The Seismic Economic Changes Behind Municipal Distress

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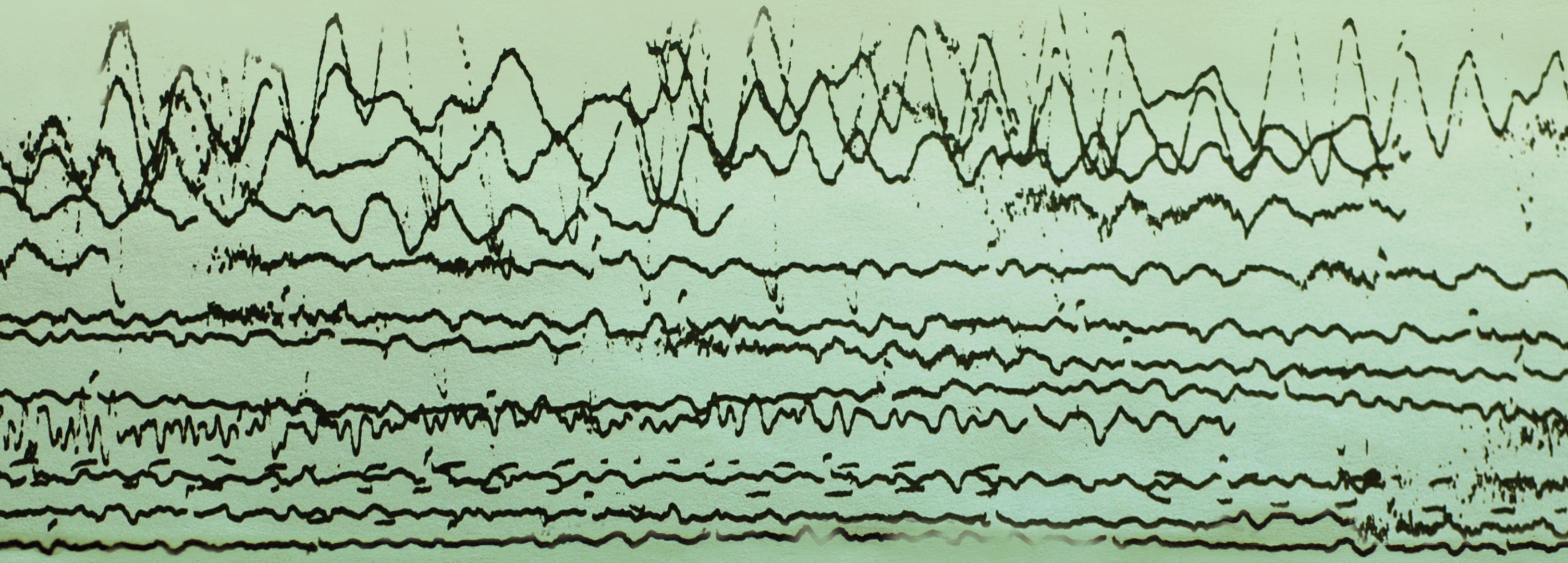


Much has been said about the increasing debt, unfunded pensions, unaffordable employee and retiree health care, and the aging, undermaintained infrastructure that have created ongoing financial stress at all levels of government. By now it should be clear that some irrefutable facts must be addressed if states and nearly 90,000 local governments in the U.S. are to recover from the ongoing financial stress many of them face.

Four fundamental mega trends affect almost every local government, particularly cities and counties that are already in financial stress or that have serious structural imbalances of operating revenues and expenses that indicate foreseeable stress. These are:

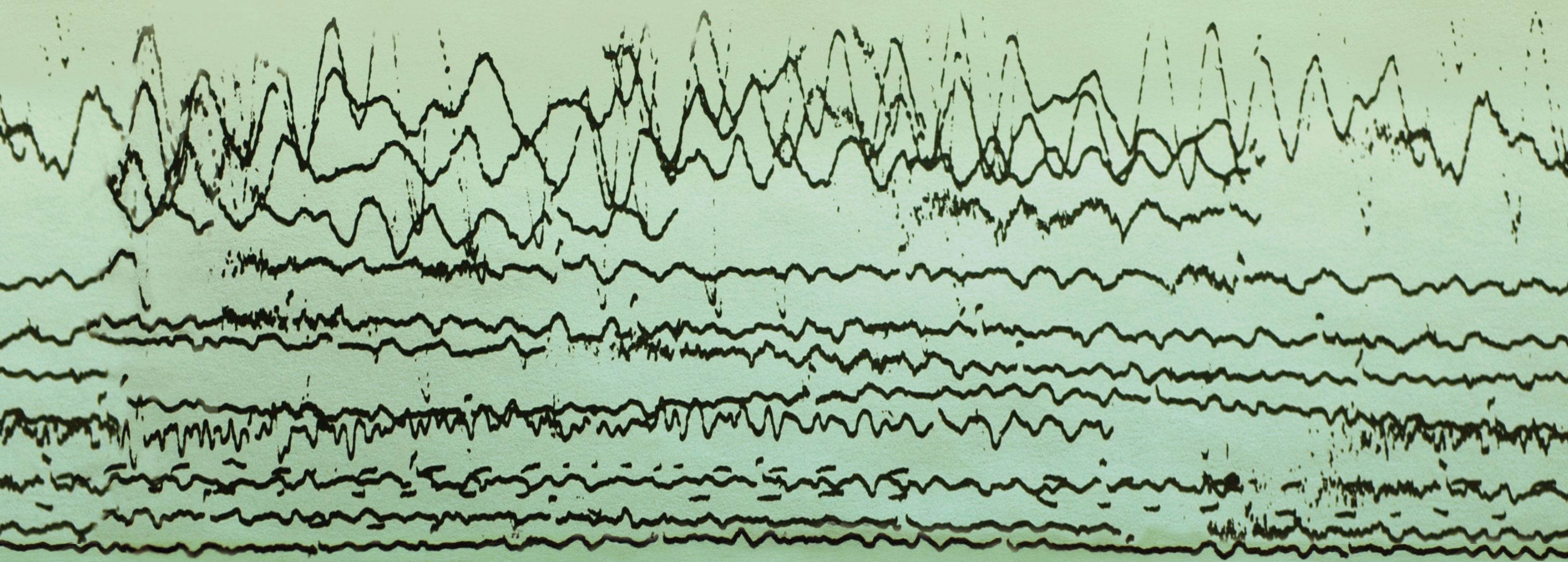
1. Declining populations in cities and/or population shifts within metropolitan areas.

2. Structural inefficiencies of the many existing and overlapping layers of governments.

3. Aging baby boomers, 3.5 million of whom will turn 65 each year for the next 15 years.

4. An eroding tax base that does not reflect the 21st century economy.

These seismic socioeconomic trends will continue to affect local governments' ability to deliver vital services while living within their means. Although these continuing trends are not recent discoveries—they existed before the recessions of the 2000s, but were exacerbated by those economic downturns—only a few communities and states have begun to address them in a meaningfully way. Other governments have made attempts to address the problems, but proposed solutions generally have failed to survive the resulting partisan political tussles.



Many of these issues are related and interdependent. Declining populations and overlapping layers of government lend themselves to straightforward management solutions involving regional government and/or consolidation or sharing of services to reduce spending. Indianapolis and Marion County, in which the city is located, did so successfully years ago, and Maryland governments did so decades ago. These governments successfully addressed what are generally considered "third rail" issues fraught with intercommunity partisanship, the protection of political constituencies, and the influence of special interest groups.

Similarly, investments in improved health care have led to a better quality of life and resulted in significantly increased life expectancy in the U.S. However, discussions of increasing the retirement age for pension eligibility, which seemingly should logically follow, are usually derailed by characterizations of any such proposal as anti-elderly. Yet changing the tax system to better reflect the current economy and improve compliance is politically unpopular, despite the need to find additional revenue to pay for millions of baby boomers who don't want to delay retirement.

Declining Population

Although the U.S. population increased by 9.7 percent from 2000 to 2010, that marked the smallest rate of increase since the Great Depression. The overall slowing of the national growth rate reflects a continuation of a cumulative population rate decline since at least 1980 and an absolute population decline in many cities in several regions of the country.

In the past decade, this trend has affected not only cities such as Detroit and Cleveland, which experienced well-publicized declines in population, but also Oakland, California; Birmingham and Mobile, Ala.; South Bend, Ind.;

Hialeah and North Miami, Fla.; and Beaumont and nearby Port Arthur, Texas. Some of this decline could be attributed to people moving from urban to suburban areas, which occurred in Philadelphia and Baltimore, yet other metropolitan areas experienced population decline throughout the larger metropolitan area. That was the case for Buffalo, N.Y., and Toledo, Ohio.[1]

However, the most pervasive declines have been in the New England, Mid-Atlantic, and Upper Midwest regions. As mentioned earlier, cities and other jurisdictions with declining populations could benefit from management solutions involving regional government and consolidation and/or sharing of services to reduce costs. Such a change requires the strong support of the business community and civic leaders to foster cooperation among governments in the area.

Demonstrating such efficiencies and cooperation can create an image of stability, which prospective new residents and new or expanding businesses look for when they are considering investing in a community. Through regional cooperative governmental structures, a city can achieve workable solutions for its financial distress while benefiting from economic development and the growth that comes with it. Absent cooperation and recognized mutual interest, struggling cities resort to attempting to raise additional revenue through such methods as the imposition of commuter taxes to prevent degradation of services and infrastructure, which may prompt businesses to locate or expand elsewhere.

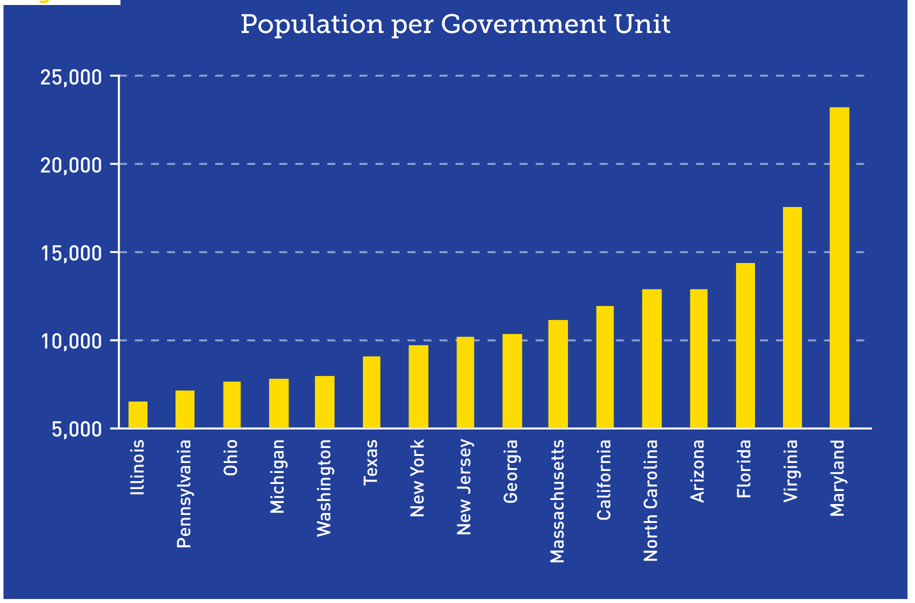
Governmental Units

Government structures that may have served well in the 20th century may not be the best options for the 21st century. The U.S. currently has 89,476 local governments. That number has increased even since the 1990s and is a marked increase from the 78,000 in 1972 that reflected the fewest number of local governments in census history.

The number of local governmental units that exist raises two questions:

1. Is there too much government?
2. Given technological advances, are there just too many governmental units?

Figure 1



With the continuing advancements in hyperconnected communications and information technologies, the geographic distribution and overlap of government jurisdictions are not only no longer necessary but, with a lack of growing revenues for vital services, are also no longer affordable.

Much of the concentration in layers of government is found in the New England, Mid-Atlantic, Upper Midwest, and Pacific regions. Overlaying a map depicting the concentration of population and job loss on another map depicting the concentration in layers of government shows that these issues apply largely to the same regions. By comparison, cities, metropolitan areas, and regions in which there has been significant population and job growth in the past 30 years—notably in Florida and Arizona—have generally not found it necessary to significantly add layers of governments.

To compare government services to those delivered by private business organizations, if elementary and secondary education delivers essentially the same product, although with varying degrees of quality, why would all the same support services, including accounting, human resources, procurement, and administrative technology, be duplicated hundreds of times over throughout a state? A private business that had many retail outlets or service centers in a given state or region would not repeat the same administrative function in each location.

Yet, there are more than 13,000 public school districts in the U.S., each with its own support systems. Why does Florida, the fourth-largest state, have just 1,600 local governments and 84 school districts operated largely through county government systems, while Illinois, the fifth-largest but with six million fewer people than Florida, has almost 7,000 local governments and more than 900 school districts?

Likewise, Washington State, the 14th-largest state, has 1,845 governments, while Virginia, the 12th-largest, has just 511. Even among states with smaller populations, Nevada, the 36th-largest, has 191 governments, while North Dakota, which ranks 49th among the 50 states in population, has 2,667. **Figure 1** indicates the density of government units per capita. Maryland, which ranks 19th in population, is the champ, both per capita and in total, with just 254 governments.

The Midwest and Upper South have the highest concentrations of large consolidated city–county governments in the country, including Indianapolis; Nashville; Jacksonville, Florida; Louisville; Kansas City, Kansas; and Lexington, Kentucky. Clearly regionalization, consolidation, and shared services should be considered in more areas of the country as well.

Further cost savings could be achieved through prudent use of information technologies. Technology is both a job creator and reducer, either by eliminating or off-shoring positions, but its role in this regard would be as an enabler of cost savings as a result of fewer governments by deploying the connectivity of communications and information technologies.

Baby Boomers

The oldest group of baby boomers turned 65 in 2011, and some of them began retiring even earlier. The result of an elevated birth rate from 1946 to the early 1960s, the boomer bubble is both tall and wide, and its impact will be felt for decades. Despite many warnings over the years about the effect of these retirees on government finances, many fear that too little has been done to ensure the sustainability of pension and health care benefits for the baby boom generation.

For the next 15 years, more than 3.5 million Americans per year will turn 65[2] and, due to increasing life expectancies, many of them will live well beyond 2030. They not only will impact the cost of Social Security and Medicare, but also government employee pensions and health care.

What's more, this demographic shift will also affect government tax revenues. The consumption patterns of senior citizens differ from those of the general population, and they generally consume less than younger people. Their incomes are often lower, and some of their income is excluded from taxation. Those aged 65 and older spend more than twice the share of their total outlays on health care as does the overall population.[3] So they will pay less income tax and also spend more of their incomes on untaxed services.

Eroding Tax Base

Most state and local governments depend primarily on a combination of property, sales, and income taxes for their revenues. Since the corporate and individual income taxes were adopted in 1909 and 1913, respectively, effective collection of income taxes from both sources has become increasingly problematic, particularly since World War II.

In part, this is because accounting and legal definitions of income are neither constant nor consistent across industries. Tax law amendments influenced by special interest groups to produce tax loopholes and taxpayers' ever-growing sophistication in tax avoidance have contributed to the tax collection problems. Over the course of a century, the U.S. Tax Code has become riddled with exceptions and complexities almost beyond comprehension.

However, another major factor affecting tax collections is the U.S. economy's transformation from goods-based to services-based. Indeed, according to the *CIA World Fact Book*, the service sector (vs. the industry and agriculture sectors) now accounts for 79.7 percent of U.S. nominal gross domestic product (GDP). As a percentage of GDP, both corporate and personal income taxes have declined.

The individual income tax share has declined, particularly since tax rates were reduced in the early 2000s. This deterioration has been exacerbated by growing income inequality, which has resulted in the top 10 percent of earners taking home half of all income—more than at any time since the 1920s. While 70 percent of the economy is consumption-based, spending by middle class consumers is expected to rise less than 1 percent per year on average over the next 20 years.[4] As a result, the base on which past economic recoveries were built also has shrunk.

Corporate income tax collections have also declined consistently over the years, from 5.9 percent of GDP in 1952 to around 2 percent in the mid 2000s. The financial meltdown of 2008 reduced corporate income tax collections by half, to 1 percent of GDP.[5]

At the state and local levels, this erosion in tax receipts has occurred largely for two reasons. First, many corporations do not pay corporate income taxes at the state and local levels because of the ease of shifting income and expenses across state and municipal borders. Many Fortune 500 companies that otherwise consistently report significant profits do not pay state and local income taxes, despite considerable sales presence in a state. Second, since the mid-20th century, increasing numbers of companies in the service and other sectors have increasingly elected a "pass through" corporate structure, which allows them to avoid paying corporate income taxes.

When property tax revenues shrank because of the Great Depression in the 1930s, states began enacting sales taxes. At that time, sales taxes helped offset the loss in property tax revenues because the economy at the time was based largely on goods. However, the agriculture and industrial sectors (including mining but excluding construction), which accounted for about 43 percent of the gross national product (GNP) until about 1930, declined to about 35 percent of GNP by 1940[6] and about 20 percent of GDP in 2012.

Only 30 percent of those employed in the United States in the early part of the 20th century worked in service professions, with the rest employed in industry or agriculture. However, by 1950, half of the workforce was employed in services, and in 1956, for the first time in the history of America's industrial society, the number of white-collar workers exceeded the number of blue-collar workers. By the 1960s, the United States could no longer be characterized as an industrial society but rather as a post-industrial or service society.

The trend away from manufacturing toward services continued throughout the last half of the 20th century. In 1984, the number of jobs in manufacturing was relatively high compared to the number of jobs in the services, but by 1999, the service industry employed about twice as many individuals as manufacturing or government. This largely resulted from the fact that more than 97 percent of the jobs added to U.S. payrolls from 1990 to 2002 were provided by the service-producing sector.

By the beginning of the 21st century, services accounted for approximately 70 percent of the national income and 80 percent of the jobs. This long-term shift from manufacturing to service is expected to continue. As the U.S. Bureau of Labor Statistics (BLS) report on industry trends "Tomorrow's Jobs," put it, "Service-providing industries are expected to account for approximately 15.7 million new wage and salary jobs generated over the 2006–2016 period, while goods-producing industries will see overall job loss."

Clearly, the U.S. tax structure is based on a different economy than exists today. As a result, most governments have a tax base that does not grow as the 21st century economy grows, while costs do increase based on the current economy. Many eroding tax bases have not kept pace with a changing economy in more than 50 years.

Not only have property, income, and sales tax revenues declined further since the 2007 recession, but the collection of these taxes for many governments also remained below pre-2007 levels, even in 2011 and 2012. Yet attempts to increase sales taxes and impose taxes on services have usually been beaten back by professional associations and other interest groups. Only a handful of states, including Washington, New Mexico, Delaware, Hawaii, South Dakota, and Ohio, tax all sorts of services using sales or forms of gross receipts taxes, while Iowa applies sales tax to about 100 services.

New Realities

The four socioeconomic facts discussed in this article are the underlying drivers of current municipal financial stress, especially in older U.S. cities. However, looking ahead just one generation and considering the costs and effects of population declines or shifts, outdated layers of government, the baby boom bubble, and the fundamental transformation to a service-based economy (reflected in both GDP composition and the jobs market), it is clear that the sustainability of municipal governments' revenues and their ability to provide vital services will be challenged as never before.

This does not mean that budgetary and management steps are not urgently needed. Municipalities need to reduce debt, implement affordable pension and retiree health care benefits, decrease spending by outsourcing functions when appropriate, consolidate or share services, and find ways to maintain or replace aging infrastructures to avoid the greater costs of delay.

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However, it does mean that essential managerial steps alone will not be sufficient without providing the revenue base to fund vital municipal services going forward. Layers of government that are no longer affordable because of shifts or declines in population must be eliminated, much of which can be accomplished through the use of communication, media, and information technologies.

In addition, the baby boom generation must recognize that their increased life expectancy and the ability to retire earlier than previous workers were made possible by private and public investments in better health care, education, and an expanding economy. However, these social advances carry real costs to succeeding generations, and baby boomers should expect to share in the sacrifices that will be necessary to offset the costs of these extraordinary benefits.

Finally, state and municipal governments must be funded with revenues that grow with the 21st century services economy. Without that, local governments will not be able to provide protective and emergency services; aid for the sick, poor, and elderly; transportation systems; infrastructure; and other vital services.

[1] U.S. Census and City-Data.com
[2] Merrill Lynch Global Research
[3] Congressional Research Service
[4] Merrill Lynch Global Research
[5] U.S. Government Revenue.com
[6] U.S. Department of Commerce