Effects of fiscal stress labels on municipal government finances, housing prices, and the quality of public services: Evidence from Ohio

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ABSTRACT

This paper analyzes the Ohio fiscal stress labeling system, which labels municipal governments that are in financial trouble and requires them to implement financial recovery plans. These recovery plans are undertaken by the municipality or by the state depending on the type of label. I examine the effect of these fiscal stress labels on municipal government financial behavior, crime, and housing prices from 1999–2012. Using difference-in-differences, I find that municipalities with fiscal stress labels reduce total expenditures per capita by nearly 25 percent. Although municipalities make reductions to both per capita capital and operating expenditures, the largest percentage reductions occur in per capita capital expenditures. There are heterogeneous responses by the type of municipality and type of governance structure in place, especially in the reductions made to operating expenditures. Cities and municipalities with council-manager governance structures much more heavily focus on reductions in spending for specific public services (e.g., safety services, roads), while villages and municipalities with mayor-council governance structures primarily reduce general operating expenditures and increase local tax revenue. These labels have minimal impacts on crime rates and police employment. While I find no statistically significant effect of label receipt on housing prices, I do find that residential home sale prices fall following fiscal stress label removal. Thus, the reductions in public service expenditures may have long-lasting ramifications on the quality of public services offered by these municipalities.

1. Introduction

In the current financial climate, local governments have not been immune to financial hardships, especially those resulting from large budget deficits. In recent years, several municipalities have filed for bankruptcy due to severe financial issues. The two most populous municipalities to file for bankruptcy in the United States are Detroit, MI and Stockton, CA and the 2013 bankruptcy filing by the City of Detroit is the largest municipal bankruptcy filing on record. Under Michigan’s Emergency Manager law, a state-appointed “emergency manager” was placed in charge of Detroit’s financial decision-making and spearheaded the financial recovery from a debt of nearly $20 billion. Beyond the direct impact that municipal financial issues have locally, municipal bankruptcies may also have potentially larger, state-wide ramifications. For example, East Cleveland, OH, the most recent municipality facing bankruptcy, has faced stiff opposition from the state in declaring bankruptcy due to the Ohio Auditor suggesting that the state’s bond rating could be negatively affected.

While many of the financial issues facing local governments do not reach such a dire level, the fiscal health of local governments is still a policy concern for many states. Several states have developed financial intervention systems that monitor local government finances and provide various forms of intervention to help local governments address growing budget deficits and other financial problems (e.g., Michigan’s Emergency Manager law). Despite the presence of these policies in several states, little is known about the effects the policies have on local government outcomes. Towards filling this gap, this paper analyzes the fiscal stress labeling policy in the State of Ohio, which requires the implementation of a financial recovery plan that is operated by either the municipality or the state depending on the circumstances.
severity of the label.

This paper provides the first analysis of the effects of these fiscal stress labels on municipal government (i.e., city or village) outcomes, crime, and housing prices. I compile a balanced panel of all 932 municipalities in Ohio from 1999–2012; collecting data on dates of label receipt and removal, municipal government expenditures and revenues, crime rates, and housing transactions. Using difference-in-differences, I find that municipalities with fiscal stress labels reduce total expenditures per capita by nearly 25 percent. Although municipalities make reductions to both per capita capital and operating expenditures, the largest percentage reductions occur in per capita capital expenditures. There are heterogeneous responses by the type of municipality and type of governance structure in place, especially in the reductions made to operating expenditures. Cities and municipalities with council-manager governance structures much more heavily focus on reductions in spending for specific public services (e.g., safety services, roads), while villages and municipalities with mayor-council governance structures primarily reduce general operating expenditures and increase local tax revenue. These labels have minimal impacts on crime rates and police employment. While I find no statistically significant effect of label receipt on housing prices, I do find that residential home sale prices fell following fiscal stress label removal. Thus, the reductions in public service expenditures may have long-lasting ramifications on the quality of public services offered by these municipalities.

2. Previous literature

This is the first study to analyze the effects of these labels in the context of local municipal governments. This study most closely relates to Thompson (2016), which examined the effects of these labels in the context of local school districts and found statistically significant changes in school district financial behavior in response to the mandated recovery plans associated with these labels. These changes included increases in local tax revenue for operating expenditures and decreases in both operating and capital expenditures. The study also found that residential home sale prices fell following fiscal stress label receipt and educational services were reduced, as evidenced by reductions in teachers, schools, and test scores. Given that the current study examines both municipal government financial behavior, public service quality, and housing prices, the results of this analysis serve as a complement to these earlier school district results.

This study also contributes to the literature examining how local governments react to budgetary problems. Much of this literature has focused on voluntary changes to finances as a result of budget deficits and finds that many financially troubled local governments seek additional revenue sources, including increases in state and federal aid, local taxes, and user fees (Pagano, 1993). These local governments also reduce administrative expenditures (Forrester and Spindler, 1990; Honadle et al., 2004; Kordycki, 1998) and delay capital expenditures in order to balance budgets, but are often forced to also make reductions to essential public services (Higgins, 1984; Maher and Deller, 2007; Trussel and Patrick, 2012). A more recent set of papers has examined how local governments respond to the greater financial oversight associated with these financial intervention systems. Several of these studies have examined local government responses to North Carolina’s Local Government Commission and find that the greater oversight led to higher municipal bond ratings, larger fund balances (Coe, 2007), and local officials becoming more informed about their government’s financial status (Rivenbark and Roenigk, 2011). Spreen and Cheek (2016), however, find no statistically significant difference in the financial stress indicators of local governments in Michigan relative to local governments in control states following the introduction of Michigan’s Fiscal Stress Indicator System.

This study also contributes to the literature on the relationship between local governance structure (e.g., mayor-council, council-man-
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