Chapter 1

Introduction

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Since the Great Recession of 2008–2009, the fiscal health of local governments in the United States has become a frequent topic of discussion. This interest demonstrates the adage "all that was old is new again" as concerns over local governments' fiscal health rise to the fore on a regular, cyclical basis. The 19th century and the first half of the 20th century saw recurrent local-government fiscal and debt crises in the United States associated with recessions, financial panics, and occasional governmental fecklessness. After the post-World War II decades of steady, incremental growth in government budgets, older local governments in particular returned to ground in the face of recessions, tax revolts, and suburbanization in the mid- to late-1970s. Although the economic bubbles of the late 1990s and mid 2000s offered temporary respite, the current fiscal climate is very challenging, and it seems unlikely that local governments will experience sustained relief from fiscal constraints in the foreseeable future. Undoubtedly, the fiscal health of local governments, both in periods of strength and periods of economic weakness, will remain a concern of policymakers at all levels of government.

Local governments themselves face the challenges of managing citizens' undiminished service expectations, the cost of postemployment benefits for past as well as present employees, and the withdrawal of recurring federal and state assistance associated with what Chris Hoene and Michael Pagano have termed, "fend-for-yourself federalism" (Hoene and Pagano, 2003). As they exhaust the less politically fraught, short-term responses to recession and fiscal shocks, local governments increasingly are confronting the financial and political challenges of reconciling constituents' desires for services with their willingness to pay taxes (and fees for service).

For state policymakers, the fiscal health of local government is important given the fiduciary responsibilities and partnership between the two levels of government. Local governments carry out many functions on behalf of state government, such as sewer and water services, police and fire protection, parks and recreation, land use planning and zoning, tax collection, and many others. These vital public services may be threatened if a local government is not fiscally sustainable. Thus, over decades, state policymakers have enacted laws to monitor, track, and address fiscal problems among local governments.

For federal policymakers, although one step removed from local government, the fiscal stability of these entities matters as well. Billions of dollars of spending flow through local governments to provide services such as community development block grants, homeland security, and many other programs. As one example, the New York City Police department plays a vital role in protecting dignitaries during large United Nations meetings. Thus, the fiscal health of New York City may matter greatly to the federal government. Again, local officials often are the ones carrying out functions the federal government deems necessary.

The fiscal bottom line ultimately comes back to local elected officials. In 2007, according to the Census of Governments, there were 89,476 local governments in the United States. This figure includes 3,033 counties, 19,492 cities, 16,519 towns, 37,381 special districts, and 13,051 school districts. Among these government entities, there were more than 500,000 elected officials. These responsible parties must bear the burden of ensuring that their local government entity remains fiscally solvent and healthy to carry out important public functions.

A variety of factors affect the fiscal health of local governments. Revenues, or the incoming sources of funds that include taxes and fees, are the backbone upon which government spending and service provision rests. Revenue forecasting must be done with care and attention to ensure that appropriate budget plans can be made. Further, the structure and adequacy of local revenue systems determine the ability of government to keep up with spending pressures and avoid the buildup of fiscal stress.

A second factor is the spending side of the equation. Local governments face many stakeholders in building their spending plans. Local citizens may demand certain services, the federal government may have many strings attached to funding sources, and state governments may mandate a variety of functions. Furthermore, local governments must purchase labor and materials in national and even global marketplaces, where cost pressures and inflation are out of their hands. Fiscal health is ultimately driven by how governments manage revenue and spending decisions in an economic and social environment that is largely out of their control. Thus, fiscal health is an adaptive process of strategic decision making requiring knowledge of a variety of functions, services, and tools. The chapters in this handbook have been written with this framework in mind.

This handbook provides an accessible compilation of the traditional literature and the most current thinking about the range of topics concerned with understanding and maintaining local governments' fiscal health and serves as a useful desk reference for students, practitioners, and academics. Each chapter is written both to complement the other contributions in the volume and to stand alone as a conceptual and practical guide to its topic. Toward that end, our contributors have provided glossaries of key terms, questions for review and discussion, and recommendations of resources for further reading and applications of the material. Although the volume's focus is on the U.S. setting, and the details of some aspects of accounting standards and intergovernmental relations in particular are quite specific to the United States, most if not all of the chapters address broadly applicable questions of local public finance and financial management and will have applications beyond the United States.

The organization of the book centers around seven parts. Following the editors' Introduction, the chapters in Fiscal Health and Sustainability Concepts and Measures, (Part I) define and assess the overall context of the fiscal health/stress literature from a conceptual perspective. In Assessing the Financial Condition of Local Governments: What Is Financial Condition and How Is It Measured? (Chapter 2), Benoy Jacob and Rebecca Hendrick explore a broad conceptual framework for understanding local government fiscal health. They first review some of the challenges in defining the scale and scope of the term *fiscal health*. This review leads the authors to conclude that each conceptual strategy has strengths and weaknesses. The specific purpose of the term "fiscal health" may determine the type of system that should be used. In a review of Measuring and Predicting Local Government Fiscal Stress: Theory and Practice (Chapter 3), Jonathan Justice and Eric Scorsone suggest some strategies for measuring and predicting fiscal health and stress. Building on Jacob and Hendrick's chapter, they begin with the premise that fiscal health is to some extent in the eyes of the beholder, that it is shaped by a complex web of interdependent factors over time so that measurement is difficult and prediction even more so, and that different stakeholders may have different definitions of fiscal health as well as different analytic resources and access to information. They go on to offer a framework of considerations for stakeholders to use in designing measurement and prediction systems appropriate to their own specific needs, together with bibliographic references to a range of examples of indicators and measurement systems developed for a range of uses and users.

There has been a long history of attempts since the 1970s to assess and predict fiscal stress among local entities. Contributors to Financial Reporting and Modeling (Part II) focus on the measurement of fiscal stress in local governments. The chapters in this section review past attempts to measure stress as well as propose new measurement strategies. In The Development of External Financial Reporting and Its Relationship to the Assessment of Fiscal Health and Stress (Chapter 4), Dean Mead discusses the specific notion of financial condition and how it has evolved over time. From representative tax systems, accounting standards, and municipal credit analysis to the most recent updates to generally accepted accounting principles (GAAP) for U.S. state and local governments, this chapter identifies key milestones and how they have affected and been affected by attempts to understand and predict fiscal health and stress. Finally, the state of fiscal health analysis is discussed in light of the most recent government accounting standards. Kenneth Kriz explores the venue of revenue forecasting in, Long-Term Forecasting (Chapter 5). Part of the fiscal health story is ensuring that adequate revenues are available as a spending plan moves forward. As the complexity and speed at which the economy changes increase, local officials face ever increasing demands to improve their assessment of future revenue streams. Inaccurate revenue forecasts can seriously hamper fiscal health. Dr. Kriz provides an extensive overview of forecasting approaches including qualitative and quantitative strategies. These are critical tools in the fiscal health of local governments.

The book turns to issues surrounding pensions and other postemployment benefits (OPEB) that represent a crucial and newly salient arena of fiscal health and stress (Part III). Many state and federal laws constrain and shape the type of obligations in which local governments engage. Previous fiscal stress measurement systems have not always accounted for these obligations. Chapters in this section assess the potential influence of pension and OPEB obligations on fiscal stress and their implications for fiscal stress measurement systems. In Postemployment Benefits and Fiscal Analysis (Chapter 6), Dean Mead provides an excellent overview of the postemployment benefits offered through local governments. The first section describes these postemployment benefits, and the next section describes how the short- and long-term costs of benefits are calculated and reported. Recent years have seen dramatic improvements in the calculation and disclosure of liabilities for postemployment benefits by U.S. state and local governments that follow GAAP. Mead offers suggestions on the role of postemployment benefits in measuring and maintaining overall local government fiscal health. Sustainable Approaches to Retiree Benefits: Options and Implementation for Program Design and Financing (Chapter 7), written by Jun Peng, describes the types of approaches needed to address the costs associated with these postemployment benefits. It describes different approaches in how these benefits are offered and the potential costs and benefits of such approaches. This discussion includes the differentiation between defined contribution and defined benefit plans. Finally, reference is made to how postemployment benefit changes influence local government fiscal health.

Revenue Elasticity and Adequacy (Part IV) focuses on revenue systems as a crucial part of the fiscal health equation. Given the wide degree of variance in property tax limitations and the variety of local option taxes, these considerations should be part of any fiscal stress measurement and management approach. During an analysis of Public-Finance and Fiscal-Federalism Perspectives on Local Government Revenue Bases and Fiscal Sustainability (Chapter 8), Donijo Robbins provides a broad overview of the role of government in our society and communities. Local governments have long played an important role in shaping and reshaping communities and providing basic services that citizens experience on a daily basis. This discussion provides some perspective on how we understand the role of government and what questions should be asked regarding the appropriate role of government in the 21st century. These questions are particularly relevant as the United States faces the long-term fiscal dilemma of an aging population and large scale government debt. In Understanding and Measuring Elasticity, Volatility, and Implications for Local Government Fiscal Health (Chapter 9), Deborah Carroll and Christopher Goodman look at the stability and change of various tax revenues that local governments rely on. Given that revenue stability is a critical element in determining when a local fiscal crisis may occur, these are important issues. A review of the existing empirical literature of revenue elasticities is provided and how to calculate revenue responsiveness or elasticity is illustrated. These are important points of analysis in assessing potential and actual local fiscal health.

Alternative strategies used to address business cycles, especially as governments enter into periods of fiscal stress, are explored in Business Cycles, Bubbles, and Reserve Funds: Cutback Management for the 21st Century (Part V). The four chapters in this section discuss the use of alternatives such as the use of reserve funds and the overall management of funds across time. In Fiscal Stress and Cutback Management Among State and Local

Governments: What Have We Learned and What Remains to Be Learned? (Chapter 10), Christina Plerhoples and Eric Scorsone offer an assessment of the use of cutback management strategies in state and local government since the 1970s. This discussion contributes to our understanding, via the many empirical analyses done since 1970, about which approaches governments are likely to use, including budget cutting and revenue raising, in times of fiscal stress. This information can assist policymakers and practitioners in assessing past performance of various strategies and build awareness of alternative approaches. While this literature has grown over the past 30 years, many avenues of research remain open to researchers, particularly in the area of the long-term implications of cutback management strategies. The next topic, A Framework for Deciphering and Managing the Fiscal Environment by Josephine LaPlante, offers a new and striking visual approach to understanding local finances. First, Dr. LaPlante reviews some of the previous contributions to understanding local fiscal health. The visual figure she provides in Chapter 11 gives us a glimpse of the complex web within which fiscal health is structured. On one hand, we must understand the revenue dynamics that allow local governments to raise funds. The other side of the equation is spending needs and mandates, some of which can be controlled and some of which cannot. She also highlights that capital investment both drives and is a consumer of funds. Another key element is the service environment within which a government must operate. Some environments may be harsher (e.g., older housing and higher poverty levels) and require a greater level of spending than others that lack these issues. The final section, using this visual framework, allows us to understand how careful comparative analysis of fiscal health should proceed.

During a review of Fiscal Slack, Reserves, and Rainy Day Funds (Chapter 12), Justin Marlowe makes it clear that beyond basic rules of thumb such as the "five percent rule," there is at present little real knowledge of how slack financial resources do or should affect fiscal health. His review of the literature suggests that no consistent approach exists even for determining what level of slack or reserves exists for any local government, which may account for the dearth of clear empirical conclusions to date. However, it is clear that accounting standards are moving toward improving and standardizing the measurement of slack, and this in turn may lead to more conclusive research. The section concludes with the topic of Managing Investments and Investment Risks (Chapter 13), by William Albrecht. Dr. Albrecht helps us understand investments and their relationship to local government fiscal health. The analysis focuses on the nature of investment risk from the perspective of local government management and shows that adequate cash flow and liquidity must be ensured while still gaining some return on investment from idle cash. Foregoing any return on investment may also be problematic as it helps in some small manner to balance overall government spending needs. Specific risk management tools are explored.

Whether a fiscal early warning system is deployed or not, there are cases where states have been forced to takeover or intervene in local units of government. Four chapters on Intergovernmental Considerations (Part VI) examine the roles of state governments in regulating, constraining, overseeing, and intervening in local governments' fiscal affairs; assess the effectiveness of these strategies and policies; and offer recommendations for future interventions. In Local Government Fiscal Health: An Intergovernmental Perspective (Chapter 14), Beth Walter Honadle addresses the issue of understanding local governments within the overall framework of the federal system. Dr. Honadle describes the various intergovernmental relationships between both state and local government and federal and local government. This intergovernmental framework provides an important perspective on the implications of intergovernmental structures for fiscal health. The clear implication is that fiscal health is strongly tied to intergovernmental arrangements. In Monitoring the Fiscal Health of America's Cities (Chapter 15), Lynne Weikart focuses on a different aspect of intergovernmental arrangements. Dr. Weikart discusses the federal and state role in monitoring and if necessary intervening in local fiscal affairs. There is a specific section that discusses various state approaches to monitoring fiscal health. Finally, the roles of not-for-profit organizations and bond rating agencies in monitoring local governments' fiscal health are examined.

In Measuring the Impacts of TELs on Municipal Financial Conditions (Chapter 16), Craig Maher and Steven Deller present information regarding the role of tax and expenditure limitations on the fiscal health of government. Increasingly, questions have been asked about the dozens of tax and expenditure limitations (TELs) imposed on local governments in the wake of Proposition 13 in California in 1978. For some observers, these limitations have restrained government appropriately while for others they have led to chronic fiscal stress and the inability to finance basic public services. Maher and Deller's findings tentatively support the notion that TEL's may actually force governments to better manage resources rather than create chronic fiscal stress. Using a sample of more than 1,000 municipalities in 47 states, they find that the severity of state-imposed TELs is associated with statistically significant but small differences not always in the hypothesized directions. Given the relative weakness of the statistical findings however, the more important lessons from this chapter may be that further research is needed and that past findings exhibited considerable analytical problems in attempting to model causal relationships of environmental and organizational characteristics with fiscal health. Next, in The Defragmentation of Authority: A Consolidation Approach to Public Service Delivery (Chapter 17), Helisse Levine suggests that despite the "one shot" infusion of Recovery Act funding for education programs, currently, the sustained, statewide economic decline is directly linked to financial challenges being felt by local school districts across the state. Dr. Levine presents a simulation model to ascertain whether the consolidation of Nassau County's 56 school districts will reduce administrative costs. Although cost savings, as a result of economies of scale, may result from consolidation across smaller sized districts, local control in the form of school board composition must be weighed against the economic differences in citizen demand for and value placed on those "public" goods.

We conclude with Debt Capacity, Management, and Policy (Part VII), which addresses debt obligations given their key role leading to the potential insolvency of a local government. This section covers current debt obligations, state policies to address local government debt commitments, and the influence of debt on fiscal health in general.

Kenneth Kriz and Qiushi Wang present Measuring and Monitoring Debt Capacity and Affordability: Market- and Nonmarket-based Models in Chapter 18, which draws our attention to the variety of approaches that have been used to assess the potential burden of debt on overall local government fiscal health. They discuss some of the traditional models for assessing debt capacity, including the bond rating agencies' approaches. The quality and effectiveness of these traditional debt scoring models is assessed and a very concise yet broad overview of debt modeling approaches is provided. In their review of State Fiscal Constraints on Local Government Borrowing: Effects on Scale and Cost (Chapter 19), Juita-Elena (Wie) Yusuf, Jacob Fowles, Cleopatra Grizzle, and Gao Liu turn their attention to the state's role in regulating municipal debt. Debt plays an important role in understanding local fiscal health. The authors take care to detail the different approaches states have used to limit municipal debt, including debt limits, TELs, and referendum requirements. Their review of the research to date finds that despite state attempts to limit debt, local governments have been able to circumvent these limits. This explains at least in part why overly burdensome debt still plays an important role in local government fiscal health. Good Debt Gone Bad: The 2008–2009 Crisis in Municipal Debt Markets (Chapter 20), by Gary Rassel and Robert Kravchuk, rounds out this section, with a specific focus on the most recent "Great Recession" and its implications for local fiscal health. They suggest that the municipal debt market remains solid following the Great Recession but will require new analytical tools with the decline of bond insurers. The suggestion is that variable rate debt will retain an important role in the market despite some recent problems. The final suggestion is that new risk assessment tools will be required.

Reference

Hoene, C. W., & Pagano, M. A. (2003, October). Fend-for-yourself federalism: The impact of federal and state deficits on America's cities. *Government Finance Review, 19,* 36–42.