Fiscal Policy is Failing Rural America

Understanding barriers to economic development, conservation, and renewable energy

Introduction

Fiscal policies are a powerful tool for economic development. Unfortunately, fiscal policies have failed rural communities in two ways. First, they have created a dependence on a narrow set of industries, including fossil fuels. Second, fiscal policies have constrained the ability of local governments to grow and invest revenues in ways that lead to economic diversification.

By **fiscal policy**, we mean the ways that governments generate revenue from economic activity—from taxes, fees for services, and royalties on resource extraction, for example—and how government uses these revenues to pay for services such as roads, schools, police, and hospitals.

Limiting the abilities of local government to collect and spend revenue is not accidental. Fiscal policies across the United States are the result of intentional and organized efforts of politicians, industry, and advocates who understand the power of fiscal policy to shape the behavior of state and local governments.

In this essay we discuss the challenges facing rural America due to constraining fiscal policies, including two areas where rural communities should be able to benefit economically—conservation (such as protection designations on federal lands) and renewable energy.

Deliberate fiscal policies have created a dependence on a narrow set of industries that hurts local economies. For example, cash-starved local governments in Utah have every incentive to support fossil fuel development over renewable energy because of the state's tax policies. The Utah Legislature passed new property tax rules that don't allow local governments to retain revenue from new wind and solar projects. Oil wells, however, continue to directly benefit local government budgets through severance taxes, royalties, and property taxes not subject to the same limits imposed on renewable energy. Thus, it simply is not logical for local leaders—who must fund roads, schools, and hospitals—to reject fossil fuel extraction, embrace climate policy, or enact land protections that would limit future oil extraction. They cannot afford it.

Understanding fiscal policy is central to resolving economic challenges in rural areas and to stimulating action on public land protections or renewable energy. Utah's restriction on public revenue from renewable energy is just one example of fiscal policies that undermine rural economies. Other examples are found in nearly every U.S. state.

In this paper we explain how fiscal policy became a barrier to rural economic development, conservation, and renewable energy through the intentional efforts of industry and politicians who understand its power.

Fiscal Policy Has Promoted Dependence on Natural Resource Revenue

Shortsighted fiscal policies can deepen dependence on natural resource revenue. Dependence limits options to diversify regional economies—harming them in the long run—and discourages local and state leaders from embracing policies that may limit continued extraction. Examples can be found across the West, from oil and coal to timber and hardrock mining.

North Dakota exemplifies the fiscal challenges facing rural states and communities seemingly blessed with natural resource abundance. Despite good intentions and proactive efforts, the state and local governments have become dependent on oil revenue and experience fiscal stress when oil prices or production falls.

When North Dakota's oil boom was in full swing in 2012, state leaders sent a delegation to Norway to learn from that nation's successful management of oil revenue.[1] North Dakota had experienced an oil bust in the 1980s that had left many local governments nearly bankrupt.[2] Offered a second chance, the state's leaders wanted to use the current oil boom to create long-term wealth. They set up the North Dakota Legacy Fund, modeled on Norway's Sovereign Wealth Fund, and began investing 30% of annual oil revenue into permanent savings.[3]

But the state made a critical mistake. Norway set up its Fund to hedge against the paradox that oil wealth can slow economic growth by "crowding out"[i] other economic sectors and by growing dependence on volatile oil revenue. To avoid crowding out and dependence on oil revenue, Norway deposits nearly *all* oil revenue into the Fund and only spends a small, fixed percent of the wealth (currently 3%).[4]

By comparison, North Dakota saves only 30% of revenue and spends the rest annually to fund state and local budgets and to finance debt. When oil prices and revenue were high, the state cut its income tax—twice—exacerbating dependence on oil revenue by narrowing and specializing its tax base around oil. As a result, the state's oil and gas taxes currently comprise about a third of the state's operating budget.[5]

Local governments in North Dakota are even more acutely harmed by poor state fiscal policies. For instance, oil booms can more easily overwhelm a city or county economy than the entire state economy. Watford City is a good example. The city's population exploded from fewer than 1,500 people to upwards of 10,000 people between 2009 and 2018. Oil revenues had to be spent on new schools, roads, utilities, and city buildings to keep up with the influx of people. The city also backed loans and bonds with future sales tax and oil tax projections that rely on continued drilling and continued high prices.

These decisions were made in a fiscal policy landscape where the state delayed revenue collections, delivered larger proportions of revenue to the state as the boom accelerated, and prohibited local governments from saving revenue or budgeting over multiple years to anticipate and manage volatility.[6] Watford City and its peer local governments crafted a regional plan in 2014 focused on stabilizing revenue, mitigating impacts of rapid growth, and diversifying the regional economy to avoid "crowding out."[7] But without supportive state fiscal policies aligned with these goals, low oil prices in 2015 depleted the city's revenues.[8] Despite Watford City's best intentions to avoid dependence, it has become increasingly reliant on continued oil development to pay its bills. State fiscal policies made dependence almost inevitable and offer few tools to unwind dependence once established.

[i] "Crowding out" occurs when oil and gas activity puts upward pressure on wages, material costs, rents, and business services, making it difficult for other employers to hire or retain workers and establish new businesses. Economies can become specialized and more vulnerable to boom and bust dynamics associated with global oil prices.

North Dakota's experience demonstrates the risks of dependence, exacerbated by poor fiscal policy. And North Dakota is not unique.

Several fiscal dynamics shape revenue dependence and specialized tax structures in rural communities across the United States:

> First, windfall revenue from natural resources is often used to lower other taxes—a policy called "tax substitution"—creating a narrow tax structure that is overly focused on resource revenue. For example, when Alaska discovered oil in Prudhoe Bay in the 1970s, the state eliminated its income tax. Today, declining production from Alaska's oil fields combined with low prices have reduced oil revenue and left the state without other revenue to fill budget gaps. Alaska is facing a budget deficit of $1.3 billion for FY 2021 and will exhaust its rainy-day savings funds by the middle of that year.
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> Second, funding government with resource revenue is politically popular because resource taxes are not paid by a state or community's residents. In Wyoming, spending fossil fuel revenues to fund government means Wyoming's residents receive high-value services with low tax rates. A family in Wyoming that owns an average home (valued at $190,000) receives $30,000 worth of services from state and local governments but pays only $3,000 in taxes.[9] Wyoming's tax structure has become so specialized around fossil fuel revenue that any new jobs created in Wyoming outside the energy industry (jobs in recreation, technology, or health care, for example) fail to generate revenue sufficient to cover the costs of roads, public safety, or water infrastructure required by new growth. This means any new non-energy job is a net drain on government finances.[10] The tax structure in Wyoming has locked it into depending on fossil fuel revenues.
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> Finally, when states use resource extraction revenues to lower taxes, they become locked into further dependence on resource revenue, which results in dependence on a narrow economic strategy that depends on internationally set commodity prices. States are unable to make long-term choices for their own futures. Local and state governments in North Dakota, Wyoming, and Alaska, for example, will likely find it difficult to embrace national or state climate policy because of the fiscal stress these policies would inflict on their budgets. They are certainly not the only examples.

Fiscal Policy Has Inhibited Community Development

Government dependence on natural resource revenues by itself is problematic. But the risks of natural resource dependence are exacerbated when states restrict taxation, revenue generation, and spending authority, which entrenches dependence and undermines the fiscal benefits of economic growth and diversification. Limits on tax rates and tax revenue disproportionately harm rural areas with specialized economies and revenue structures. These actions are typically associated with the property tax revolt. The tax revolt began as a political movement to protect homeowners from rising property values and property taxes.[11] The anger against the property tax has been leveraged by anti-government activists to advocate for smaller government. While smaller government was not the goal of property owners, the tax revolt movement is now a powerful political force that limits the ability of governments to grow and diversify revenue.

For example, county governments throughout the Pacific Northwest financially benefitted from federal revenue-sharing payments during the post-World War II booms in timber harvests on federal lands. U.S. Forest Service and Bureau of Land Management "county payments" (revenue-sharing programs designed to compensate local governments for the tax-free status of federal lands) peaked at more than $1 billion in 1977 (in 2019 dollars).[12]

Oregon received about a third of these payments. For the next 40 years, timber revenue allowed Oregon's rural communities to enjoy high levels of government services (e.g., schools, roads, police, and fire protection) and low tax rates. The counties that received the highest timber payments often maintained the lowest local tax rates in the state.[13] Timber revenue, like fossil fuel revenue elsewhere, resulted in a narrow and specialized tax structure reliant on continued harvests on federal lands.

But the high timber payments tell only part of the story. Another layer of fiscal policies compounded natural resource dependence in Oregon. In the 1990s, Oregon voters passed Measures 5 and 50 which froze property tax rates and property assessments (the way property is valued for taxation). The new limits on local taxation and property valuation locked rural counties into dependence on timber revenue by blocking their ability to raise revenue from other economic sectors.

The limits are so severe that Jackson County, OR, Commissioner C.W. Smith, serving on a governor's task force focused on declining timber payments (revenue-sharing payments have fallen more than 90% from the peak), noted that "most of these [timber-dependent] counties can't build themselves or develop themselves into solvency. Every new resident is a negative on the budget."[14] Encouraging more and larger federal timber harvests or asking Congress to authorize appropriations every year are the only viable revenue solutions for some rural counties.

Fiscal policies at the local, state, and federal level have failed to translate timber wealth into long-term prosperity and now present substantial barriers to rural regions. Counties continue to push for policies that would increase commercial timber receipts on federal land—at the expense of alternative strategies that could help diversify and grow economies. For example, local leaders identified lost revenue from decreased logging as a primary reason for opposing an expansion of the Cascade-Siskiyou National Monument in Oregon, despite the monument's potential to diversify the economy and attract tourism dollars.[15]

The property tax revolt also exacerbates struggles for rural communities in other states including Colorado, Idaho, Louisiana, Massachusetts, Michigan, and Montana. In Colorado, the 1982 Gallagher Amendment limits residential property taxes to shield homeowners from rapidly rising home values on Colorado's Front Range. In 1992, the Taxpayer Bill of Rights (TABOR) limited the amount of revenue governments can raise and spend, forcing government to shrink relative to the size of the economy.

Together, Gallagher and TABOR have stripped local leaders of the autonomy they need to manage local budgets. State-imposed limits have divorced property tax revenue from their local economy. For instance, Colorado's coal-dependent communities are losing royalty, severance tax, and property taxes as coal mines and power plants retire. Lower residential property tax rates (required to stay within Gallagher's statewide limit) and TABOR's limits on revenue growth and savings mean communities are checked by state rules from replacing lost revenue and often will not benefit fiscally from new economic development.[16]

Most property tax and revenue limits can be overturned by voters. But doing so is difficult in rural communities already feeling left behind by rapid growth in cities and potentially facing an acute loss of revenue from markets and policies outside their control. Efforts to raise taxes in rural Oregon have failed repeatedly. Due to failures in fiscal policy, resource-dependent communities such as the timber towns in the Pacific Northwest have largely failed to grow and diversify their economies.

Rural leaders are not uninformed or ideological. Their actions are rational responses to incentives: local governments need revenue to provide services that citizens demand, and local leaders pursue strategies to meet their budget obligations. As long as policies impose barriers to economic diversification, rural communities will struggle to embrace conservation, climate policy, and renewable energy.

Fiscal Policy Has Resulted in Over-Reliance on Incentives

States have long offered property tax discounts as part of fiscal incentive packages to lure business to their regions. This fiscal policy can have unintended consequences at the local level by further limiting revenue benefits from growth and making dependence harder to overcome.

In 2007, Montana's Governor Brian Schweitzer signed a clean energy incentive bill that lowered property taxes for renewable energy transmission projects across the state. The governor claimed, "This [incentive] will spur economic growth all over Montana, create good-paying jobs, and help our nation reduce its dependence on foreign sources of energy."[17]

Ironically, the incentive may have contributed to the failure of a major transmission proposal that would have carried wind energy from Montana through Idaho and eventually to California. Already skeptical of the proposal, county governments and landowners were asked to accommodate the line's potential impacts to views, wildlife, agricultural operations, and property values. Headwaters Economics evaluated the likely property tax outcomes for counties along the route[18] (and for rural counties across the West with the greatest renewable energy potential[19]) to inform state and local officials of the outcomes of incentives and property tax limits.

Analysis revealed that current fiscal policies would result in some counties receiving relative windfalls while others (such as counties in Montana and Idaho along the proposed transmission line) would receive relatively little new revenue. Montana's renewable energy incentive would result in local governments receiving nine times less revenue from a transmission line carrying wind and solar compared to an equivalent line carrying power from coal or natural gas.

And in Idaho, state restrictions cap local government property tax revenue to the rate of inflation with some exemptions for new growth. However, industrial property—including transmission lines—are not exempt from the revenue cap. Therefore, a new transmission line would not result in new revenue, but instead would simply lower tax rates to remain within revenue limits, limiting local governments' ability to adapt to the changing economy.

With the perceived costs outweighing the benefits at the local level in the two states, the permitting process slowed. Ultimately energy markets and policy shifted in California and the proposal was withdrawn by the developer.

In another example of the unforeseen consequences of incentives, replacing a coal-fired power plant in Montrose County, Colorado, with a similar-sized solar project (100 MW each) would return only a third of the tax revenue to local government because the state lowers the taxable value of renewable energy projects as an incentive to developers.

Public revenue is arguably the largest benefit of renewable energy projects in rural areas. Wind farms, solar fields, and related transmission lines are effectively large construction projects with specialized, short-term jobs that do not create a large number of permanent jobs. Property tax limits and incentives can nearly eliminate these projects' public revenue benefits, meaning a pivot to renewable energy is often not a viable option for local governments from a fiscal perspective.

Fiscal Policy is a Political Tool

Resource-dependent communities are not blind to the dilemma of reliance on fossil fuel, timber, and mining revenue to pay the bills. But they remain trapped by it because of fiscal policy crafted at state and federal levels. It is easier for Wyoming community leaders to protect the fossil fuel industry from climate policy or public land protections (such as national monuments, for example) that may limit fossil fuel extraction than to ask their constituents to raise taxes on themselves—to much heftier levels than they are accustomed to paying—to replace fossil fuel revenue. In the town of Colstrip, Montana, property tax rates for residents and businesses would have to rise fourfold to replace industrial property taxes paid by the retiring coal-fired power plant.[20]

These dynamics are not lost on politicians seeking to remain in office, nor by lobbyists seeking to protect the fossil fuel industry and other natural resource sectors from conservation proposals or climate policies. Ronald Theisen, CEO of a mining company seeking to permit the Pebble Mine in Alaska, revealed that the company hid the true scale of the project hoping to get the mine permitted, then assuring investors: "Once you have something like this in production, why would you want to stop? It's $10,000 [in tax revenue] per man, woman, and child. They want that to go away? No."[21]

Revenue-sharing programs also can be used intentionally to create dependence on extractive industries. Conservationists scored a major win in 2020 by securing full and permanent funding for the Land and Water Conservation Fund (LWCF). LWCF can potentially receive $900 million of offshore oil and gas revenue to fund state and federal conservation and outdoor recreation projects. The idea behind LWCF is sound: oil and gas drilling have environmental impacts, so some oil and gas revenue ought to be spent offsetting those impacts by investing in conservation and recreation projects across the United States. But the tie to annual oil and gas revenue is problematic. Proponents of the oil and gas industry support LWCF because it establishes a dependent relationship that benefits them. American Petroleum Institute Vice President Lem Smith recently warned that "policies that end or limit production in federal waters would put these essential conservation funds in doubt."[22] Indeed, dependence on federal disbursements of fossil fuel revenue that averages more than $2 billion annually remains a barrier to ending fossil fuel production on federal lands and waters.

And finally, the movement to limit property taxes—known as the "property tax revolt"—has been exploited by an aggressive and organized anti-government and anti-tax agenda. Rapid growth in property values in growing cities and suburbs in the 1970s and '80s resulted in escalating property tax bills. Homeowners, particularly those on fixed incomes, feared being driven out of their homes and neighborhoods by unaffordable property taxes. The property tax revolt was not, in its origins, anti-government. However, the property tax revolt was co-opted by an anti-government, anti-regulations agenda that created a narrative of taxpayers angry at government spending and government programs. This is wrong. Voters prefer low taxes to high taxes, but they also desire high-quality services and infrastructure provided by the government.

Clearly, fiscal policies can be used as political tools. We began this paper with an example of renewable energy projects in Utah that result in no net new property tax revenue for local governments. That outcome is not accidental. The Utah Legislature rewrote state law in 2017 in such a way that newly constructed renewable energy generation facilities would no longer be exempt from property tax limits. This policy change directly impacts conservation. One of the justifications given for shrinking the Bears Ears National Monument was that it supposedly locked up valuable resources that would provide important tax revenues for local schools and roads. While this claim is vastly overstated (there are few economically viable resources inside the monument boundary and few taxes would have been generated), the need for diversification in San Juan County, where the monument is located, is an urgent issue. However, given Utah's fiscal policy, the county has lost the option of raising taxes from renewable energy projects, including from its new wind farm and from a proposed new solar facility.

The challenges facing rural America and the difficulties it faces in embracing climate policies or land conservation were planned. Fiscal policies across the United States are the result of intentional and organized efforts of politicians, industry, and advocates who understand the power of fiscal policy to shape the behavior of state and local governments.

Fiscal Policy – The Way Forward

Fiscal policies have failed rural communities rich in resources and have obstructed conservation and energy transition. Fiscal policy is the outcome of intentional efforts to shape local economies and motivate government behavior. Little progress on economic recovery, public land conservation, or climate policy can be made or sustained without changes to fiscal policies.

If you care about helping rural economies, you need to start with fiscal policy reform.
Those who care about rural communities and economies must support greater autonomy for communities to stabilize natural resource revenue and reconnect the tax base to the changing economy so local governments can pursue new opportunities.

If you care about conservation on public lands, you need to start with fiscal policy reform.
Local governments are incentivized to continue timber harvests and fossil fuel development on public lands and oppose national monuments that have the potential to erode their tax base. Local communities would benefit over the long term from fiscal policies that are designed to stabilize volatile revenues and diversify their economies.

If you care about enacting climate change legislation, you need to start with fiscal policy reform.
Those who care about climate policy must decouple local and state budgets from annual fossil fuel revenue and reward communities that host renewable energy and transmission projects as part of climate planning.

In the short-term, COVID-19 has exacerbated regional disparities between urban and rural job markets, wages, and wealth. But new realities of remote work, health care, and climate change are potential opportunities for rural areas to reimagine themselves. They cannot do so without changes to fiscal policies.

Re-aligning fiscal policy with new economic realities and with policy priorities can ensure that rural areas benefit from economic recovery and that public lands conservation and climate adaptation make financial sense and provide a legacy for future generations.

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About Headwaters Economics

Headwaters Economics is an independent, nonprofit research group whose mission is to improve community development and land management decisions. https://headwaterseconomics.org/

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