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PERSPECTIVE COLUMN

# Mind the Gaps

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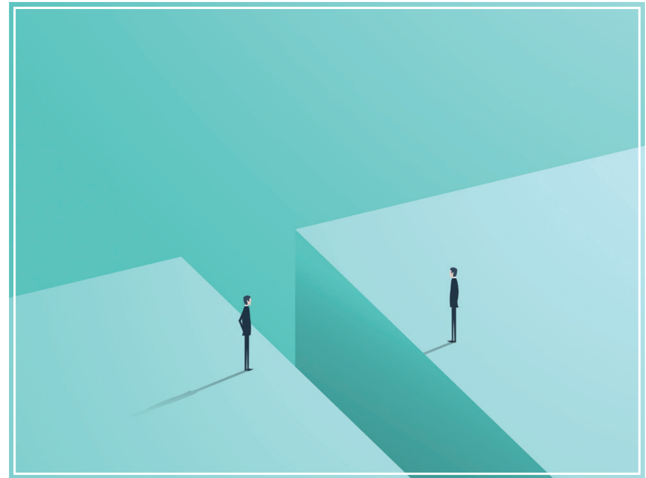

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The two issues brought forward by this column may not sound much like urgent real estate issues, but they are and if the industry does not mind them, it may miss out on important implications. The two issues are the state of municipal finances coming out of COVID-19 and the urgent need for municipalities to attract immigrants. Any city failing on these two fronts may not be where real estate investors want to invest.

First, let's consider the state of municipal finances coming out of COVID-19. However, before tackling this issue, let's have a look at the revenue structure of local governments in the United States. This is done in **Table 1**. According to the Urban-Brooking Tax Policy Center, more than a third of local governments' revenues (35.6%) comes from intergovernmental transfers. Of this share, 32% comes from state government transfers and roughly 4% directly from federal transfers. Almost another third of local governments' revenues originates from property taxes (30.1%). By way of comparison, in Canada, property taxes account for about two-thirds of local governments' revenues, while the share of sales taxes (7.3%) and personal income taxes (2%) as a percent of total local government revenues totals about 10% in the United States, but is marginal in Canada.

It is also interesting to note that local governments total revenues, after increasing as a share of gross domestic product (GDP) from 8.6% in 1977 to a peak of 10% in 2008 at the beginning of the global financial crisis, have come back down to 8.8% of GDP in 2017 (see **Table 2**). Half the drop during this decade was attributable to a decline in intergovernmental transfers. This is more or less surprising since the global financial crisis (GFC) took its toll on the fiscal situation of state and federal governments, leading to a reduction in transfers to local governments. As well, the depth of the GFC put a dent



## ABOUT THE AUTHOR

**Mario Lefebvre, CRE** was appointed Regional Director (Economics) at the Bank of Canada's Quebec Regional Office in July 2020 after spending the last four and a half years with Ivanhoe Cambridge as Vice President, Research. In this capacity, he directs research and analysis on economic and sectoral developments in the region, including overseeing the Bank's Business Outlook Survey in Quebec. Mr. Lefebvre also plays a major role in the office's activities by communicating the Bank's messages to various external audiences and promoting an exchange of views on the economy and monetary policy. For Mr. Lefebvre, this is a return to the Bank of Canada, where he spent the first eight years of his career from 1990 to 1998.

**Table 1: Local Government Revenues by Sources in the United States (fiscal year 2017)**

| | |
|---|---|
| Intergovernmental Transfers | 35.6% |
| Property taxes | 30.1% |
| Charges and miscellaneous | 22.7% |
| Sales tax | 7.3% |
| Other taxes | 2.4% |
| Individual income taxes | 2.0% |

*Source: Urban-Brookings Tax Policy Center*

**Table 2: Evolution of Local Governments' Revenue Sources as a Share of GDP**

| | 1977 | 2008 | 2017 |
|---|---|---|---|
| **Total** | **8.6%** | **10.0%** | **8.8%** |
| Intergovernmental transfers | 3.7% | 3.7% | 3.1% |
| Property taxes | 2.8% | 2.8% | 2.6% |
| Charges and miscellaneous | 1.3% | 2.3% | 2.0% |
| Sales taxes, income taxes and other | 0.8% | 1.2% | 1.1% |

*Source: Urban-Brookings Tax Policy Center*

on growth in local government revenues stemming from property taxes, thanks to the housing crisis that followed the GFC.

As stated above, the significant drop in intergovernmental transfers to local governments following the GFC stemmed from a rapid rise in both the federal and state government debt. Indeed, the federal debt rose from roughly $9 to $12 trillion between 2008 and 2010, while the state government debt rose from $0.9 to $1.1 trillion over the same time frame. While the outcome coming out of COVID-19 is still unknown, estimates point to a rise in federal debt from about $23 trillion to more than $25 trillion in 2020 alone! This is assuming that there will be no second wave of the pandemic, which is a risky hypothesis at the time of writing these lines (early September 2020).

The sharp rise in federal debt during COVID-19, which will likely be reflected in the state government debt as well, does not bode well for intergovernmental transfers to local governments, as was the case following the GFC. Moreover, given the depth of the recession caused by COVID-19, one can assume that local government revenues stemming from property taxes, the sales taxes, and the income taxes will also struggle at least in 2020 and 2021. Bottom line: one should expect that growth in local government revenues will be mediocre at best this year and next. This is bad news for the country's infrastructure since state and local governments are paying the lion's share of U.S. infrastructure. Indeed, according to the U.S. Bureau of Economic Analysis Fixed Assets, state and local governments owned 93% of non-defense infrastructure assets in the U.S. in 2017. Already, following the GFC, state and local governments' capital spending as a share of GDP has dropped from 2.5% of GDP in 2009 to 1.8% of GDP in 2017. This share was as high as 3% of GDP in the 1970s, leading to several studies suggesting that

infrastructure in the U.S. has been neglected for quite some time now. Given the expected struggles in local government revenues following COVID-19, one can expect that public investment in infrastructure could probably decline some more in the coming years.

The state of infrastructure is a key ingredient to the economic success of any community. The condition of roads, bridges, schools, water treatment plants, and other physical assets greatly affects the economy's ability to function and grow. Real estate investors have to consider the state of infrastructure prior to investing in a given community since their investment will only be successful if the community in which they are investing is successful over the medium and long term. Infrastructure quality is no stranger to this success. Since infrastructure investment depends, at least in part, on the fiscal situation of municipalities, investors had better be aware of where the latter stands.

The second issue is immigration. This issue is all the more important as the population is aging, not only in the United States but across the developed world. Focusing on the U.S., the population aged 65 and over, which represents about 16% of the total population today, is expected to account for 20% of the population in 2040 and 25% in 2060. The direct economic impact of an aging population is that the workforce will become increasingly scarce. As a result, businesses will become increasingly selective in their decision to choose a location.

In a not so far distant past, companies would pick their location without being worried at all about whether they would be able to find the workforce they need unless the business was in a very narrow field of expertise. But for most manufacturing plants, for example, the *modus operandi* was more along the line of "build it and they will come." This has already changed over the past decade as firms, worried about being able to find their required workforce, would pay a little more attention to the population growth and the age structure of a community prior to establishing a plant in a given location. This trend will only accelerate moving forward.

The United States has performed relatively well with respect to attracting immigrants, particularly in the 19th century, when, on average, the share of the foreign-born population hovered regularly around 15%. That share dropped continuously through the 20th century, reaching a low of 4.7% in 1970. However, when U.S. immigration laws replaced a national quota system in 1965, the number of immigrants coming to the U.S. eventually soared and the share of the foreign-born population was back up to 13.6% of the U.S. population by 2017.

But now is no time to rest on its laurels. Attracting immigrants to the U.S. will be tougher than ever since the aging population is a global phenomenon. This means that every developed country will have its eyes set on attracting immigrants. Moreover, the pool of immigrants to choose from may shrink since several countries in Asia are developing rapidly, which means that Asian residents have fewer reasons (at least from an economic standpoint) to leave their countries. It must be stated that Asian immigrants to the United States have outnumbered Hispanics each year since 2008.

U.S. communities must therefore increase their efforts to ensure that they will continue to attract their fair share of immigrants. Their future prosperity will depend on it. Attracting immigrants requires, among other things, integration programs for which a budget is required. This makes a direct connection to the first issue discussed in this column: the fiscal situation of local governments.

These are challenging times. COVID-19 has put an abrupt end to one of the longest economic expansion in history. It will bring about an increased level of public debt in the United States and, for that matter, around the World. Tough choices will have to be made given that the fiscal situation of governments will be stressed. However, policymakers will have to be careful in making these tough choices in order not to put at risk their future prosperity, which will require both sound infrastructure and continued healthy immigration flows. Real estate investors must therefore monitor

closely the choices that policymakers will make from one community to another, as the success of their future investment will, at least in part, directly depend on it. •

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