



Factors Shaping Local Government Financial Decisions

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Local government finance is complex, with finance directors and other public administrators needing to understand various factors influencing budgetary decisions. This guide explores five key elements shaping local government financial decisions: political involvement, economic influences, social and demographic changes, legal and intergovernmental matters, and unfunded mandates.



Public Involvement

Local governments increasingly use budgets to understand citizens' perspectives on government services. However, the impact on budget allocations and the size of city and county agencies is not uniformly established across all local governments.

While citizen input is sought more frequently, its direct influence on decision-making varies. Some studies suggest that resource-allocation decisions are seldom modified as a direct result of input, but rather, citizen preferences are considered alongside other factors.



Economic Influences

Economic cycles

S&P Global Ratings Economics forecasts a downshift in U.S. GDP growth to 2% in 2025, compared to the three-year average of 2.7% that has supported local governments. This slower growth is expected to create additional strains on local governments.

Inflation

The ongoing effects of inflation remain strong as local governments grapple with higher costs following several years of high inflation.

Interest Rates

The Federal Reserve has signaled fewer rate cuts in 2025. Higher rates strain local governments as they continue accommodating rising operating costs from inflation and wage and salary growth

Competition Among Local Governments Factors Driving Local Competition

Economic Development

Business attraction :Local governments compete to attract businesses through favorable tax environments.

Job Creation

Tax policies are often designed to stimulate local employment opportunities.

Population Growth

Areas aim to attract new residents, balancing development needs with tax burdens.

Revenue Generation

Property tax considerations: Local governments rely heavily on property taxes for essential operations like police, fire, and parks.

Diversification of revenue sources: Municipalities explore various funding options to reduce dependence on a single tax type.

Infrastructure and Services

Funding for public projects: Cities use various sources, including property taxes, Tax Increment Financing (TIF) funds, bonds, and grants, to fund infrastructure while minimizing tax impacts.

Quality of Life

Competitive tax rates must balance maintaining high-quality public services to attract and retain residents and businesses.

Social and Demographic Change

Three primary factors significantly impact local budgets:

Population Changes

Some regions experience population growth, leading to economies of scale, while others face declining populations and struggle to reduce spending proportionately.

Age Distribution

The aging population is reshaping spending priorities, particularly in public education, public safety, and recreational services.

Personal income

Changes in personal income continue to affect the size of local government budgets, with higher-income households often demanding more and better services.



Legal and Intergovernmental Matters

Legal and intergovernmental factors shape local budgets in several ways:

Budgetary Balance

Most local governments are legally required to pass balanced budgets, unlike the federal government⁷⁹. However, a statutorily balanced budget may not ensure long-term financial sustainability. A balanced budget, where recurring revenues equal recurring expenditures, is crucial for long-term fiscal health.

Mandates and Revenue Constraints

Federal and state governments impose mandates on local governments, often without full funding. Local governments face restrictions on revenue sources and tax increases, with state laws determining available revenue instruments and imposing tax and spending limits.

State Aid and Property Taxes

State Aid Outlook

For 2025, state budgets are expected to shrink substantially. Total general fund spending is projected to decline to \$1.22 trillion, a more than 6% drop from estimated levels in fiscal 2024. This reduction in state budgets is likely to result in decreased aid to localities.

Property Tax Outlook

Overall, while some states are implementing measures to provide property tax relief, others may face pressure to increase property taxes due to budget constraints and the need to fund local services. The long-term trend shows that property tax burdens have been growing faster than inflation and personal income in some areas. Which will continue to put pressure on homeowner finances.

Long-term Fiscal Sustainability

Identifying key components of structural balance:

- Recurring revenues should equal recurring expenditures
- Avoiding reliance on non-recurring resources for ongoing expenses
- Considering demographic changes and healthcare cost growth

Adopting rigorous policies for all operating funds:

- Implementing written investment policies
- Establishing rainy day reserves for unforeseen events
- Developing contingency spending plans⁶

Long-term Planning:

- Creating multi-year financial plans
- Assessing long-term liability obligations (debt, pension, OPEB)
- Forecasting revenues and expenditures considering economic trends

Regular Assessment

- Conducting long-term budget assessments to analyze ongoing fiscal sustainability
- Evaluating the impact of current decisions on future budgets
- Using tools like long-term budget assessments and stress tests to analyze ongoing fiscal sustainability. This involves projecting balance between revenue and spending
- Identifying potential future deficits and their causes

Strategic Use of Surpluses

Utilizing temporary surpluses wisely to improve long-term fiscal position, such as adding to endowments or trust funds that generate investment earnings

Addressing Long-Term Liabilities

Managing and funding long-term obligations, including:

- Pension liabilities
- Other Post-Employment Benefits (OPEB)
- Infrastructure maintenance and replacement

Diversification of Revenue Sources

Reducing dependence on volatile revenue streams and exploring new, stable sources of income.

Data Management

Utilizing data effectively to support long-term fiscal sustainability decisions and planning.

Regular Review and Adjustment

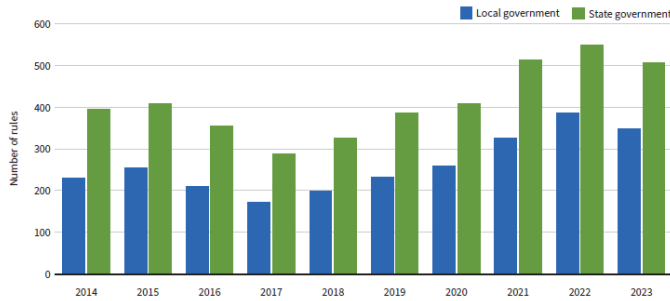
Continuously monitoring fiscal health and making necessary adjustments to maintain sustainability in the face of changing economic conditions.



Unfunded Mandates

Unfunded mandates have become a significant challenge for local governments in 2025. These are legislative or regulatory requirements imposed by federal or state governments that require implementation and compliance without providing adequate funding.

Federal Rules Affecting State and Local Governments



Source: Compiled by the author from "The Regulatory Plan and Unified Agenda of Federal Regulatory and Deregulatory Actions," *Federal Register*, various years' editions, and from online edition at <http://www.reginfo.gov>.

Source: Competitive Enterprise Institute

The impact of unfunded mandates on local budgets is substantial. Unfunded mandates are estimated to cost localities hundreds of billions of dollars annually.

In some cases, implementing and complying with mandates can consume as much as two-thirds of the annual budgets of local governments. Further, the aggregate cost of complying with unfunded mandates can be substantial and extends beyond direct financial costs.

Local governments are forced to divert resources from other essential services, potentially affecting public safety, infrastructure maintenance, and community programs.

Unfunded mandates can also impact economic growth. Research analyzing 518 OECD regions over the period 1997-2018 found a negative, statistically significant, and robust impact of unfunded mandates on economic growth. This effect was found to be stronger in more politically and fiscally decentralized regions.

The study revealed that the losses from unfunded mandates may exceed any benefits gained from devolving powers to lower tiers of government. This results suggest that the financial strain imposed by unfunded mandates can indeed hinder overall eco-

What Local Governments Can Do About Unfunded Mandates

Advocating for legislative reforms

Many states have adopted statutory or constitutional restrictions to limit their legislatures' ability to impose unfunded mandates on local governments.

Implementing reporting requirements:

Most states require cost estimates to be reported to the legislature during debates on potential mandates. This increased transparency aims to make the financial impact of unfunded mandates more visible.

Seeking reimbursement

Some states have mandated that state governments reimburse local jurisdictions for costs associated with state mandates. However, legislatures often continue to pass unfunded mandates when they deem the interests compelling.

Pursuing legal action

Some local governments are suing the federal government, citing the Tenth Amendment, to challenge unfunded mandates.

Supporting new legislation

Local government organizations are backing bills like the Unfunded Mandates Accountability and Transparency Act (UMATA), which aims to reduce excessive unfunded government mandates and encourage job creation.

Testifying before Congress

Representatives from local government organizations, such as the National Association of Counties (NACo), have testified before congressional committees to advocate for improving the federal government's process for evaluating and reducing the harmful effects of federal mandates on counties.

