

Political Incentives and Municipal Policymaking in Cities in Fiscal Distress

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March 2014

Senior thesis submitted in partial fulfillment  
of the requirements for a  
Bachelor of Arts degree in Economics  
at the University of Puget Sound

## Introduction

In recent years cases of municipal fiscal distress and bankruptcy have been on the rise. The major identified culprit has of course been the sharp decline in housing values, and thus city property tax revenues, during the Great Recession. Less attention has been paid to how municipal management incentives may have contributed to these undesirable outcomes. In this paper I will explore the politics of dealing with fiscal distress, and ways in which political behavior has negatively contributed to the well being of cities and their residents.

Using Wolman's model of municipal decision making under fiscal distress, along with the literature on political incentives and local development policy, I will model local government official (LGO) decision-making in cities in fiscal distress. I will use the term LGO to specifically refer to elected officials, being the mayor and council members. Using the theory of utility maximization, in this case LGOs seeking to maximize the number of votes they gain in the next election cycle, this paper will model and explain some of the ways by which cities respond to prolonged fiscal distress. Further, this paper will shed light on who bears the cost of, and who profits from, municipal fiscal distress. I will use the conclusion to suggest potential policy options to mitigate some of the external social costs of municipal fiscal distress.

## Literature Review

Wolman (1983) provides the sole generalized political model for how cities deal with fiscal distress. He models municipal decisions as catering to the interests of two constituencies: the public (external) and government employees (internal). Wolman assumes that LGOs of cities in fiscal distress will make policy decisions to jointly minimize

welfare losses to each of these two constituencies. He measures public welfare by city expenditures, and [measures](#) government employee welfare by number of jobs and salary earned.

Wolman argues that LGOs first reaction to fiscal distress will be to “buy time,” [by](#) [drawing](#) down existing fund surpluses and [using](#) short-term debt. This allows the LGOs to maintain service levels to the public and maintain existing staff levels in order to maintain political popularity, without raising the local tax burden. He cites as an example San Francisco’s policy post-Proposition 13 of drawing down \$20 million in reserves and transferring a utility fund surplus [to](#) the city’s general fund. This allowed the city to maintain service levels after local revenues were cut due to the property tax limits of Prop 13. Further, Wolman suggests LGOs will ‘roll over’ short-term debt into the next fiscal year in order to delay service cuts to their constituents.

If buying time does not suffice [to](#) [balance](#) the municipal budget, Wolman posits that LGOs will seek intergovernmental assistance to cover budget shortfalls. This allows LGOs to maintain service levels without raising taxes, which would cause a negative reaction from the LGOs public (external) constituency.

Once intergovernmental assistance is exhausted, Wolman suggests that LGOs will now have to make politically costly decisions either [to](#) [raise](#) taxes (increasing revenues) or cut services. Wolman posits that LGOs will only raise taxes to the level that they *perceive* the public would be willing to accept. Similarly, LGOs will seek to cut services only to the level they *perceive* the public would be willing to accept. When it comes to reducing government employment levels, Wolman suggests that layoffs will be minimized and cuts will likely be in [wage or hiring freezes](#).

The public administration literature suggests that LGOs have an additional set of political incentives when their cities are in fiscal distress: the incentive to appear to promote economic development through targeted development incentives<sup>1</sup>. Several studies document the link between local fiscal distress and increased use of economic development incentives (see Feiock et al. 2003, Feiock 1991, Rubin & Rubin 1987, Betz et al. 2012, Fleischmann et al. 1992, Kirby 1985, Wolman & Spitzley 1996). Feiock (2003) surveyed more than 2,000 local governments in 1984 and 1989 on their use of economic development policies. His regression analysis found that the use of financial incentives for development is [positively](#) linked to declining population and economic base. Rubin & Rubin (1987), based on regression analysis of a survey of 178 cities in Illinois with populations above 5,000, found that cities with low median incomes, high poverty rates, high unemployment rates, and high property tax rates used a greater number of economic development incentives than did other cities. Further, in a survey of 1,756 county governments, Betz et al. (2012) found that cities experiencing declines in population, low income, and high unemployment used a larger number of economic development incentives than economically healthier cities. In a survey of 1,126 cities with populations between 10,000 and 250,000, Fleischman et al. (1992) found similarly that central cities with higher poverty rates were more likely to use a larger number of development incentives than cities with lower poverty rates. The public policy literature consensus [is](#) that fiscally distressed cities are more likely to use economic development incentives than their fiscally healthy counterparts. This result [implies](#) LGOs in cities with deteriorating

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<sup>1</sup> Development incentives here are defined as tax abatements, cash compensation, tax deferrals, guaranteed loans, and tax-increment financing for specific businesses.

economic bases will more aggressively promote policies that at least look like they will boost their city's economic and employment base.

The use of development incentives by fiscally distressed cities would not be concerning except for the general consensus that they generally do not add much to a city's economic base (Kwon et al. 2009, Rubin & Rubin 1987, Kirby 1985, Feiock 1991)<sup>2</sup>. Feiock (1991) cites empirical evidence that local government economic development policy has far less influence on business location and investment [decisions](#) than economic variables such as available markets [for](#) distribution, labor force characteristics, and costs of production. He used a disequilibrium adjustment model to estimate the effects of local economic development policy and manufacturing firm's location decisions. He [found](#) that while economic development policy can influence capital investment in manufacturing in a given area, local economic development policy had virtually no effect on local employment. In line with this finding, Kirby (1985) [pointeds](#) out the lack of evidence that cities can ensure that firms receiving aid from development policy hire local workers, or maintain promised levels of investment in the area. He [cites-cited](#) statistics from the 1980 U.S. census that indicate that 25% of all workers work in a city other than where they reside.

This political incentive to use development incentives comes in part from the LGOs in distressed cities need to appear as if they are doing something to create jobs and a business-friendly environment in their city. Development incentives are thus useful because they provide highly visible credit-claiming opportunities for LGOs (i.e. ribbon-cutting ceremonies for development projects)(see Feiock et al. 2003, Rubin & Rubin 1987,

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<sup>2</sup> See also Moriarty 1980, Keischnick 1981, Wheat 1986, Wollman 1988, Mandelker 1980, and Stermnes 1984.

Kwon et al. 2009, Kirby 1985, Rubin 1988, Wolman 1988). Betz et al. found an inverse relationship between single party dominance and use of development incentives. Reese's analysis further supports this as he finds that a mayor's margin of victory is inversely related to the total number of tax abatements offered by a city (Reese 1991). This evidence suggests that economic development incentives are used by LGOs as a tool to gain political capital in order to gain votes, and thus re-election.

## Analysis

Here, I develop a model of political utility (vote maximization) driven decision making for an LGO when faced with fiscal distress. The following model will assume the following attributes of LGOs in fiscally distressed cities:

1. The primary goal of LGOs is to gain reelection (gain over 50% of votes).
2. In order to maximize votes, LGOs will implement policies that satisfy the short-run demands of the most influential constituencies.<sup>3</sup>
3. The long-run fiscal impact of policy is highly discounted by LGOs in the political utility model compared to short-run reelection incentives.
4. The fiscally distressed cities that these LGOs are governing have underlying economic deficiencies that are contributing to fiscal stress, including at least one of the following:

- A relatively high rate of poverty
- A relatively high rate of unemployment.
- Population in decline.

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<sup>3</sup> For underlying theoretical basis, see Feiock 2006.

-A [deteriorating](#) tax base (low per-capita revenues)

This model does not apply to cities in fiscal distress due primarily to misuse of public funds, while having a relatively healthy underlying economy. Orange County, CA's bankruptcy would fit into the category of cities not included in this model, as the county's default was primarily due to investment in risky financial instruments (Halstead et al. 2004). In order to build a comprehensive model of LGO decision-making in times of fiscal distress, [my analysis will depend heavily](#) on Wolman's model, while adding additional layers of political responses to fiscal distress.

This model would [predict](#) the first response of LGOs to fiscal distress would be to buy time before cutting expenditures or raising taxes. This includes drawing down city surpluses, transfers of external funds to the general fund, and using short-term debt to transfer current year expenditures into the next fiscal year. This will be the first predicted course of action, rather than keeping surpluses and cutting spending or raising taxes, because it keeps politically useful programs funded in the near-term without raising voters' tax burdens. While this does put the city in a more vulnerable position if there is a fiscal or economic crisis, Wolman's model predicts that satisfying constituents will be the primary goal of LGOs in this position, and the conditions set forth in this model assume the same.

After exhausting fund surpluses, we expect LGOs to seek intergovernmental assistance to cover budget shortfalls. Again, this will be preferred to cutting services and raising taxes, because there is no explicit political disutility derived from intergovernmental assistance. As long as city services remain the same, along with voter tax burdens, the popularity of LGOs should not suffer. However, these revenues

do not serve as a particularly stable method of maintaining city services, as they are prone to cuts during economic downturns or the presence of a new state or federal administrations. Considering broader economic downturns can contribute significantly to fiscal stress, municipalities cannot wholly depend on intergovernmental aid as a means of coping with fiscal distress.

An example of the instability of these revenues can be seen in the case of the now bankrupt city of Detroit and its intergovernmental assistance from the state of Michigan. Between 1998 and 2012 the state of Michigan reduced Detroit's shared revenue by 48%, cutting assistance to the city by approximately \$172 million.<sup>4</sup> This served to strain an already tenuous fiscal situation in Detroit.

Once LGOs have exhausted surpluses and government assistance, following Wolman's model we predict that LGOs will now have to make decisions about cutting city services and/or raising taxes. Given that either option will be politically unpopular, we expect LGOs to cut services up to the level they *perceive* the median voter as willing to accept. Similarly, we expect taxes to be increased to the level that the median voter will accept. Whether LGOs choose to cut services or raise taxes will depend on legal requirements for raising taxes. Specifically, whether or not the city is required to hold a public referendum on whether or not to raise taxes. In absence of a public referendum requirement, it seems that LGOs are more likely to raise taxes (Wolman and Peterson 1980). On the other hand, limits on tax and revenue increases, such as those set out in Proposition 13 in California, can effectively force LGOs to cut services when facing fiscal

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<sup>4</sup> Borney, Nathan, and John Gallagher. "How Detroit Went Broke: The Answers May Surprise You - and Don't Blame Coleman Young." *Detroit Free Press*. Detroit Free Press, n.d. Web. 09 Mar. 2014.



distress. In cutting services, we expect LGOs to minimize layoffs of municipal employees in order to avoid disrupting the government's internal constituency, public employees. Further we expect cost cutting through wage and hiring freezes, rather than layoffs (Wolman 1983). Given the expectation of LGOs to cater to their internal constituency (gov't workers), we should not be surprised to see increases in public-employee pensions and other retirement benefits even during times of fiscal distress. This provides an alternative method of compensation in order to satisfy the demands of public-employee unions. Since the costs of pensions will be accrued in future fiscal years, and will thus not have any significant effect on the current budget, we expect to see LGOs use such action. That said we would expect some concern by LGOs over the effect of increased pension obligations on the city's credit rating, which would have an immediate effect on the cost of borrowing, and thus spending, for the city. This happened in the case of Stockton, CA, where in 1996 the city offered free health care to firefighters in lieu of wage increases. The free health care was later extended to all Stockton full-time employees in the 2000s. However, despite the large increase in retirement-related obligations during the 2000s, the city's credit rating was not downgraded until 2010. This allowed LGOs in Stockton to continue to borrow to finance an underfunded pension fund.<sup>5</sup> Detroit had similarly favorable policies with respect to pensions even during periods of budget tightening; sending so-called "thirteenth checks" to public employees whenever the pension fund drew a surplus.<sup>6</sup> One of

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<sup>5</sup> Reuters. "Stockton Bankruptcy The Result Of 15-Year Spending Binge." *The Huffington Post*. TheHuffingtonPost.com, 04 July 2012. Web. 09 Mar. 2014.

<sup>6</sup> Surpluses in the fund indicate any amount above the city's yearly funding obligation. Surpluses could have been due to higher than anticipated market returns or lower than

Detroit's two pension funds doled out \$951 million in excess earnings between 1985 and 2008. By one estimate, the present value of those surpluses would have totaled \$1.9 billion if they had been kept in the fund.<sup>7</sup>

If LGOs in fiscal distress decide to either pursue large-scale layoffs of public employees, we would expect voters in the public employee union and their supporters to vote for the challenger to the LGO in the next election cycle instead of the incumbent. We would expect the same outcome if LGOs decide institute wage or hiring freezes without any bump in deferred compensation for public employees. The extent to which LGOs will cater to public employee union interests is of course dependent on the size and electoral power of the local public employee union, and whether or not that LGO is dependent on union support for reelection.

Wolman's model suggests that once cities see declining revenues, LGOs will either maintain or lower current spending levels across all departments, however, there is evidence that suggests that cities in fiscal distress will not necessarily decrease spending proportionally, but will increase spending on economic development tax incentives at the expense of spending on redistributive programs. Specifically, cities with lower revenue spend more on tax abatements and tax increment financing than cities with higher revenue. One explanation for the use of generally ineffective economic development practices by low-revenue cities is that LGOs feel pressure to "do

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expected expenditures from the fund. Instead of reinvesting the surpluses into the fund, the city chose to use the surpluses to provide bonuses to city employees as a form of additional compensation.

<sup>7</sup> Borney, Nathan, and John Gallagher. "How Detroit Went Broke: The Answers May Surprise You - and Don't Blame Coleman Young." Web.

something” to promote jobs or economic growth, even if that something has little likelihood of generating sustainable economic growth (Betz et al. 2012). Tax abatements and tax-increment financing thus provide visible short-term benefits (i.e. bringing a well-known business into the city) that will benefit LGOs in the next election cycle. The lack of sustained economic benefits of these development incentives will only be seen many years in the future, which is of little concern to LGOs in this situation (Betz et al. 2012). Further, the future economic and jobs growth, or lack thereof, will not be as visible to the public as a new local corporate office or factory.

If LGOs in this situation decide to not pursue highly visible economic development incentives, we would expect a decrease in the share of votes they receive from pro-business constituents. Further, this also may limit campaign contributions from developers and business interests, which could have a significant effect on the share of the vote the incumbent LGO receives. This policy may also serve to lower the vote share from all constituencies for the incumbent if voters perceive that the LGO is responsible for the economic decline of the city, or is at least not doing his or her part to mitigate the decline. However, if the LGO pursues funding redistributive programs instead of funding business tax incentives, we may see the lower-income community increase its voting in support of the incumbent LGO. This may be problematic, however, given that low-income citizens tend to vote less frequently than higher-income citizens.<sup>8</sup> Further, increased funding for redistribution instead of business would further decrease the

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<sup>8</sup> "United States." *OECD Better Life Index*. OECD, n.d. Web. 07 Mar. 2014.

incumbents vote share from the high-income community, which derives little benefit from redistributive programs.

Examples of this type of behavior can be seen in the formerly distressed, but now bankrupt city of Detroit, MI. Facing 13% unemployment in 1981<sup>9</sup>, the city claimed eminent domain and razed a neighborhood where 3438 individuals, 144 businesses, multiple schools, a hospital, and 16 churches resided to allow the construction of a new Cadillac plant in the city (Kirby 1985). During the most recent recession, in 2009, Detroit granted General Motors Corporation a total of \$1.2 billion in tax credits and rebates.<sup>10</sup> These efforts to grow and maintain GM's presence in Detroit provided the easily observed political benefits of keeping the company in the city, but at least for the Cadillac plant, failed to provide the number of jobs promised by the company (Kirby 1985).

This increased spending on economic development by distressed cities seems to come at the expense of redistributive programs. Hajnal and Trounstein (2010) measure redistributive spending as comprising social welfare spending, public health programs, public education, and housing and community development funding. They find that cities in the 95<sup>th</sup> percentile of revenue per capita spend 89% more on redistributive programs than cities in the 5<sup>th</sup> percentile of per capita revenue. Even though cities with lower revenues will likely have higher needs for redistributive

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<sup>9</sup> UPI. "7 Michigan Cities Are in Top 10 For Worst Unemployment Rates." *The New York Times*. The New York Times, 19 Jan. 1981. Web. 09 Mar. 2014.

<sup>10</sup> "Michigan Summary | Good Jobs First." *Michigan Summary | Good Jobs First*. N.p., n.d. Web. 09 Mar. 2014.

spending, it seems that these services are luxury goods to LGOs and can only be afforded when revenues are sufficiently high.

### Conclusion/Policy Suggestions

Before I begin to suggest any conclusions based on this model, I would like to highlight that this model should only be viewed as modeling specific incentive structures facing LGOs, and should not be viewed as a precise prediction of how all LGOs in fiscally distressed cities will behave. Specifically, this model should be useful in that it highlights *potential* areas where LGOs may not make optimal fiscal decisions when faced with fiscal distress.

Fiscal distress presents a significant set of problems for LGOs. They must balance the constant needs of voters, public employee unions, and private business with declining levels of resources. Private businesses, at least those large enough to attract significant interest from LGOs, seem to benefit from municipal fiscal distress. The economies of fiscally distressed cities have increased needs for private investment, and LGOs representing these cities have increased needs to show voters that they are 'doing something' to try to bolster their city's economic base. This seems to allow private businesses to attract higher rents from distressed localities, in the form of tax cuts and rebates, in exchange for the 'service' of moving to, or simply staying in, the city. Businesses seem to extract the bulk of the benefits generated, however, as the literature suggests that these tax incentives fail to generate any significant local job or economic growth. Residents of distressed cities, particularly those more highly dependent on city services, seem to lose out when it comes to LGO responses to fiscal distress. Those

dependent on redistributive spending, including public education, will see spending on these programs significantly declining in value under fiscal distress. Ineffective corporate subsidies come at the expense of redistributive spending, leaving the most vulnerable portion of the urban population the worst off.

Based on this model, LGO responses to fiscal stress seem less than ideal. Ideally, local governments should have been more proactive in cutting spending or raising taxes when faced with fiscal distress, so there is some sort of safety net left if local economic conditions do not improve in the short-term. Currently there does not seem to be much incentive for LGOs to make spending cuts or tax increases preemptively, to safeguard against economic shocks. Since most local governments do not project revenues or expenditures very far into the future, the incentive to maintain spending and service levels as long as possible can leave local governments vulnerable to revenue shocks, such as what happened during the Great Recession in 2007. This has undoubtedly contributed to the increased cases of local fiscal stress and bankruptcy in the last 6 years.

One way to counteract the potential externalities created by sluggish local responses to fiscal stress is to increase funding requirements for so-called 'rainy day funds'. If states set minimum requirements for 'rainy day' fund levels, local governments would face lower risks of insolvency when faced with periods of substantially declining revenues. Even better would be to have states match local governments contributions to these funds, so in the case of a substantial economic downturn, states will have less need to bail out struggling local governments when state revenues are likewise strained. While this would put a slight strain on municipal

budgets in the short term, in the long-run it would serve to mitigate the negative effects more extreme cuts in services or tax increases in the event of a future economic downturn.

When it comes to seemingly wasteful development incentive expenditures, voters would benefit from increased information on both the costs of these subsidies, and their potential economic impact. If the public is more aware of the costs and benefits of these short-term development interests, LGOs may find themselves more incentivized to take on more sustainable and longer-term forms of economic development. Cities would do better to increase education and worker training resources to make themselves more desirable locations for businesses. Efforts to decrease crime could also be indirect ways to counter fiscal distress if the distress is primarily due to population decline. Cullen and Levitt (1999) demonstrate a strong link between population decline and exogenous increases in crime. Increasing expenditures on community and redistributive programs may benefit distressed cities in the long run, if they serve to keep potential criminals off the streets, and enhance amenities in the city.

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