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What Prevents Local Governments From Managing Their Finances More Effectively?

American voters can be forgiven for thinking that their local governments are in a constant state of fiscal crisis. New York City continues to struggle with an influx of migrants that has jeopardized its ability to maintain services and led the mayor to appeal for greater state and federal support. Chicago grapples with a massive pension shortfall and debt burden amidst persistent difficulty in finding common ground, as illustrated by the recent failure of a mayor-led initiative to reform the real estate transfer tax. Los Angeles faces a growing budget shortfall that imperils its efforts to confront a homelessness crisis. American cities are struggling to adjust to a post-pandemic world of empty office towers and shifting commuting patterns.

Yet, many of the fiscal problems that governments face predate the pandemic. In fact, one can't help but wonder whether there has ever been a time that local governments have managed their finances prudently, when cities did not face impending budget cuts and threats of drastic service reductions. The answer is: they haven't. And the reason why is the same reason why so many governance challenges persist: the institutional structure and the incentives that it gives rise to. Too often, municipal leaders simply are not incentivized to engage in prudent fiscal management.

To explain why, it helps to start with one of the most basic features of local government budgets: the balanced budget requirement. Unlike the federal government, city and state governments in the United States cannot engage in deficit spending. And while the details of these requirements vary from place to place, the overarching picture is the same: governments must balance their operating budgets on a cash (or near-cash) basis.

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June 3, 2024