

Research Brief on America's Cities

October 2007 Issue 2007-2

City finance officers report that the fiscal condition of the nation's cities improved in the past year. However, as they prepare to close the books on 2007, finance officers are less optimistic, predicting a slowdown in revenues and increased spending pressures.² Among the findings of the National League of Cities' latest annual survey of city finance officers are:

- Seven in ten city finance officers (70%) report that their cities are better able to meet fiscal needs during 2007 than in the previous year;
- Final tallies on 2006 revenues reveal that city revenues increased by 6.6% in current dollars, but when accounting for inflationary factors, grew by a much smaller 1.1%;
- As finance officers look to the close of 2007, they predict that revenues will slow further, with growth in inflation-adjusted revenue of only 0.4%, while expenditures will increase by 3.5% – a budget deficit of 3.1%;
- Spending pressures stem from increased public safety and infrastructure needs as well as increasing employee-related costs for health care, pensions, and wages;
- To close projected budget deficits and meet ongoing spending needs, many cities are increasing fees and charges for services and some are raising property tax rates; and,
- Ending balances, or “reserves,” remain at high levels and will provide a buffer against a future downturn.

Ability to Meet Fiscal Needs

In 2007, seven in ten (70%) city finance officers report that their cities are better able to meet fiscal needs in 2007 than in 2006. City finance officers' assessment of their cities' fiscal conditions in 2007 has improved dramatically since 2003, the low point after the fiscal recession, when only 19 percent of city finance officers said their cities were better able to meet fiscal needs than in the previous year. Optimism about the ability to meet city fiscal needs in 2007 is similar to levels reported nearly a decade ago after a long period of economic growth.

There is little variation in finance officers' assessments of positive fiscal conditions in 2007 based on their tax reliance (property, sales, or income) or the basis of their population. However, city finance officers in the Midwest (51%) are less likely to say their cities are better off in 2007 than city officials in the South (79%), Northeast (74%), and West (73%).³

City Fiscal Conditions in 2007

Michael A. Pagano
*Christopher W. Hoene*¹

¹ **Michael A. Pagano** is Interim Dean of the College of Urban Planning and Public Administration at the University of Illinois at Chicago. He has written the annual City Fiscal Conditions report for NLC since 1991. **Christopher Hoene** is Director of Policy and Research for the National League of Cities. The authors would like to acknowledge the 359 respondents to this year's fiscal survey. The commitment of these cities' finance officers to this project is greatly appreciated. **Christiana McFarland**, Research Manager at NLC, also contributed to the project.

² All references to specific years are for fiscal years as defined by the individual cities. The use of “cities” or “city” in this report refers to municipal corporations.

³ Regional classifications are based on U.S. Census-defined regions: “Northeast” includes cities in CT, ME, MA, NH, NJ, NY, PA, RI, VT; “Midwest” includes cities in IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI; “South” includes cities in AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV; “West” includes cities in AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY.

The City Fiscal Conditions Survey is a national mail survey of finance officers in U.S. cities conducted in the spring of each year. This is the 22nd edition of the survey, which began in 1985.



**National
League
of Cities**

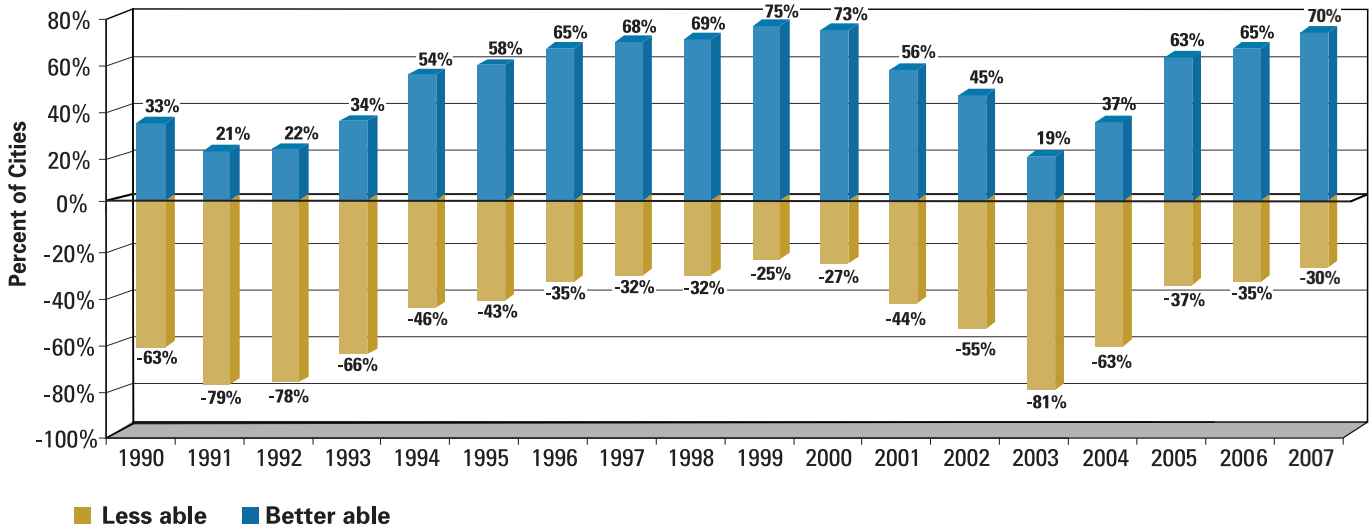


FIGURE I
Percent of Cities that Are “Better Able/Less Able” to meet Financial Needs This Year Than Last Year

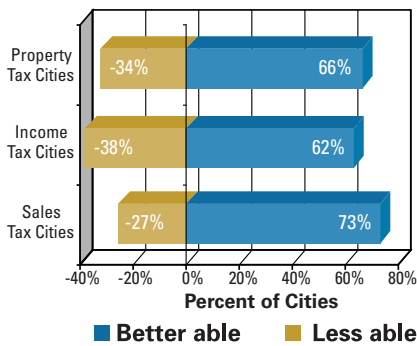


FIGURE IA
By Taxing Authority

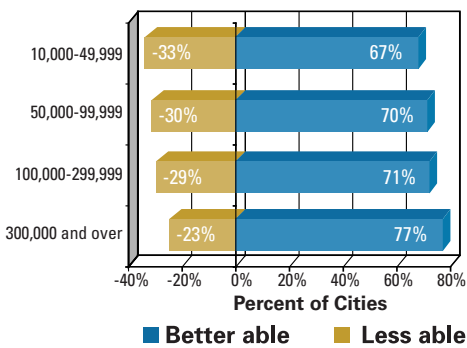


FIGURE IB
By City Size

Revenue and Spending Trends

Closing the books on 2006, cities experienced solid growth in year-to-year revenue, but that growth was eroded by the influence of inflationary factors in the state and local government sector.

In current dollars, not adjusted for inflation, the year-to-year change in general fund revenues in 2006 was 6.6% over 2005 revenues.⁴ Looking to the close of 2007, city finance officers are expecting year-to-year revenue growth to slow to 3.6%.

While the 2006 current-dollar growth in city presents a somewhat rosy fiscal picture for the nation’s cities, the purchasing power of this revenue growth is severely eroded by inflationary forces. The National Income and Products Account’s estimate of inflation for the state and local government sector for 2006 was 5.44%, significantly reducing the purchasing power of city revenues. In constant dollars, adjusting for inflationary factors, the year-to-year change in city revenues from 2005 to 2006 was 1.1%. The 2006 level represents the fourth year in a row that city revenues increased at relatively slow rates, or actually declined, from one year to the next. For 2007, finance officers project that general fund revenue growth will be slow again, at 0.4%.

Likewise, the current-dollar growth in city spending for 2006 of 6.6% was above inflationary costs for state local governments, resulting in actual year-to-year growth in constant-dollar spending of 1.2%. Projected spending growth for 2007 amounts to what appears to be a healthy 6.8% over 2006 levels in current dollars, or in constant-dollar terms spending levels are projected to increase by 3.5%.

Taken together, city finance officers’ projections for 2007 revenues and spending point to a budget gap of 3.1% (3.5% increase in spending -0.4% growth in revenues) in constant dollars. Since nearly all local governments are required to balance their budgets under state law, this budget gap suggests that many city governments are confronted with decisions about how to raise revenues, reduce spending, or dip into their reserves in 2007.

⁴ The General Fund is the largest and most common fund of all cities, accounting for 66% of city revenues in 2006.

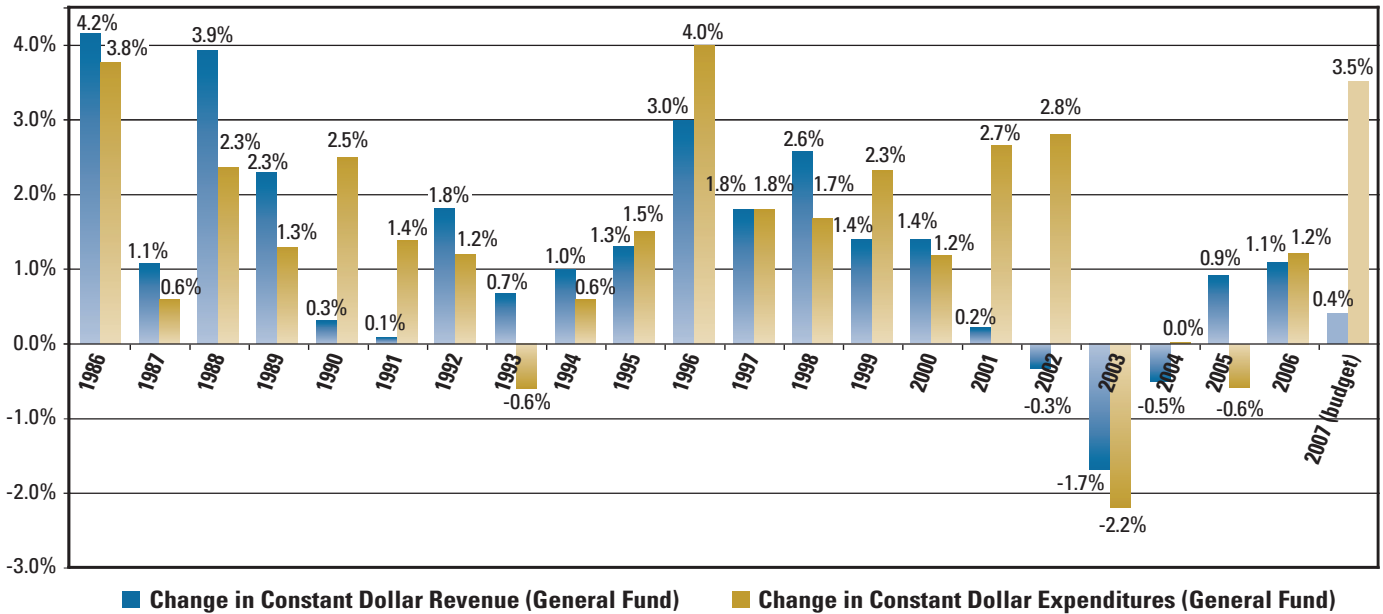


FIGURE 2
Year-to-Year Change in General Fund Revenues and Expenditures (Constant dollars)

Changes in Tax Revenues

It is important to note that the fiscal condition of individual cities varies greatly depending on differences in local tax structure and reliance. While an overwhelming majority of cities have access to a local property tax, many are also reliant upon local sales taxes and some are reliant upon local income taxes. Consequently, it is also worthwhile to understand the differing performance of these tax sources.

The well-publicized downturn in the real estate market might affect cities' fiscal fortunes in the future, but for 2006 property tax revenue collections increased at an above-average pace. Property tax revenues increased in 2006 by 9.4% compared to 2005 levels, or in constant dollars, an increase of 4.0%. Projections for

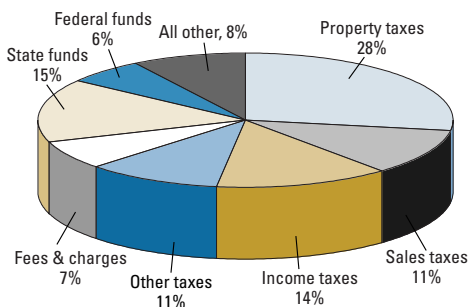


FIGURE 3
General Fund Revenue Composition for the Municipal Sector, 2006

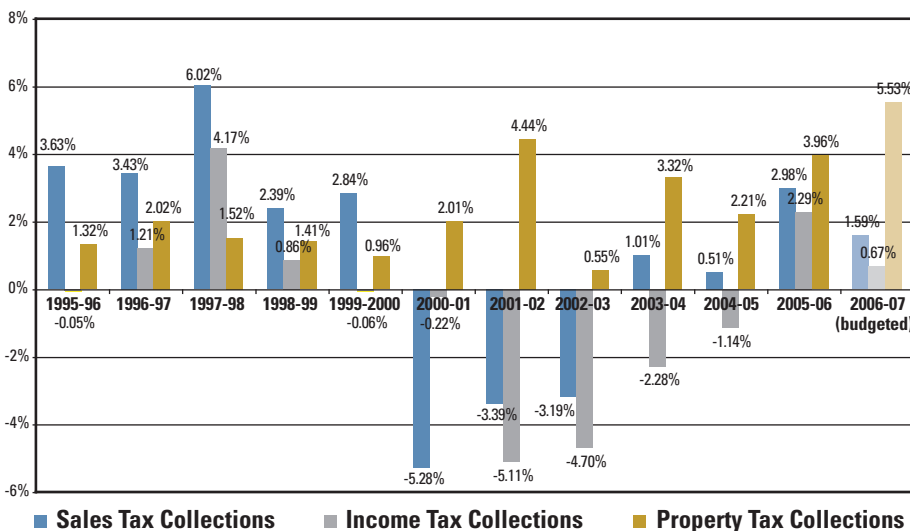


FIGURE 4
Year-to-Year Change in General Fund Tax Receipts (Constant Dollars)

2007 indicate that property tax collections will continue to grow by 8.8% in current dollars, or 5.5% in constant-dollar terms. Growth in 2006 property tax collections and projected growth for 2007 are both historical highs for the NLC survey, revealing that city governments are continuing to reap the benefits of a strong real estate market in recent years. The current downturn in the real estate market will likely impact cities revenue collections in the next couple of years as assessment practices catch up with market changes. In the meantime, the lag between property tax values and tax assessments will likely result in increasing pressure from homeowners and residents to decrease property tax rates.

Sales tax receipts improved in 2006 over previous year receipts, increasing by 8.4% in current dollars or 3.0% in constant dollars. Projections for 2007 indicate a 4.8% current-dollar growth rate over the 2006 level, which represents a 1.6% increase in constant dollars. Income tax collections had struggled the most since 1999, but grew by 7.7% in 2006 current dollars (2.3% in constant dollars). Projections for 2007 indicate a 3.9% growth in income tax receipts, but in constant dollars terms this amounts to a small increase (0.7%).

Factors Influencing City Budgets

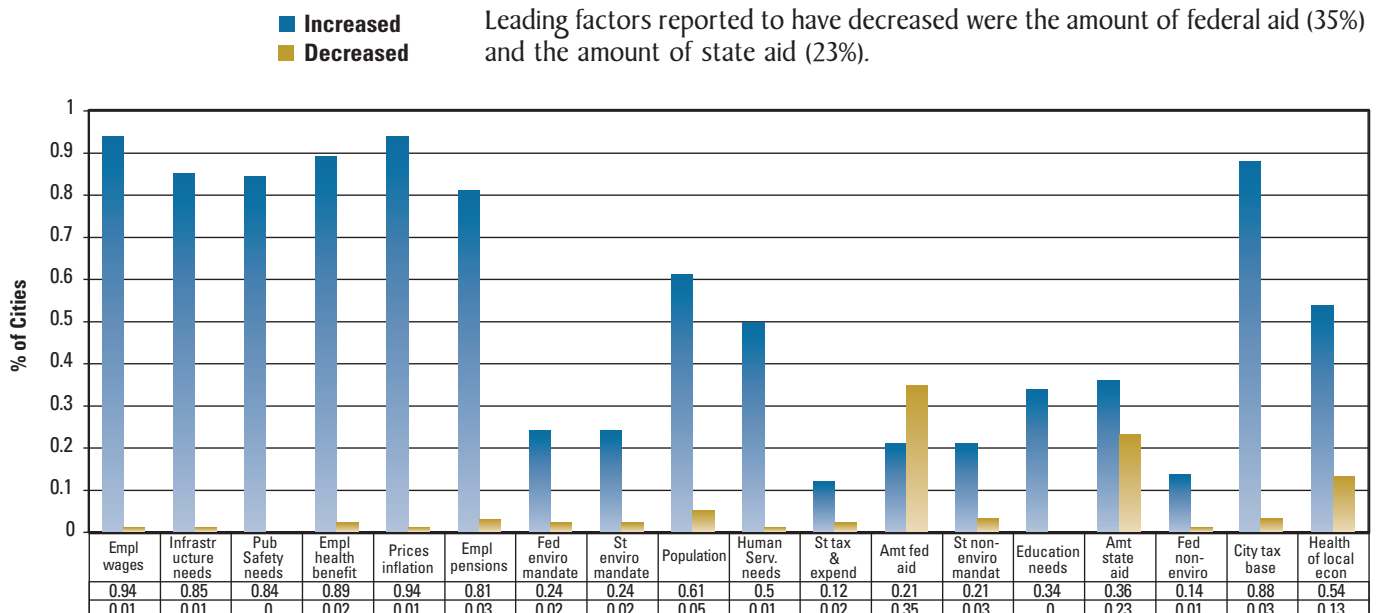
A number of factors combine to determine the revenue performance, spending levels, and overall fiscal condition of cities. The survey presented city finance directors with a list of 18 factors that affect city budgets.⁵ Respondents were asked whether each of the factors had *increased* or *decreased* between 2006 (regardless of impact) and 2007 and whether the change is having a *positive* or *negative* influence on the city's overall fiscal picture.

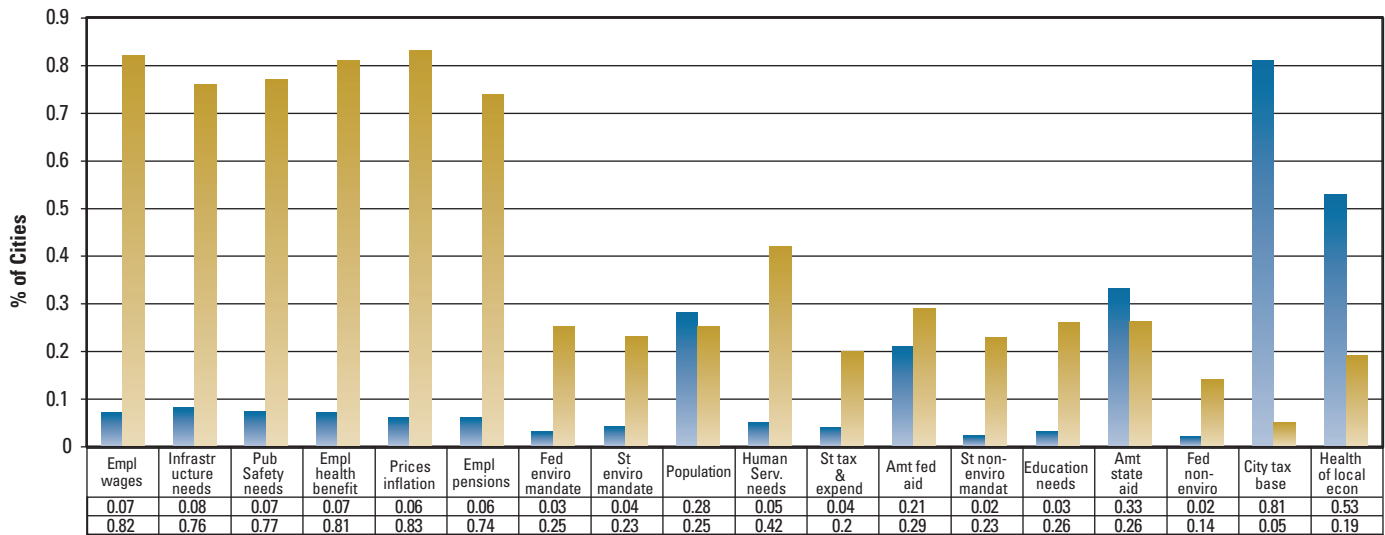
Leading the list of factors that *increased* over the previous year were employee wages (cited by 94%), prices, inflation and the cost of living (94%), the cost of employee health benefits (89%), and the city tax base (88%). In addition, more than 8 in 10 city finance officers cited increases in infrastructure needs (85%), public safety needs (84%), and employee pension costs (81%).

Leading factors reported to have decreased were the amount of federal aid (35%) and the amount of state aid (23%).

⁵ The 18 factors include: infrastructure needs, public safety needs, human service needs, education needs, employee wages, employee pension costs, employee health benefit costs, prices and inflation, amount of federal aid, amount of state aid, federal non-environmental mandates, federal environmental mandates, state non-environmental mandates, state environmental mandates, state tax and expenditure limitations, population, city tax base, and the health of the local economy.

FIGURE 5
Change in Selected Factors From
FY 2006





■ Positive Impact
■ Negative Impact

FIGURE 6
Impact of Selected Factors on
FY 2007 Budgets and Ability to
Meet Cities' Overall Needs

Not surprisingly, when asked about the positive or negative impact of these and other factors on city finances in 2007, eight in ten city finance officers cite prices and inflation (83%), employee wages (82%), and the cost of employee health benefits (81%) as having negative effects. The next most often cited factors in the negative category are public safety needs (77%), infrastructure needs (76%), and employee pension costs (74%). One in four city finance officers also say that changes in the amount of federal aid (29%) and state aid (26%) to cities are having a negative impact on city budgets.

Eight in ten (81%) city finance officers indicate that increases in the local tax base are having a positive effect on their ability to meet their cities' overall needs. The health of the local economy is also cited as a positive factor by 53 percent of city finance officers.

When city officials were asked to identify three items that are having "the most negative impact" on their ability to meet city needs, three of the top vote-getters in recent years have been the costs of city workers' health benefits (cited by 51% of respondents), public safety needs (39%), and infrastructure needs (38%).

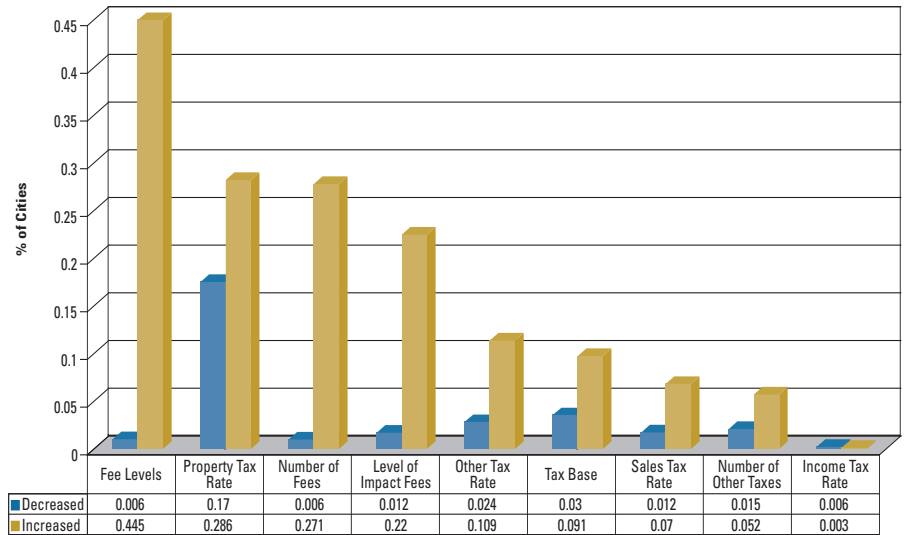
Fiscal Actions

City finance officers were also asked about specific revenue and spending actions taken in 2007.

The most common action taken to boost city revenues during 2007 has been to increase fees and charges for services. Nearly half (45%) of all responding city finance officers report that their city has taken this step. One in four cities also increased the number of fees (27%) and/or the level of impact and development fees (22%).

In other revenue actions, 29 percent of city finance officers report that their city has opted for increasing property tax rates, while seventeen percent report decreasing property tax rates. Increases in sales tax rates (1%), income tax rates (1%), and other tax rates (2%) have been much less frequent.

FIGURE 7
Revenue Actions in 2007



On the spending side, three in four (77%) city finance officers report increases in public safety spending in 2007, while 59 percent are increasing infrastructure/capital spending, 52 percent are increasing the growth rate in their operating budgets, and 39 percent report increases in human services spending, often referred to as social services or programs.

Ending Balances

One way that cities can prepare for future fiscal challenges is maintain high levels of ending balances, or what are often referred to as “rainy day funds” or “reserves.” Despite recent cyclical changes in economic and fiscal conditions, city ending balances have grown in recent years. In 2006, city ending balances, as a percentage of general fund expenditures, reached an historical high for the NLC survey of 25.7%.

Ending balances, which are transferred forward to the next fiscal year in most cases, are set aside for many reasons. For example, cities build up healthy reserves in anticipation of unpredictable events (e.g., storms, natural disasters, real estate declines). But they are also built up deliberately, much like a personal savings account, to set aside funds for planned events (e.g., construction of water treatment facility). Bond underwriters also look at reserves as an indicator of fiscal responsibility, which can increase credit ratings and decrease the costs of city debt, thereby saving the city money. Finally, as federal aid to cities has become a small proportion of city revenues while state aid has remained stable or declined slightly, cities have become more self-reliant and as such are much more prudent in setting aside funds for emergency or other purposes, such as an economic downturn.

Looking to 2008

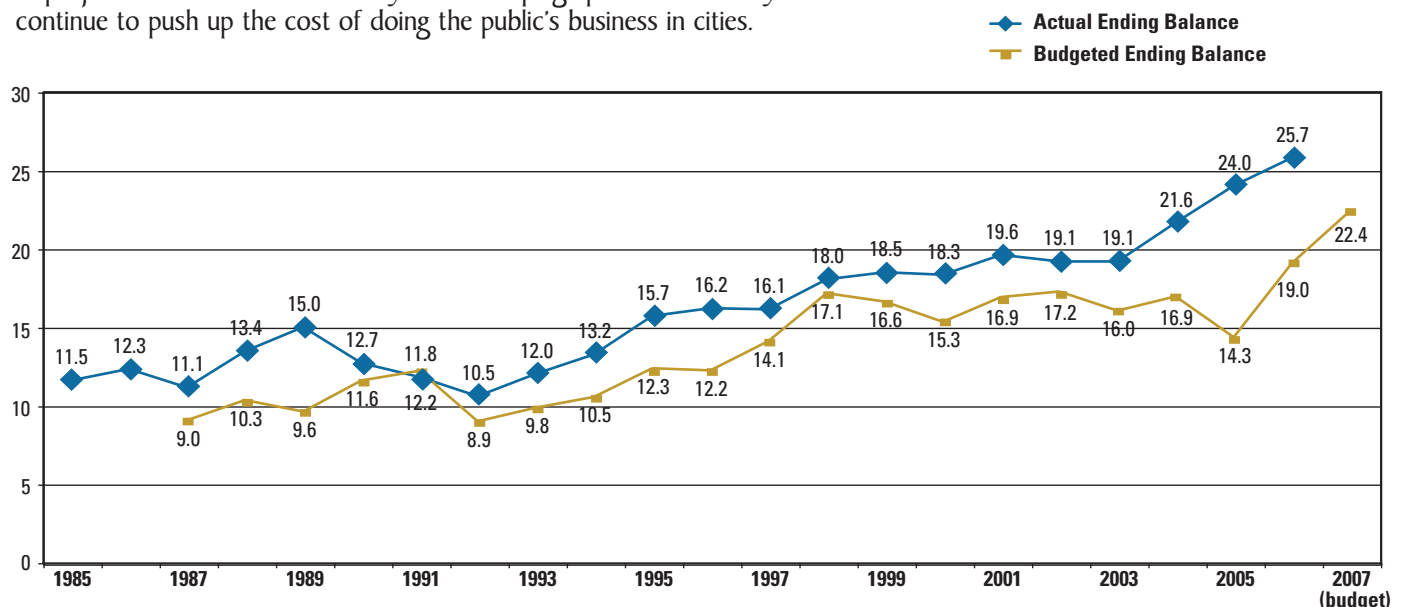
While 2007 reveals relative optimism about cities’ ability to meet their fiscal needs, mixed economic signals, the coming impact of the decline in the real estate market, and ongoing spending pressures temper finance officers’ optimism about the coming year.

The outlook for the nation's cities in the next year includes a number of concerns.

- City tax bases and collections improved markedly in 2006 and somewhat in 2007, but inflationary factors will continue to reduce the purchasing power of city revenues.
- Cities are faced with a property tax conundrum. Constant-dollar growth in property tax receipts have been positive for the past decade, but concerns about the health of real estate markets and potential impacts on property tax revenues, combined with increased calls for property tax relief from homeowners and residents, will cloud the picture in 2008.
- Three of the factors that city finance officers report as having the largest negative impact on their ability to meet needs are employee-related costs for health care coverage, pensions, and wages. Health care and pension costs, in particular, are increasing at a faster rate than city revenues. This reality is unlikely to change in the near future, placing added fiscal strain on city budgets.
- In addition, changes in accounting standards require that cities report liabilities for pension and other post-employment retirement benefits as part of their annual end-of-year balance. Since nearly all cities are required by state law to balance their budgets, the reporting of these liabilities as part of the bottom line means that cities will be confronted with additional fiscal constraints and choices.
- Despite revenue and spending pressures, cities are likely to maintain high ending balance levels, providing a buffer in the event that conditions decline.
- Public safety and infrastructure maintenance and investment will continue to be high priorities for city spending.

In short, difficult choices continue to be on the horizon for city officials in the coming years about how to plan for the future and how to fill gaps in revenue and spending levels. Although city finance officers are more optimistic today about their cities' fiscal futures compared with just a few years ago, the purchasing power of projected increased revenues may not be keeping up with inflationary forces that continue to push up the cost of doing the public's business in cities.

FIGURE 8
Ending Balances as a Percentage of Expenditures (General Fund)



About the National League of Cities

The National League of Cities is the nation's oldest and largest organization devoted to strengthening and promoting cities as centers of opportunity, leadership and governance. NLC is a resource and advocate for more than 1,600 member cities and the 49 state municipal leagues, representing 19,000 cities and towns and more than 218 million Americans.



National League of Cities
1301 Pennsylvania Avenue, NW
Washington, DC 20004
www.nlc.org

About the Survey

The City Fiscal Conditions Survey is a national mail survey of finance officers in U.S. cities. Surveys were mailed to a sample of 1,055 cities, including all cities with populations greater than 50,000 and, using established sampling techniques, to a randomly generated sample of cities with populations between 10,000 and 50,000. The survey was conducted from April to June 2007. The 2007 survey data are drawn from 359 responding city finance officers, for a response rate of 34.0%. The responses received allow us to generalize about all cities with populations of 10,000 or more.

Throughout the report the data are compared for cities of different population sizes, regions of the country, and with different tax structures. The response rates for these categories are provided in the table below.

Categories	Number of Surveys Sent	Number Returned	Response Rate
Population			
>300,000	59	33	55.9%
100,000-299,999	179	77	43.0%
50,000-99,999	315	112	35.6%
10,000-49,999	502	137	27.2%
Region			
Northeast	222	51	23.0%
Midwest	302	87	28.8%
South	277	115	41.5%
West	254	106	41.7%
Tax Authority			
Property	384	116	30.2%
Sales & Property	534	214	40.1%
Income & Property	110	24	21.8%
Other	27	5	18.5%

It should be remembered that the number and scope of governmental functions influence both revenues and expenditures. For example, many Northeastern cities are responsible not only for general government functions but also for public education. Some cities are required by their states to assume more social welfare responsibilities than other cities. Some assume traditional county functions. Cities also vary according to their revenue-generating authority. Some states, notably Kentucky, Michigan, Ohio and Pennsylvania, allow their cities to tax earnings and income. Other cities, notably those in Colorado, Louisiana, New Mexico, and Oklahoma, depend heavily on sales tax revenues. Moreover, state laws may require cities to account for funds in a manner that varies from state to state. Therefore, much of the statistical data presented here must also be understood within the context of cross-state variation in tax authority, functional responsibility, and state laws. City taxing authority, functional responsibility, and accounting systems vary across the states.

The dollar amounts presented in this report are in either current or constant dollars. Constant dollars are deflated using the state and local government implicit price deflators from the National Income and Product Accounts reported by the U.S. Bureau of Economic Analysis (www.bea.gov).

When we report on fiscal data such as general fund revenues and expenditures we are referring to all responding cities' aggregated fiscal data included in the survey. As a consequence, it should be noted that those aggregate data are influenced by the relatively larger cities that have larger budgets and that deliver services to a preponderance of the nation's cities' residents. When asking for fiscal data, we ask city finance officers to provide information about the fiscal year for which they have most recently closed the books (and therefore have verified the final numbers), which we generally refer to as FY 2006, the year prior (FY 2005), and the budgeted (estimated) amounts for the current fiscal year (FY 2007).

When we report on non-fiscal data (such as finance officers' assessment of their ability to meet fiscal needs, fiscal actions taken, or factors affecting their budgets), we are referring to percentages of responses to a particular question on a one-response-per-city basis. Thus, the contribution of each city's response to these questions is weighted equally.