Rethinking Fiscal Policy for Inclusive Rural Development

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Introduction

The role of state and local government fiscal policy in driving geographic inequality is underappreciated in academic and policy discussions. Our work with rural communities experiencing economic restructuring suggests that fiscal policy—specifically the failure to capture and retain public revenue from resource extraction and the decoupling of public revenue from the underlying economy—remains a substantial barrier to rural prosperity in America. With this chapter's focus on fiscal policy failures and possible reforms, we engage in a growing dialogue about fiscal drivers of regional inequality.[1]

Fiscal policy is the primary pathway linking today's economic activity to the cultivation and maintenance of place-based assets, including good schools, access to health care, parks and libraries—and functioning infrastructure—essential to resilient economic futures.[2] Public revenue management is especially critical in peripheral rural economies with little influence on the commodity and recreation/amenity markets upon which they depend.[3] A survey of rural America, however, documents how current fiscal policy hinders the development and maintenance of place-based assets in some locations. After decades of generating wealth for national and regional economies in the form of low-cost commodities such as cattle, timber, coal and oil, small towns face recurring fiscal crises and the erosion of local institutions and infrastructure.[4] Similarly, an outdated tax structure and policies constraining local autonomy make it impossible to translate recreation- and amenity-based economic growth into resources for local public services.[5] Revenue structures are so limiting that in rural economies seemingly as different as coastal Oregon and central Wyoming, new jobs created outside natural resource sectors fail to generate revenue sufficient to maintain local budgets, causing otherwise beneficial economic diversification to actually deepen fiscal crises.[6]

The economic challenges facing rural areas cannot be solved without serious efforts to generate new conceptual and practical approaches to fiscal

policy.[7] In this chapter, we reprise the principles informing current fiscal policy and then use several examples to demonstrate how the resulting institutional forms fail rural communities. We finally highlight existing and proposed policy solutions to illustrate how updated principles, put into action, would better serve rural America.

Fiscal Policy

Fiscal policy comprises the ways that governments generate revenue from economic activity—from taxes, fees for services and royalties on resource extraction—and how governments use these revenues to pay for services such as roads, schools, police and hospitals. This chapter focuses on state and local government revenue, including the fiscal relationship between federal public lands and state and local government revenue.

The dominant theory shaping local government fiscal policy is the "Tiebout model" of public policy, which imposes market theory of competition on government taxation.[8] The Tiebout model assumes that consumers move freely from community to community to sort themselves based on desired tax rates and levels of services. According to this model, optimal tax policies are natural outcomes of market competition and the revealed preferences of consumers, in this case residents and businesses. Even as regional science has developed a more nuanced understanding of drivers of growth, the Tiebout model remains a powerful driver of local government policy and action.[9]

As evidence of the dominant logic about the role of public revenue in the economy, consider New Mexico's 2003 tax cuts that reduced top income tax rates and cut the capital gains tax in half. In adopting the cuts, the governor declared New Mexico "open for business."[10] The tax cuts were largely financed by spending oil and gas revenue—including federal royalties returned to the state—to fund the state's annual operations, substituting one-time taxes on the depletion of public resources for other less popular, but recurring, taxes. New Mexico's income and capital gains tax cuts resulted in revenue dependence on fossil fuels, dependence that increases revenue volatility and risk of revenue loss if markets or policy reduces oil production or prices in the future.[11]

Ample research now undermines such comparative-advantage approaches to local fiscal policy, not only by complicating ideas about

drivers of growth, but by demonstrating connections between tax structures and the growing wealth disparities of the contemporary U.S. economy.[12] In addition, scholars have reintroduced a theory of the state that positions government as a market-forming and value-creating institution, whereby government investments are central to an equitable and productive economy (e.g., early childhood education, gray and green infrastructure, and planning and economic development).[13]

Rural communities across the U.S. that have lost population since the global financial crisis and are now acutely affected by the global COVID-19 pandemic need a new model for public revenue and investment. The idea that competition results in efficient provision of public goods without political or policy direction does not serve these places. In the following sections, we demonstrate two categories of state and local fiscal policy failures in rural economies: first, the failure to collect and manage natural resource revenue effectively; and second, the barriers to generating public revenue from emerging economic sectors embedded in tax and expenditure limits.

Failure of Natural Resource Revenue

The difficulties of capturing and effectively managing a potential windfall from natural resource taxes are a familiar motif in the literature on the resource curse, and one that is well-represented in the United States.[14] While many natural resources are often owned by the American public, their extraction is left to private markets.[15] Because natural resource fiscal policy is informed by market theories about comparative advantage, states vie for the attention of resource developers by lowering tax rates and offering tax incentives. Elected officials, incentivized by a politics of austerity, frequently engage in tax shifting. Officials use natural resource revenues to fund annual budgets and to cut other less-popular sources of revenue, including income and property taxes. The result is the liquidation of public wealth and the erosion of institutional capacity during successive periods of boom and bust. Consider the following two examples.

For the last several decades, Big Horn County, Montana, home to the Crow Reservation, has depended on royalties and taxes from its four coal mines to fund local government. As U.S. coal-fired power plants have closed in recent years, demand for Big Horn County's coal has declined.

The county's mines helped fuel regional and national growth and a state permanent fund worth $1 billion. However, the local government has little to show for the massive wealth extracted and exported. As mines announce cutbacks and closures, Big Horn County's commissioners have been forced to cut services and staff. With one out of three local jobs in the public sector, cutting government jobs and services has profound effects. Moreover, without a healthy public sector and functioning public infrastructure, the county struggles to respond to the COVID-19 pandemic and to transition to a recreation-based economy.

Josephine County, Oregon, used windfall revenue from timber harvests on federal public lands to fund government services and avoid local property taxation throughout the 1960s, '70s and '80s. Across rural Oregon, county governments that received the highest federal timber payments maintained the lowest property tax rates.[16] Federal timber sales were so lucrative to Josephine County and its peers that other forms of economic development were not pursued, creating a specialized revenue system dependent on federal timber receipts. Dependence on timber revenue exposed local government budgets to fiscal crisis when timber harvests declined due to changes in federal land management.[17] Structural changes in the timber industry and incentives offered to the industry that affected state timber severance taxes also had substantial fiscal and employment impacts in rural Oregon.[18] In socioeconomic monitoring of the effects of the Northwest Forest Plan, U.S. Forest Service economists and social scientists came to the surprising conclusion that a county's dependence on timber played virtually no role in its economic trajectory after the 1990s.[19] Counties already diversifying continued to do so despite the loss of a major employer (these counties tended to be connected to major urban markets). Peripheral counties lacking access to cities struggled when timber declined, and many have failed to recover from the loss of a mill or timber harvest jobs. In other words, natural resource development (timber extraction) generally failed to provide durable and lasting prosperity for rural counties remote from cities.

In rural America, there are additional, compounding fiscal policy failures that sit outside of conventional resource curse framings—including the failure of policy to adapt to economic restructuring and the legacy of the nation's 1990s-era "tax revolt."[20] We turn to these policies next.

Failures and Obstacles in Modernizing Fiscal Policy

In most rural areas, the key sources of public revenue include property and sales taxes, revenue from resource extraction, and charges and fees on services. However, the value and composition of these revenue sources have changed as the economy has restructured. Several issues demonstrate how fiscal policy needs to adapt to the changing economy. Sales tax policies tend to exclude many services. Structural shifts in the economy from goods to services result in sales taxes' covering a declining share of total economic activity. Property tax regimes designed to protect farming/agricultural land use forgo potential revenue from rising land values driven by recreation and amenity migration in rural communities.[21] Finally, an overreliance on tax incentives and deductions to achieve economic and policy goals can undermine the revenue benefits of growth, including from the development of renewable energy generation and transmission infrastructure.[22]

The inability to pursue tax reform is often attributed to a lack of political will. In rural America, tax reform is blocked by a number of legal and structural barriers imposed at the state level that actively prevent the realignment of local taxation even where the political will exists to raise taxes. Policy deterrents include caps on property tax rates, property assessments or total revenue collected by local governments. While the histories of taxation and expenditure limits vary state to state, these limits often connect to the national property tax revolt that followed the success of Proposition 13 in California in 1978.[23] For example, in the 1990s, Oregon voters passed Measures 5 and 50, which froze property tax rates and property assessments. These constitutional measures limit the property tax revenue benefits that local governments can derive from new development. Studying a new industrial manufacturing project in one rural Oregon county, economists concluded it would generate property tax revenue amounting to just 3% of the public revenue that a medium-sized sawmill sourcing 60 million board feet of federal timber per year could. Oregon's tax revolt made it virtually impossible for counties that had relied on timber revenue for decades to "grow themselves into solvency."[24]

In Colorado, two statutes impede coal-dependent communities' ability to replace lost resource revenue. The Gallagher Amendment (1982) imposes a statewide limit on residential property tax levies, and the Taxpayer Bill of

Rights (1992) places constraints on revenue growth. Communities facing economic decline are forced to lower property tax rates and often cannot retain revenue from new economic development. These barriers together hampered the ability of some Western Slope communities to thrive during the natural gas shale boom between 2000 and 2008[25] and stand in the way of a socially just energy transition in others going forward.[26]

In another example, property tax revenue limits interact with renewable energy incentives to produce startling revenue outcomes. Our analysis showed how a renewable energy transmission project would generate windfall revenue for counties in some states and relatively little revenue for counties in other states. In Montana, renewable energy incentives mean counties would receive nine times less local revenue from a transmission line carrying wind and solar compared to an equivalent line carrying power from coal or natural gas. In Utah, property tax law *requires* local governments to use property tax revenue from renewable energy projects to lower tax levies for all taxpayers rather than capture and retain new revenue to fund schools, roads, libraries and other public services.[27]

The theory that government has no role or value in creating and shaping markets has allowed industry to impose limits on the state's capacity and the authority to tax economic activity. The outcome for rural communities is an inability to benefit from economic development, deeper dependence on declining resource sectors, and political opposition to policy objectives popular with urban votes, such as public lands conservation and the energy transition.

Tax policy can be remade to benefit rural America. Reforms should reflect the emergence of new conceptual frameworks about both natural resource revenue and the role of public investment.

Solutions

This section highlights ongoing efforts to put forth alternative policy frameworks to rework the fiscal relationship between federal and state governments and public lands, with examples from New Mexico and proposed federal policy.

The New Mexico State Land Office offers an alternative framework for managing oil and natural gas royalties. The State Land Office has a fiduciary

responsibility to manage state trust lands to benefit public institutions, such as public schools and state universities.[28] The State Land Office also has a unique mandate to permanently protect the value of the original endowment. All revenue from the depletion of a resource—through land sales or extraction of nonrenewable resources—is saved in the Land Grant Permanent Fund. By investing 100% of the royalties generated from oil extracted on trust lands in the Permian Basin, the State Land Office had built New Mexico's Land Grant Permanent Fund to nearly $20 billion by the end of 2020. The Permanent Fund is invested to continue to produce revenue for current and future beneficiaries, generating $785 million in fiscal year 2020.[29]

As of early 2021, the federal government compensates local governments for the nontaxable status of public lands through several payment programs. Historically, payments were tied to commodity production on public lands, whereby counties and schools received a share of commercial receipts. Annual revenue from natural resource extraction financed ongoing road and education expenses.[30] When public land policy and resource markets shifted, receipts available to share with communities declined. Congress has historically intervened to bail out county governments by passing appropriations that have also failed to provide certainty for rural communities.

The existing fiscal policy framework for counties with federal public lands—revenue sharing or discretionary appropriations—is failing to provide equitable and predictable compensation, to protect and invest public value from natural resources, and to link public value generated by conservation and recreation on public lands to local prosperity. Proposals modeled on the example of the state trust lands would create a federal endowment financed from activities on public lands to stabilize payments to counties, protect public value, and extend to communities the capacity to build local economies around multiple values of public lands freed from the need to maximize revenues on an annual basis.

Conclusion: Road Map to New Fiscal Principles for Rural America

This chapter establishes the importance of fiscal policy failures in understanding barriers facing economic development in rural America. Solutions

based in market theory—including tax competition, business relocation incentives and place-based initiatives focused on bringing urban capital to rural areas—have fallen short. Solutions that require massive and continued appropriations to solve rural problems are unsustainable and ultimately fail to address underlying structural dynamics.

We argue that what's needed, at least in part, is a new fiscal system built around principles of public value, reinvestment and local autonomy. Communities need tools to protect and reinvest resource wealth into permanent assets that will continue to generate wealth after the resource endowment is depleted. In addition, local governments must be agile and resilient to futures not yet imagined. Failed fiscal policies can be fixed. Doing so is a necessary condition to resolving today's concurrent crises of inequality, climate change, public health and growing political resentment.

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Endnotes

[1] See Gbohoui et al.

[2] See Flora et al.

[3] See Goetz et al.

[4] See Edelman.

[5] See Liechty.

[6] See Graham; and State of Oregon, 2009.

[7] See Mazzucato.

[8] See Oates.

[9] See Boadway and Tremblay.

[10] See Massey.

[11] See PFM Group Consulting, LLC.

[12] See Batchelder and Kamin, Mohr, and Zucman.

[13] See Boushey.

[14] See Humphreys et al.

[15] See Jacquet et al.

[16] See State of Oregon, 2016.

[17] See Thomas et al.

[18] See Schick et al.

[19] See Charnley.

[20] The property tax revolt was a political movement that imposed legal and constitutional limits on tax rates, property assessments and total revenue collections. Although the property tax revolt is often understood as an ideological movement intended to shrink the size of government by cutting off its ability to generate revenue, it is more aptly aligned with efforts to protect the wealth and privilege of homeowners against rising property values and assessments. (See Martin.)

[21] Preferential assessments for agricultural and rural land value these lands for property tax purposes based on their use-value—typically defined by agricultural receipts or the productive classification of agricultural lands—rather than on their market value in real estate markets. (See England.)

[22] See Haggerty and Haggerty.

[23] See Wen et al.

[24] See State of Oregon, 2009.

[25] See Headwaters Economics.

[26] See Eason.

[27] See Boyle.

[28] See Souder and Fairfax.

[29] See New Mexico State Investment Council.

[30] See Haggerty.