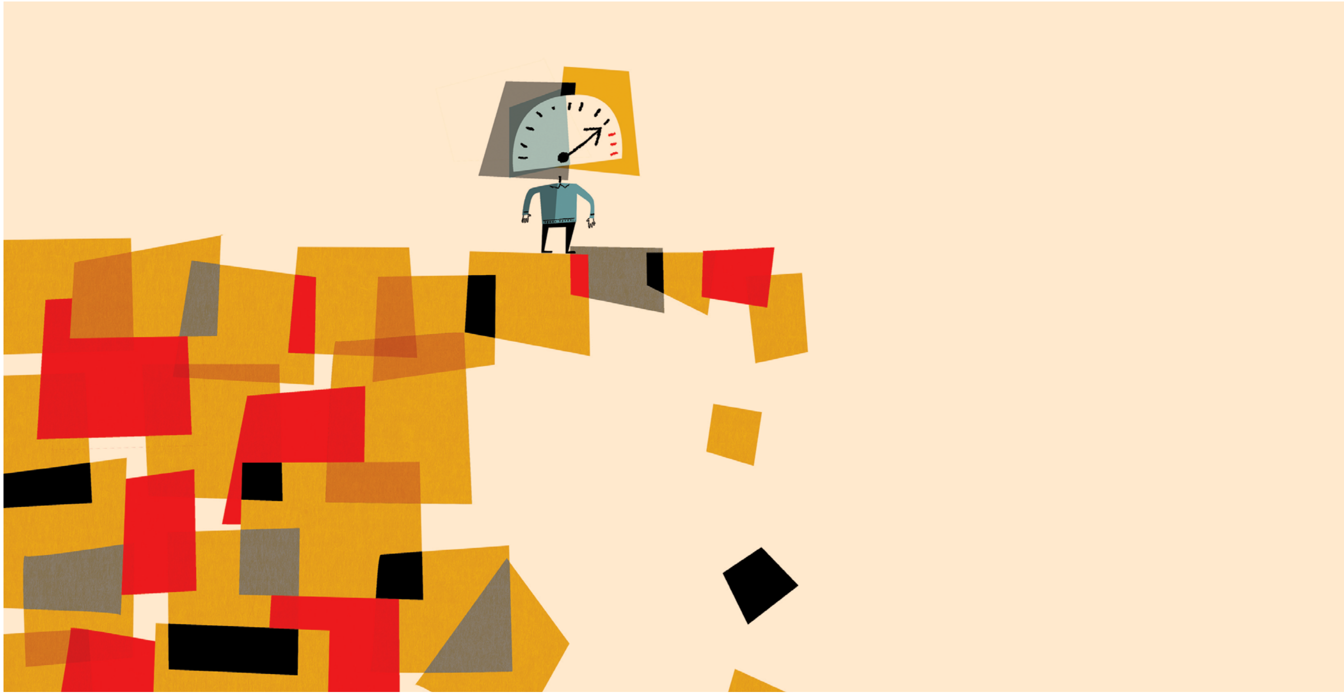

PERSPECTIVE

The Fiscal Cliff

BY KATHERINE BARRETT AND RICHARD GREENE

Over the summer of 2023, the fiscal status of local governments and states appeared to be in reasonably good condition. Property values—especially for homes—were strong, so property taxes were holding up well, according to Farhad Omeyr, program director of research and data for the National League of Cities. And "to my surprise," he said, "we weren't seeing a plateauing of sales taxes." Meanwhile, local governments were accumulating money in their rainy-day funds, at the same time, as inflation appeared to be slowing. There was growing hope that the economy, as a whole, might be heading for that much-hoped-for "soft landing."

That's the good news. But don't count on it lasting forever. A series of stresses and strains on towns, cities, and counties are unquestionably heading our way. Some of the biggest challenges will be felt when the huge sums of money that have been buttressing public-sector balance sheets begin to fall away. The American Rescue Plan Act (ARPA), including the State and Local Fiscal Recovery Fund, for example, contributed $350 billion to states, cities, counties, territories, and tribal governments. But that money needs to be obligated by the end of 2024 and spent by December 31, 2026.

At that point, it won't be so much a question of if but when many places will be confronting a darker fiscal world, which William Glasgall, senior director of public finance at the Volcker Alliance and fellow at the Penn Institute for Urban Research, has described as a fiscal cliff.

This cliff represents a combination of slowing revenues and cascading expenditures. Beverly Bunch, professor at the school of public management and policy at the University of Illinois and author of an upcoming report about the topic, predicts the advent of major spending issues "related to health access and affordability, including mental health and substance abuse; others associated with the aging of our population, including pensions; adaptation to change (like remote work); and continued economic development needs."

One of the biggest challenges faced on the expenditure side of the ledger is the specter of emergencies. While the pandemic may have been an unprecedented catastrophe, climate change appears to ensure that unpredictable expenses will continue to hit. Consider this summer's national heat wave. Based on a study of the Commonwealth of Virginia, the Center for American Progress extrapolated those costs attributed to extreme heat, including emergency room visits and hospital admissions, and found that they will likely add about $1 billion to healthcare costs, many of which are born by governments.

The Town of Bluffton, South Carolina, which has a population of 27,000 and is located in the low country of the state, is carefully preparing for the inevitable ill effects of climate change. "The rising sea levels mean we have very high tides around us," Chris Forster, Bluffton assistant town manager, said. "As the water levels rise, they hit the septic tanks, and when the tide goes back out, it affects the quality of the water." The community used a study by the University of Florida to determine the costs of recovering from the damage to infrastructure when climate change-related events hit and has ensured that sufficient funds are available in the community's rainy-day fund. This preparation for an uncertain future contributed to the town's recent bond rating increase to AAA by Moody's, Forster said.

But many communities aren't following Bluffton's lead and will find themselves hard pressed to pay the bills when the next natural disaster hits. "We have to be prepared for these things," Bunch said. "The question is only when and what magnitude."

Even absent infrastructure-destroying hurricanes, wildfires, tornadoes, and so on, another element pushing localities toward a fiscal cliff is the need for huge sums of money for roads, water, and buildings, beyond what is being supplied by the federal government through sources like the Infrastructure Act.

Glasgall said: "The good news is that there is a lot of money in the infrastructure bill and the Inflation Reduction Act. But there's still a big shortfall in necessary infrastructure maintenance dollars. State and local governments provide 80 percent of the funding for public infrastructure in the United States, and that's out of their own taxes, fees, gasoline taxes, tolls, water charges, sewer charges, and so on. And more money is going to be necessary if we're going to have a 21st century infrastructure. We need to be able to handle electric cars and trucks. And we have a lot of bridges and water plants out there that are at the end of their useful life."

Also, with a workforce shortage that's ravaging the capacity of localities to deliver the services they've promised, it seems

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nearly inevitable that the cost of labor is going to rise. "The labor market is just so hot that wages are going up," Emily Mandel, senior economist of Moody's Analytics, said. "They're already rising now, and given the private sector's pace, there is going to continue to be a lot of competition for those workers."

As for the revenue side of the equation, growing pressures are also imminent. "The pace at which revenues have been going up is going to taper," Mandel said. "It's not sustainable. The economy is slowing from where it is today, based on interest rates being higher and the Federal Reserve doing all it can to slow down the economy."

And although the price of housing has been a robust driver of higher property taxes, "we're already beginning to see some reductions in home values," Mandel said. Of course, there will be a delay between softening prices and the actual reduction in property taxes because it's not until homes are reevaluated that this impact will be seen. Mandel makes it clear that she's not anticipating any kind of housing bust as we've seen in years past, "but we're expecting a decline nonetheless."

What's more, there's a great deal of uncertainty about property taxes emanating from commercial real estate as downtowns suffer from the

Above, downtown Montpelier, Vermont, is nearly submerged in floodwaters from the overflowing Winooski River after record rains fell on the northeastern region in July of this year, resulting in hundreds of rescues and forcing evacuation of thousands of people.

introduction of remote work. "It's going to be an adjustment process," Mandel said, "and cities are going to have to rethink what to do when many of their office buildings aren't so full."

Finally, though the states have been preparing themselves carefully by avoiding using federal one-time money on long-term expenditures, a number have made significant tax cuts. "So, they'll be bringing in less money, particularly on the personal income side," says Mandel. "No one is going to say we're going to cut taxes and give less money to our localities, but that could be an impact of those cuts. Revenue growth has been so strong in recent years, and these tax cuts are so new that we haven't even begun to see what's going to turn out."

Katherine Barrett *and* ***Richard Greene*** *are principals of Barrett and Greene, Inc., at greenebarrett.com. They are advisors to GFOA, senior advisors and columnists for Route Fifty, NAPA Fellows, senior advisors to the Government Finance Research Center at the University of Illinois, and senior advisors to the American Society for Public Administration.*