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Fiscal Crisis in Federal Reserve Districts 9 and 10 “Plains States”

John R. Bartle

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Profile

The states in these two districts include all of Minnesota, North Dakota, South Dakota, Montana, Wyoming, Colorado, Nebraska and Oklahoma, and parts of Wisconsin, Michigan (Upper Peninsula), New Mexico and Missouri. The region is generally more rural and lower in population density than the nation. Economically, the area is more reliant on agriculture, and in some areas, energy and mining. It is less reliant than the nation on manufacturing, financial services and tourism. Cities in this region are generally smaller than national averages. In their fiscal structure, no personal income tax is imposed in Montana and South Dakota. All these states impose a sales tax. There is substantial variation in municipal revenue sources.

Economic Changes

According to the National Bureau of Economic Research, the national recession began in December, 2007 (Grunewald and Madden, 2009). However slower economic activity was not evident in this region until September, 2008 (Kansas City Federal Reserve District 2008a and Minneapolis Federal Reserve District 2008a). So far, the recession is not as deep in this region as nationally. The national recession began in the housing and financial sectors, and has spread from there. In this region, the slowdown is affecting construction, real estate and retail trade most adversely. These sectors are expected to be affected the longest and deepest. The agricultural sector has not seen a major adverse impact, and energy and mining is mixed. The recession appears to be disproportionately affecting luxury consumer spending. For example, the new car market is down more than used cars; lower valued homes are in greater demand than higher valued homes in some markets, and tourism and restaurant spending is down sharply in the Tenth District. One positive is that inflation is low. Some input prices (energy, steel, and some minerals) are down. Wages are expected to moderate; in the Ninth District, over 90% of businesses expected wages to grow at less than 3%. Unemployment is expected to rise in most states, except Montana (Kansas City Federal Reserve District 2008a and 2008b; and Minneapolis Federal Reserve District 2008a and 2008b).

The effect on housing in this region is less severe than in others. In some states (North Dakota, South Dakota, Oklahoma, Wyoming, Montana and Kansas) housing prices increased between the third quarter 2007 and the third quarter 2008. Only in Minnesota and Michigan was the drop in housing prices greater than the national average (Federal Housing Finance Agency, 2008).

The Position of City Revenues

On average, municipal governments in this region draw somewhat less revenue than the national average from intergovernmental revenue, except in Michigan, Wisconsin and Wyoming. They also employ user charges more heavily, with the exception again of Michigan and Wyoming. Otherwise, the use of tax sources is diverse among these cities. The local sales tax is used heavily in some states (Oklahoma, Colorado and South Dakota) and not at all in others (Michigan, Montana, Wisconsin and Wyoming). Municipalities use the property tax lightly in Colorado, Missouri, Oklahoma and Wyoming, and heavily in Montana, Michigan, and Wisconsin. Only Michigan and Missouri use a municipal income tax, and only for selected cities. Excise taxes are heavily used by Missouri cities, while municipalities in North Dakota, South Dakota, and Wisconsin are light users of these taxes (US Census Bureau, 2005).

Differing combinations of revenue sources create different portfolios for cities. A recent study by the Kansas City Federal Reserve looked in detail at the growth and volatility of state tax revenue sources in the Tenth District (Felix, 2008). While this only gives partial information on the profile of local taxes, it is helpful for this study. It found that the general sales tax grew slightly faster than personal income in this district, and was relatively low in volatility. The volatility is affected by the composition of the tax base. It is increased by exempting food and relying on taxing consumer durables such as motor vehicles and furniture. Also sales taxes that are narrowly applied to services tend to be more volatile. Cities fitting these characteristics will likely face challenges. Excise taxes are very low in growth potential but also low in volatility, in part because many of them are assessed as unit taxes per item, such as a pack of cigarettes or a gallon of gas. Clearly in a recession, volatile taxes create problems, so the very limited use by these cities of the two most volatile tax sources, state personal and corporate income taxes, is a positive. By its nature, the property tax is a more stable tax, although this stability is threatened by delinquencies, foreclosures, and tax limitations.

Two recent studies by Pagano and Hoene (2008a and 2008b) examine trends in city spending, revenues, property tax and sales taxes. For fiscal year 2008, city spending dropped by 1.5% adjusted for inflation, while city revenues are expected to decline by

4.3% overall. This creates a budget gap that will need to be filled. Sales tax revenue is expected to drop by 4.2% in real terms, and property tax revenue by 3.6%. Because of the lag between property values changes and assessments, property tax revenues are expected to decline 18-24 months after the downturn in the economy. If property values bottom out in the first half of 2009, this would leave cities with declining values until early-to-mid 2011. While most city spending is expected to slow or decline, Pagano and Hoene point to fiscal pressure from rising costs for health care and pensions. Pension funds will be especially stressed if they are invested in under-performing portfolios. One bright spot is that on average, city budget reserves in 2007 were quite high, so some cities will be able to cushion the downturn, at least initially.

State Fiscal Position

At the state level, NGA/NASBO (2008) found that balances at the end of FY 2008 were over 10% for Montana, North Dakota, Wyoming, Nebraska, Missouri, Oklahoma and New Mexico; and between 5% and 10% in all other states in the district, except Wisconsin whose balance was 1%. Similarly, the NCSL (2008) found that state budget gaps in 2009 were either zero or less than 10% of expenditures in all states in the region. In 2010, these gaps are expected to widen in Kansas and Wisconsin. If so, the ability of these states to assist cities will be strained.

Vulnerabilities

While this region is better positioned than most, its cities are vulnerable to the economy. Specific concerns are:

- The decline in sales of consumer durables and luxury goods will affect sales tax revenues. This may hit some cities hard, in particular those in states more heavily reliant on the sales tax (Oklahoma, Colorado and South Dakota), and those with narrow tax bases due to the limited coverage of services, food and other stable sources of consumer spending. Cities without this tax do not face these problems, but in many cases rely heavily on the property tax or state aid.
- The housing market decline will affect cities where property tax limits are binding or there is significant political resistance to rate increases. This decline seems to be continuing in the region, as housing prices do not appear to have bottomed out. Property tax bases will likely be depressed into 2011.
- City and state budget reserves are important cushions that will help some cities at least postpone the hard budget choices. In other cases, the cushion is insufficient.

- States with progressive income taxes and that rely more on taxing capital gains and corporate profits have more volatile tax bases. They will be affected more and in turn, are more likely to cut aid to cities.
- Some city pensions are in danger of becoming more severely under-funded because of the decline in portfolio values and the pressure of retirements.

The states in this region whose local government are most vulnerable to the economic downturn are Michigan, Minnesota and Wisconsin because of the weak underlying economy, the drop in housing prices, and in the case of Wisconsin, the state's weak fiscal condition. Cities in Colorado are vulnerable because of high reliance on the sales tax and a narrow tax base. Cities also use the sales tax widely in Oklahoma and South Dakota but both states are safer because of a relatively broad sales tax base. Cities in Wyoming and Montana are not vulnerable at this time because of their strong economies and the strong state fiscal position. Those in North and South Dakota are less vulnerable.

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