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Rural America's Fiscal Challenge

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Fiscal challenges at state and local governments are a potential threat to the economic recovery in rural America. Rural communities depend heavily on intergovernmental transfers from the states to provide local services. Many people in rural communities rely on the state or local government for their jobs and on Medicaid as a part of their income. Thus, rural economies are highly susceptible to state budget shortfalls. As state governments cut spending in response to looming budget deficits in coming years, rural America's fiscal problems may also deepen.

Although strong rural real estate markets continue to support property tax revenues, rural governments must still find ways to offset the declines in state and federal intergovernmental transfers. Rural governments are responding by raising taxes, limiting service delivery, cutting jobs, and improving the efficiency of service delivery. While many of these solutions can be painful, the challenge has a bright side for rural America—an opportunity to foster a new round of innovation in service delivery through consolidation, cooperation, and privatization of services.

GOVERNMENT REVENUES SHRINK

Despite the resilience of real estate values and property tax receipts, many local governments in rural America still

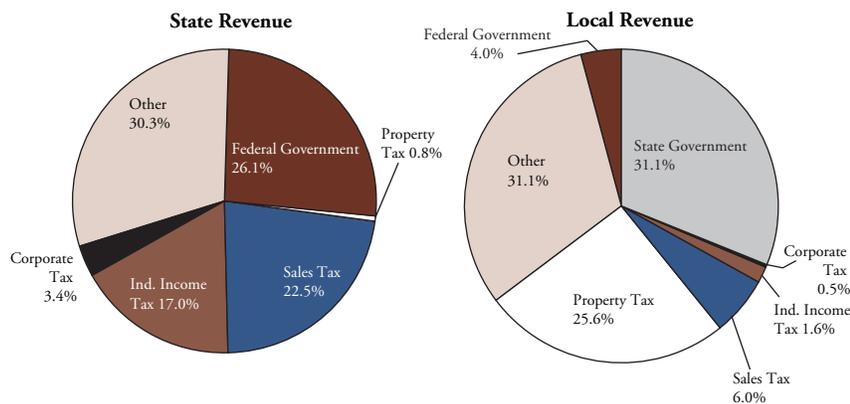
face budget shortfalls. Rural local governments rely heavily on intergovernmental transfers from state governments to balance their budgets. As state governments slash their budgets, revenue streams to local governments also shrink.

During the current economic downturn, strong property tax receipts supported local tax revenues, especially in rural areas where real estate markets stayed relatively healthy. In contrast to state governments, property tax revenues account for a large share—roughly a quarter, of local government revenues (Chart 1). In 2009—property tax receipts rose more than 5 percent and underpinned an overall increase in local government tax receipts (Chart 2).

Thanks to the strong real estate markets in rural areas, tax revenues for rural governments could fare better than their metro peers over the next few years as new property assessments are made. By the fourth quarter of 2009, home prices in rural America had fallen a modest 0.6 percent below 2006 levels, compared to 13.7 percent declines in metro areas.¹

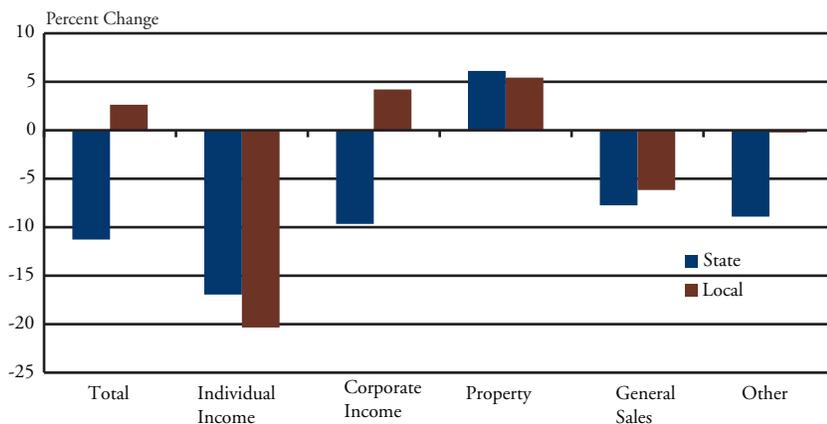
Farmland values, meanwhile, remain near record highs. After jumping more than 60 percent from 2004 to 2008, farmland continues to support rural property tax revenues.² For example, in Nebraska, property tax valuations and levies on agricultural real estate rose more than 10 percent in 2009, while valuations and levies on

CHART 1
THE COMPOSITION OF STATE AND LOCAL REVENUES, 2006-2007



Source: U.S. Census Bureau

CHART 2
STATE AND LOCAL TAX REVENUE GROWTH, 2008-2009



Source: U.S. Census Bureau

residential real estate rose less than 2.5 percent. Most of the gains in residential property tax valuations came from rural Nebraska, which enjoyed a 3.4 percent gain compared to a 0.2 percent gain in metro Nebraska.³

Unlike local tax revenues, state tax revenues fell sharply as the recession intensified, leaving almost every state with a budget shortfall. Rising unemployment slashed personal income tax receipts, while weak consumer spending cut general sales tax revenues (Chart 2). In addition to sharp declines in personal income and sales tax receipts, corporate income tax receipts also declined as businesses struggled to post profits. Nationally, state tax receipts fell more than 11 percent in 2009.⁴ Lower tax revenues have led to severe budget shortfalls with state governments facing a combined

\$196 billion shortfall, representing 29 percent of their budgets in fiscal year 2010 (McNichol and Johnson). State fiscal problems are likely to persist since rebounds in tax revenues usually lag an economic recovery. In addition, most of the federal stimulus funds directed to states expires at the end of 2010. The Center on Budget and Policy Priorities projects that state budget shortfalls could reach \$300 billion in the 2011 and 2012 fiscal years combined.

As state budget problems deepen, rural governments could suffer further from reduced intergovernmental transfers. Local governments receive 31 percent of their total revenue from state governments, making them sensitive to state budget cuts (Chart 1).⁵ In rural counties, intergovernmental transfers from federal and state governments have historically accounted for roughly 45 percent of the total local government revenues, with most of the assistance coming from the states. For poor rural counties, with low employment and persistent poverty, intergovernmental

transfers are even more important, accounting for 55 percent of total revenues. According to the City Fiscal Conditions survey, half of all U.S. cities reported decreases in state aid in 2009. As state budget shortfalls intensify, this number is likely to increase. For example, for fiscal year 2011, the governor of Wyoming has proposed cutting state aid to local governments by more than half (Johnson and others).

STATE SPENDING CUTS CHALLENGE RURAL ECONOMIES

The shortfalls of state and local government budgets could have larger implications for rural economies than their metro counterparts. In rural areas, Medicaid accounts for a larger share of personal incomes than in metro areas, and state and local governments account for a larger share of jobs. Contractions in government spending and Medicaid could

have even bigger effects on rural economies in poor rural regions, where unemployment is already high and poverty is the norm. Further straining state and local budgets are the rising numbers of the unemployed, which have boosted the demand for social services during this recession.

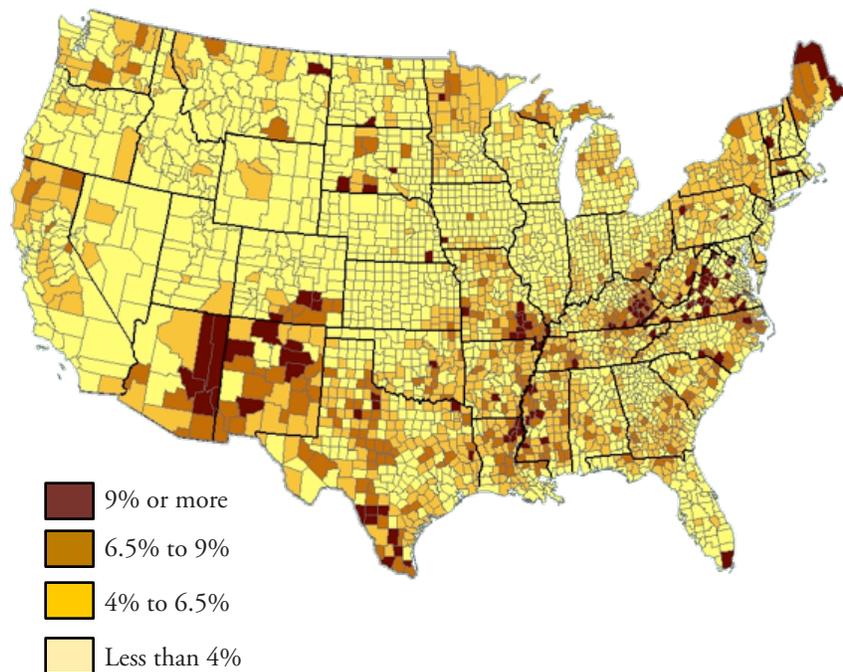
Cuts in Medicaid spending could have dramatic impacts on rural incomes. Over the past decade, government transfers to individuals (Social Security, Medicare, and Medicaid) have accounted for a rising share of rural incomes. According to the Census Bureau, Medicaid spending alone accounted for more than 4 percent of personal incomes in rural communities in 2008, compared to roughly 2.7 percent in metro areas. The impacts could be even larger for poorer rural communities as Medicaid spending accounted for 7.3 percent of the personal income in persistent poverty counties, double the percentage in other rural counties.⁶ Medicaid spending accounted for a larger share of personal incomes in the rural South, the Mississippi Delta, Appalachia, the Southwest, and the Great Plains, where persistent poverty and high levels of unemployment are common (Map 1).

State fiscal challenges pose a threat to future Medicaid spending at the same time the recession has boosted the demand for public assistance programs, such as Medicaid. In fact, national enrollment in the Medicaid program jumped 7.5 percent in 2009 and is projected to grow an additional 6.6 percent in the 2010 fiscal year (State Fiscal Conditions and Medicaid). Medicaid spending accounts for 21 percent of all state expenditures, and this rising demand has strained state budgets. In the American Recovery and Reinvestment Act of 2009, the federal government increased the Medicaid matching rate to help states manage their spending on Medicaid and other public assistance programs. While state Medicaid spending declined 2.2 percent in 2009, federal spending

on Medicaid jumped 15.9 percent (State Expenditure Report). However, the higher matching rate for Medicaid is currently set to expire in December 2010, and state governments will again be forced either to make additional cuts to Medicaid services or to increase taxes to pay for current service levels.

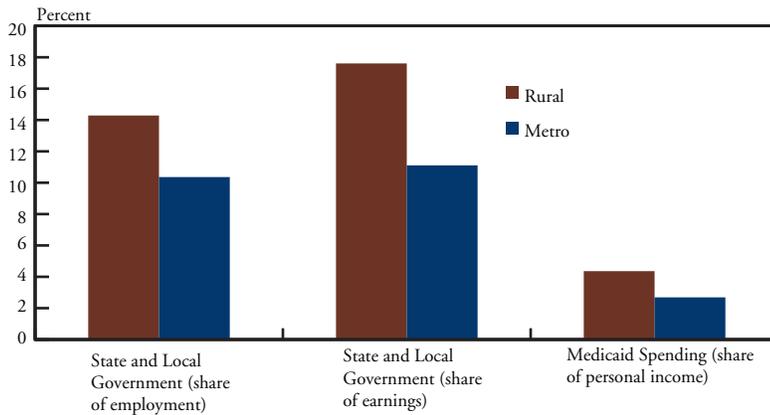
Additional spending cuts at state and local governments could have larger impacts in rural communities as well. State and local governments account for a larger share of rural employment and earnings than in metro areas. By 2008, state and local governments accounted for 14 percent of rural employment and 18 percent of rural earnings compared to roughly 10 percent of each in metro areas (Chart 3). These shares are even higher in rural counties in the Great Plains, the South including the Mississippi Delta, and upstate New York—places where earnings from state and local governments exceed 30 percent of total earnings (Map 2). Fiscal strains could have even larger implications for persistent poverty regions and those experiencing high unemployment, where state and local governments accounted for 20 and 25 percent of jobs and earnings, respectively, compared to 14 and 18 percent of jobs and earnings in other rural counties.

MAP 1
MEDICAID SPENDING SHARE OF PERSONAL INCOME, 2008



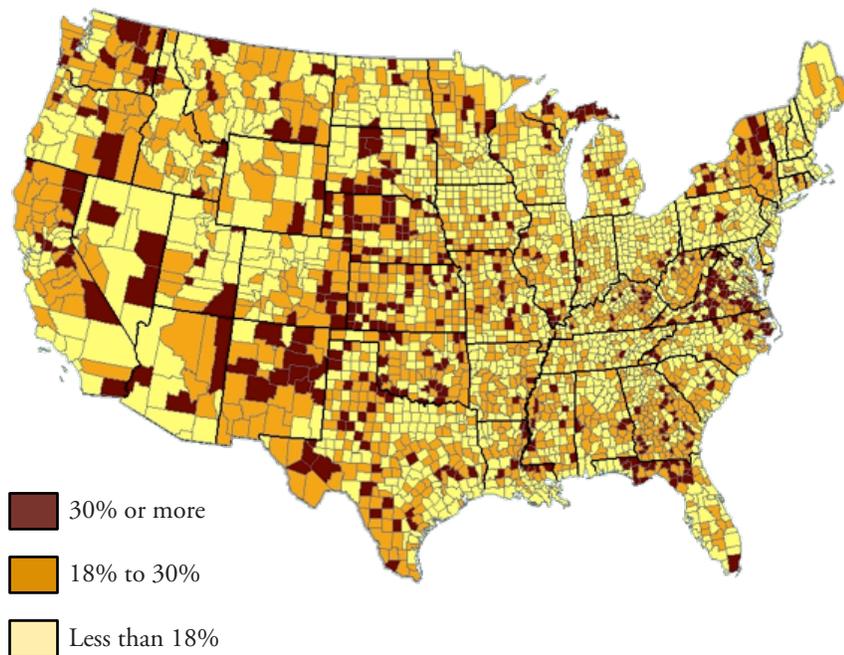
Source: Calculations based on BEA data

CHART 3
STATE AND LOCAL GOVERNMENT ACTIVITY AND MEDICAID SPENDING
BY METRO STATUS, 2008



Source: Calculations based on BEA data

MAP 2
STATE AND LOCAL GOVERNMENT SHARE OF WAGE EARNINGS, 2008



Source: Calculations based on BEA data

OVERCOMING FISCAL CHALLENGES IN RURAL COMMUNITIES

Declining tax revenues, combined with higher public expenditures, leave local governments with some tough decisions. Rural governments can deal with the fiscal challenges in one of three ways. First, they can increase revenues to pay for current spending by raising taxes and fees. Second, they can reduce spending by cutting services. Or third, they can reduce costs by becoming more efficient in delivering their services. This last option provides an upside to the current fiscal challenge by potentially spurring a new round of innovation in rural service delivery.

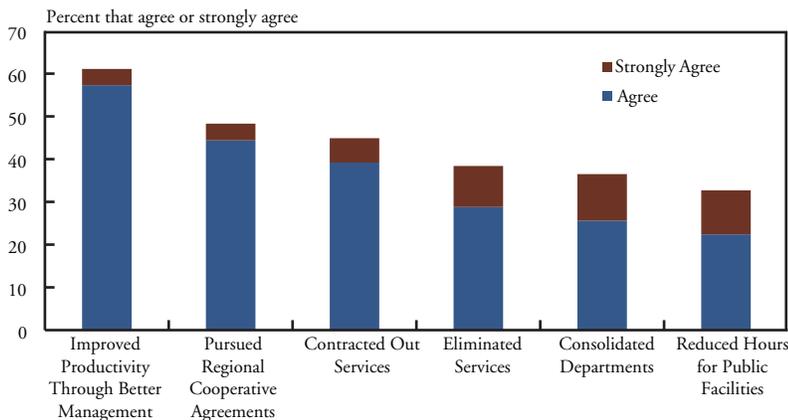
Local governments, and especially rural governments, have limited resources for increasing tax revenues. Most of them rely almost exclusively on revenue from property taxes. Some local governments have also imposed or raised local income taxes, sales taxes or fees for services to spur revenue gains. These higher tax rates, however, often reduce economic activity, leading to lower tax revenues than expected. In addition, raising taxes may not be politically feasible or desirable during an economic downturn, when citizens are already struggling with job losses, limited income gains, reduced property values, and lower wealth. Despite this, the National League of Cities’ annual survey revealed that 25 percent of cities raised

their property tax rate in the 2009 fiscal year. In addition, 45 percent of cities raised service fee levels, and 27 percent increased the number of fees (Hoene and Pagano).

An alternative for struggling local governments is to reduce spending, either by cutting services or by being more efficient in service delivery. More than 90 percent of cities reported making spending cuts in fiscal year 2009, and more than 80 percent expect to make

more cuts in fiscal year 2010. Two-thirds of cities reduced spending by laying off workers or instituting hiring freezes, and more than 60 percent delayed or cancelled capital projects. A smaller percentage of cities made cuts to other services or employee benefits (Hoene and Pagano). Governments can also reduce the number and types of services provided or reduce the availability of services by reducing hours or locations (Chart 4).

CHART 4
LEVELS OF SUPPORT FOR SPECIFIC STRATEGIES IN RESPONSE TO FISCAL STRESS



Source: Maher and Deller

Instead of increasing taxes or cutting services, many local governments may find it more desirable to reduce costs by increasing efficiency. In Wisconsin’s small, rural municipalities, for example, eliminating services and reducing the hours for public facilities were two of the least favored options by local government officials.⁷ Instead, these small cities and villages preferred enhancing productivity of service delivery through better management (Maher and Deller).

Local governments have a number of options for increasing efficiency, and most fall into one of four categories—consolidation, intermunicipality cooperation, internal reorganizing, or privatization. If local governments can find ways to increase efficiency, they can cope with current fiscal challenges more easily and improve their long-term fiscal health.

Consolidation—combining local governments or creating special districts to provide certain services—is perhaps the most dramatic and difficult step local

governments can use to potentially increase efficiency. This can be a lengthy process and is often unpopular with local residents who want to maintain their local autonomy and identity. Although consolidation is often politically unfeasible, Papoulias and Tannenwald (2005) suggest that it “might make sense in sparsely populated areas where production of goods and services is difficult and expensive.” The consolidation of services has been debated for decades, and in Nebraska, a local research

institute recently proposed to consolidate service from 93 Nebraska counties into 20 service centers to reduce administrative duplication.⁸ Just this year, three rural Indiana governments (Zionsville, Eagle Township, and Union Township) merged in part to streamline service delivery (Annis).

A less dramatic option for local policymakers is to *cooperate or collaborate* with other local governments or organizations. This can be as simple as increasing small government’s purchasing power by buying in bulk or as complex as creating contracts and boards to share resources or jointly produce goods.⁹

Coordinating the production of goods is most likely to produce efficiency gains in capital-intensive industries where economies of scale can be achieved. Examples of these types of industries include water, electricity, waste management, and highway transportation departments (Papoulias and Tannenwald). In Pennsylvania, four small, local governments (Freeland, West Hazleton, Butler Township, and Black Creek Township) started working together on road projects and were able to cut their costs by 50 percent (Christman). In another example of a common trend in smaller rural communities, two rural school districts in Michigan recently decided to share superintendents, saving each district \$50,000 annually. To save additional money, these districts also share natural gas purchasing and business and food services managers (Goodman). Compared to larger cities, smaller rural government authorities were more likely to use cooperative agreements with other governments to provide services (Mohr, Deller, and Halstead).¹⁰

For some local governments, *reorganizing* within their existing structure may create efficiency gains (Otto and Edelman). This effort could involve cooperation or consolidation among various functions or departments within the local government. Resources such as technology, personnel, training, and structures could be shared, while some redundancies might be eliminated. In addition, local governments may also be able to reduce costs by increasing their use of technology and offering online applications. The cost savings from internal restructuring often come from eliminating some government workers, making this option a difficult one for local authorities, as evidenced by rural officials in Wisconsin (Maher and Deller).

Apart from deciding to provide a public good or service, a local government could also decide whether to produce the good itself or contract the production out to a private company. *Privatization* can mean many things for local governments. A municipality can privatize an entire service such as garbage collection or a public library or obtain private contracts for specific jobs such as landscaping, custodial services, and facility repairs (Machado). Waste, fire, and ambulance services are commonly privatized. Two possible advantages of privatization include lower costs and higher quality resulting from increased efficiencies. In Illinois, Elk Grove Rural Fire Protection District contracted with a private provider for fire protection more than 30 years ago and continues to report savings of 30 to 40 percent over similar municipal departments (Stanek).

However, economic studies find mixed efficiency results from privatization (Warner and Hefetz). For privatization to be efficient, a competitive market for production of that good must exist in the area. For many rural towns, this may eliminate the possibility of privatizing many services. In fact, smaller communities in Illinois, New Hampshire, and Wisconsin are less likely to use private contracts to deliver public services (Mohr, Deller, and Halstead). Other concerns about privatizing involve the cost of contracting and monitoring and also the possibility that the quality of the service may decline (Warner and Hefetz).

Most economic literature is careful to point out that none of these solutions—consolidation, intermunicipality cooperation, internal restructuring, or privatization—

will work for every town or every situation. Carefully analyzing all of these options and choosing the best one for each situation, however, may lead to more efficient local governments. Still, many rural communities may look to balance efficiency gains with the desire to maintain community identity when deciding how best to cope with difficult economic times.

CONCLUSION

Fiscal strains are forcing rural governments to make tough budget choices. The recession has cut revenues and raised public service demand. Although local, rural tax revenues are performing relatively well due to a heavy reliance on property taxes, the resulting budget shortfalls at state and local governments are placing economic pressures on rural economies. Rural economies are more dependent on Medicaid and other government spending than their metro counterparts. And, the biggest challenges could emerge in rural America's poorest communities.

Over the next few years, rural governments may be forced to make changes in service delivery in response to fiscal pressures. Rural government authorities can choose to raise revenues, cut services, or improve efficiency of service delivery through consolidation, cooperation, or privatization. These decisions will be difficult. Tough times present tough choices, but carefully crafted solutions may not only alleviate current fiscal strains but also create a more efficient service delivery system for rural America.

ENDNOTES

- ¹National rural and metro home prices were calculated from state level rural and metro home prices obtained from the Federal Housing Finance Authority.
- ²Farmland values were obtained from the Economic Research Service, U.S. Department of Agriculture.
- ³Authors' calculation based on data from the Nebraska Department of Revenue.
- ⁴Authors' calculation based on U.S. Census Bureau data.
- ⁵Authors' calculation based on data from the U.S. Census Bureau.
- ⁶Persistent poverty counties are those with 20 percent or more of the population measured as poor during the 1970, 1980, 1990, and 2000 censuses.
- ⁷These findings are based on a 2004 online survey of Wisconsin municipalities, in which 119 cities and villages responded. The survey's focus was to measure fiscal stress and responses to fiscal stress (Maher and Deller).
- ⁸Platte Institute for Economic Research. 2010. "County Consolidation: Is Less More?" http://www.platteinstitute.org/docLib/20100405_County_Consolidation_FINAL.pdf
- ⁹One example of an organization designed to help local governments increase their purchasing power is U.S. Communities (www.uscommunities.org).
- ¹⁰This finding is based on three separate municipal surveys that were analyzed together in Mohr, Deller, and Halstead (forthcoming). The surveys were conducted in Illinois (1995), Wisconsin (1997) and New Hampshire (2004). The paper analyzes the responses of municipalities with fewer than 50,000 people. The surveys include questions about fiscal health, service provision and satisfaction, and privatization.

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