaders have become increasingly disengaged from local public affairs, weakening their traditional role as government watchdogs and governing partners. In their place, local political debates have come to be dominated by single-issue, place-based businesses, such as land developers and local hotel owners, who have few roots in the local community and whose long-term interests are much less likely to coincide with those of local taxpayers (Erie *et al.*, 2011). Even as the magnitude of government financial challenges has grown, the political capacity for addressing them has continued to shrink.

KEY ISSUES FOR FUTURE RESEARCH

Financial crises at the state and local level have a tremendous impact on the lives of ordinary constituents and service users. As governments lay off workers, reduce service levels, or increase taxes to regain their fiscal footing, public policies create hardships for many families. The collateral damage from such crises, in other words, is substantial, so scholarly efforts to identify their causes and examine potential institutional and political reforms to avert problems before they occur have the promise to make important scholarly and societal contributions.

To do so, however, researchers must move toward better research designs that allow them to draw credible causal inferences. To date, much of the empirical work on the origins and causes of fiscal crises, particularly at the local level, remain confined to single-city case studies and cautionary tales. While such case studies are certainly informative for building new theories

and deriving testable hypotheses and propositions, they rarely provide credible evidence about causal processes. Examining *only* cases of financial distress leads to the well-known problem of selection on the dependent variable, without providing a clear basis for counterfactual comparison. The fact that truly serious financial crises are incredibly rare, even though the factors cited by scholars for their causes—voter apathy or misinformation, strong interest groups, economic business cycles—are far more prevalent, suggests that something important is missing from pictures painted by the widely read and closely studied cases. Although many factors identified in the literature appear to be necessary conditions for financial calamities and government bankruptcies, few of them are sufficient.

Aside from a few notable exceptions (e.g., Baldassare, 1998; Clark & Ferguson, 1983; Erie *et al.*, 2011), much of the existing work on fiscal stress and crisis generally focuses on elite actors in and outside of government, while paying scant attention to the role played by ordinary voters. To the extent that voters enter the picture, they are generally portrayed as victims of mismanagement, corruption, or malfeasance. Yet publicly officials are almost always constrained by the preferences of their constituents and many of the short-term decisions linked to long-term problems are rooted in the electoral incentives faced by officeholders. In order to understand the political conditions that give rise to financial problems, scholars must place ordinary voters and the decisions they make at the ballot box front and center.

Finally, financial problems rarely go away when deficits disappear or when governments regain access to the public bond markets. Efforts to increase taxes or make substantial service cuts that are necessary to balance the budget result in long-run consequences, both for the end-users of government services and for the political actors responsible for making the tough decisions. Although the question of why crises occur has been well studied by scholars, understanding *how* governments respond to such crises and the distributional consequences of financial reforms enacted in response requires substantially greater attention from scholars. Although there may be few winners during tough economic times, varying policy responses clearly produce different sets of losers.

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