

## City Fiscal Conditions in 2011

The nation's city finance officers report that the fiscal condition of cities continues to weaken in 2011 as cities confront the persistent effects of the economic downturn.<sup>2</sup> Local and regional economies, characterized by struggling housing markets, slow consumer spending and high levels of unemployment, are driving declines in city revenues. In response, cities are continuing to cut personnel, infrastructure investments and key services. Findings from the National League of Cities' latest annual survey of city finance officers include:

- As finance officers look to the close of 2011, they project declining revenues, with corresponding spending cutbacks in response to the economic downturn;
- The pace of decline in property tax revenues quickened in 2011, reflecting the inevitable and lagged impact of real estate market declines in recent years;
- Ending balances, or "reserves," while still at high levels, decreased for the third year in a row as cities used these balances to weather the effects of the downturn;
- Fiscal pressures on cities include declining local economic health, infrastructure costs, employee-related costs for health care, pensions and wages and cuts in state aid; and,
- Confronted with these pressures and conditions, cities are making personnel cuts, delaying or cancelling infrastructure projects and cutting local services — cuts that have implications for jobs and national economic recovery.

### MEETING FISCAL NEEDS — A "NEW NORMAL?"

Since 2008, nearly all reflections on the economy and on government fiscal position mention the Great Depression of the 1930s that began with the stock market crash on Black Tuesday, October 29, 1929. "Not since the Great Depression..." is an oft-used prelude to many descriptions of the current period. A similar refrain is heard when policy analysts and citizens discuss cities. In reality, however, the Great Recession that began with the bursting of the housing bubble in 2007 and the sharp drop in stock markets in 2008 did not begin to wreak havoc on cities' revenue profiles until later.

For cities, the collective impact of property values continuing at levels far below their 2007 peaks, consumer spending slowing, consumer confidence eroding and markets possibly entering a double-dip recession is the worst since the Great Depression. Yet, America's cities are not looking to the past as a guidepost for the future. Indeed, lower property values and declining sales may portend something entirely new, a "new normal."

<sup>1</sup> Christopher W. Hoene is Director of the Center for Research and Innovation at the National League of Cities. Michael A. Pagano is Dean of the College of Urban Planning and Public Affairs at the University of Illinois at Chicago. The authors would like to acknowledge the 272 respondents to this year's fiscal survey. The commitment of these cities' finance officers to the project is greatly appreciated.

<sup>2</sup> 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.

*The City Fiscal Conditions Survey is a national mail and online survey of finance officers in U.S. cities conducted in the spring-summer of each year. This is the 26<sup>th</sup> edition of the survey, which began in 1986.*

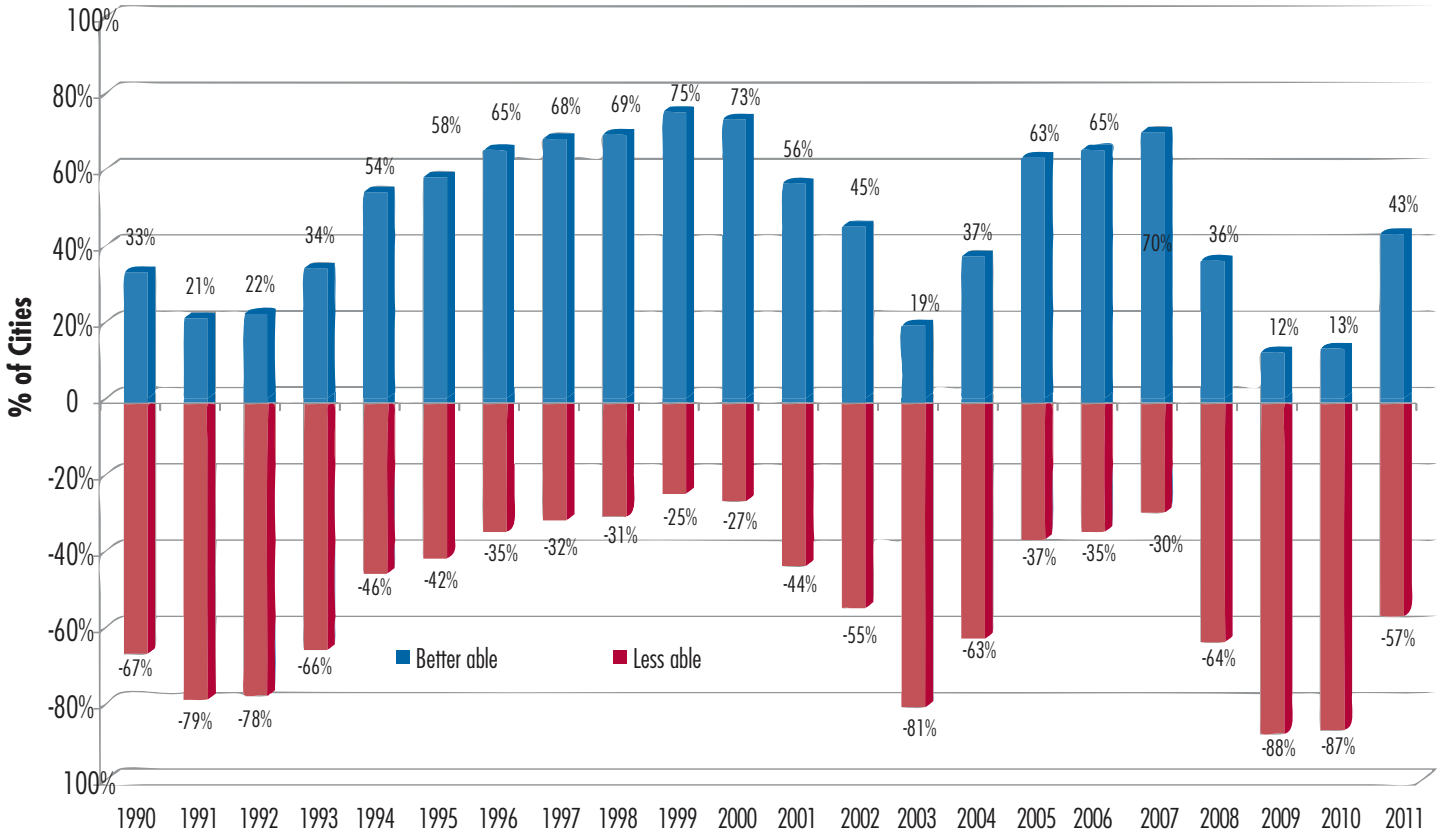


Figure 1: Percent of Cities "Better Able/Less Able" to Meet Financial Needs

In 2011, 57 percent of city finance officers report that their cities are less able to meet fiscal needs than in 2010 (See Figure 1). City finance officers' comparative assessment of their cities' fiscal conditions from year to year in 2011 improved from their 2010 assessment, when 87 percent of city finance officers said their cities were less able to meet fiscal needs than in 2009, the highest level in the history of NLC's 25-year survey. The 2011 findings suggest that city finance officers' perceptions are still mostly negative, but they are not necessarily worsening and may reflect a new normal in terms of their assessment and expectations of meeting nearer-term financial needs. Finance officers in cities that rely more upon property taxes (73%) — the most common local tax source — are more likely to say that their cities are less able to meet fiscal needs in 2011 than those in cities reliant upon sales taxes (50%) or income taxes (47%) (See Figure 1A).

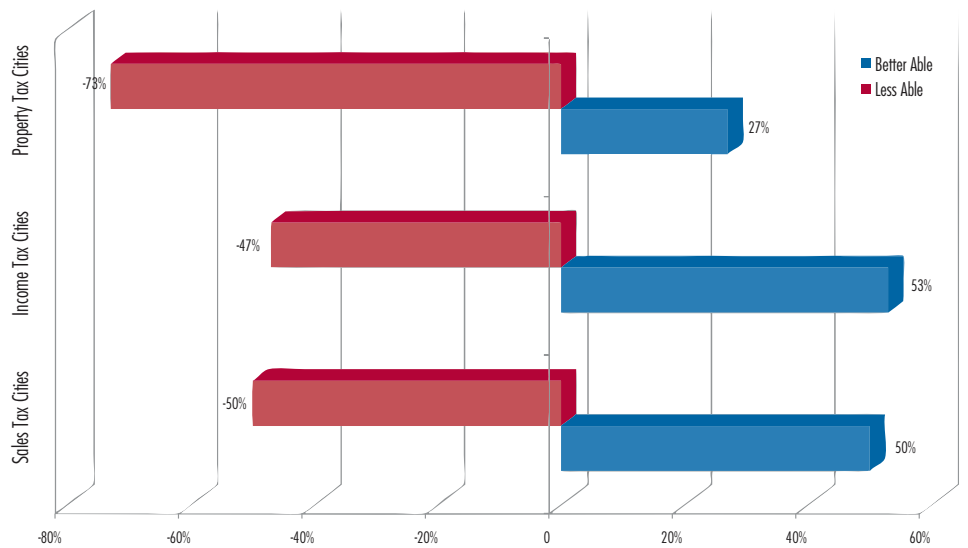


Figure 1A: Percent of Cities "Better Able/Less Able" to Meet Financial Needs in FY 2011 by Tax Authority

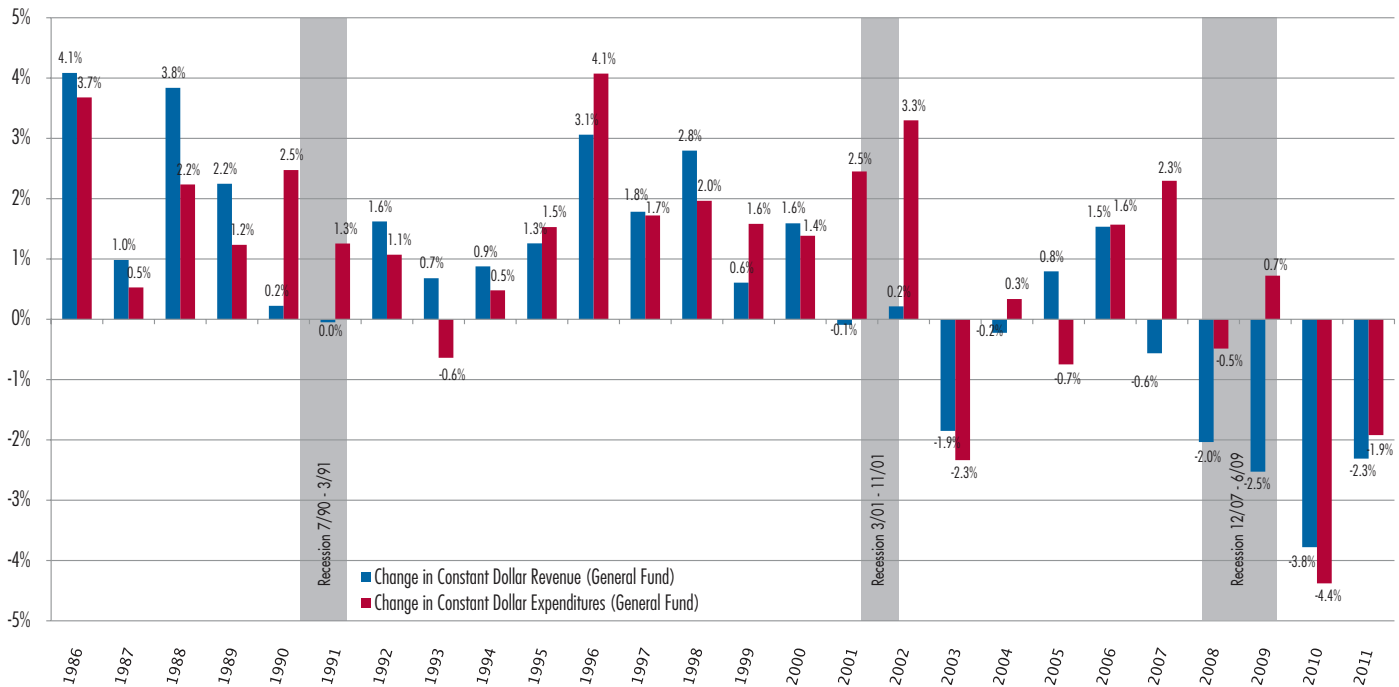


Figure 2: Year-to-Year Change in General Fund Revenues and Expenditures (Constant Dollars)

## REVENUE AND SPENDING TRENDS

Cities ended fiscal year 2010 with the largest year-to-year reductions in general fund revenues and expenditures in the 26-year history of the survey.<sup>3</sup> In constant dollars (adjusted to account for inflationary factors in the state-local sector), general fund revenues in 2010 declined -3.8 percent from 2009 revenues, while expenditures declined by -4.4 percent.<sup>4</sup> Looking to the close of 2011, city finance officers project that general fund revenues will decline by -2.3 percent and expenditures will decline by -1.9 percent (See Figure 2).

Revenue and spending shifts in 2010 and 2011 portray a worsening fiscal picture for America's cities. The projected decline in 2011 revenues represents the fifth straight year-to-year decline going back to 2007. Over the same period, year-to-year expenditures have declined in three of the last four years. In comparison to previous periods, the most recent decade, with recessions in 2001 and 2007-09, continues to be characterized by volatility in city fiscal conditions. With a national economic recovery that has been weak or stalled, and taking into account a lag between economic shifts and the effects for city budgets, it seems very likely that cities will confront further revenue declines and cuts in city spending in 2012. (For more on the lag between economic changes and city revenues, see page 9.)

## TAX REVENUES

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 cities (fewer than 10% nationally) are reliant upon local income or wage taxes. Understanding the differing performance of these tax sources and the connections to broader economic conditions helps explain the forces behind declining city revenues.<sup>5</sup>

<sup>3</sup> The General Fund is the largest and most common fund of all cities, accounting for approximately 55% of city revenues across the municipal sector.

<sup>4</sup> "Constant dollars" refers to inflation-adjusted dollars. "Current dollars" refers to non-adjusted dollars. To calculate constant dollars, we adjust current dollars using the U.S. Bureau of Economic Analysis (BEA) National Income and Product Account (NIPA) estimate for inflation in the state and local government sector. Constant dollars are a more accurate source of comparison over time because the dollars are adjusted to account for differences in the costs of state and local government.

<sup>5</sup> For more information on variation in local and state tax structures, see "Cities and State Fiscal Structure," (NLC, 2008) at [http://www.nlc.org/FileLibrary/Find City Solutions/Research Innovation/Finance/cities-state-fiscal-structure-2008-rpt.pdf](http://www.nlc.org/FileLibrary/Find%20City%20Solutions/Research%20Innovation/Finance/cities-state-fiscal-structure-2008-rpt.pdf).

**Property Taxes.** Local property tax revenues are driven primarily by the value of residential and commercial property, with property tax bills determined by local governments' assessment of the value of property. Property tax collections lag the real estate market because local assessment practices take time to catch up with changes. As a result, current property tax bills and property tax collections typically reflect values of property from anywhere from 18 months to several years prior.

The effects of the well-publicized downturn in the real estate market in recent years are increasingly evident in city property tax revenues in 2011. Property tax revenues in 2010 dropped by -2 percent compared with 2009 levels, in constant dollars, the first year-to-year decline in city property tax revenues in 15 years. Property tax collections for 2011 point to worsening effects from the downturn in real estate values, projected to decline by -3.7 percent. The full weight of the decline in housing values is now evident in city budgets, and property tax revenues will likely decline further in 2012 and 2013 as city property tax assessments and collections catch up with the market (See Figure 3).

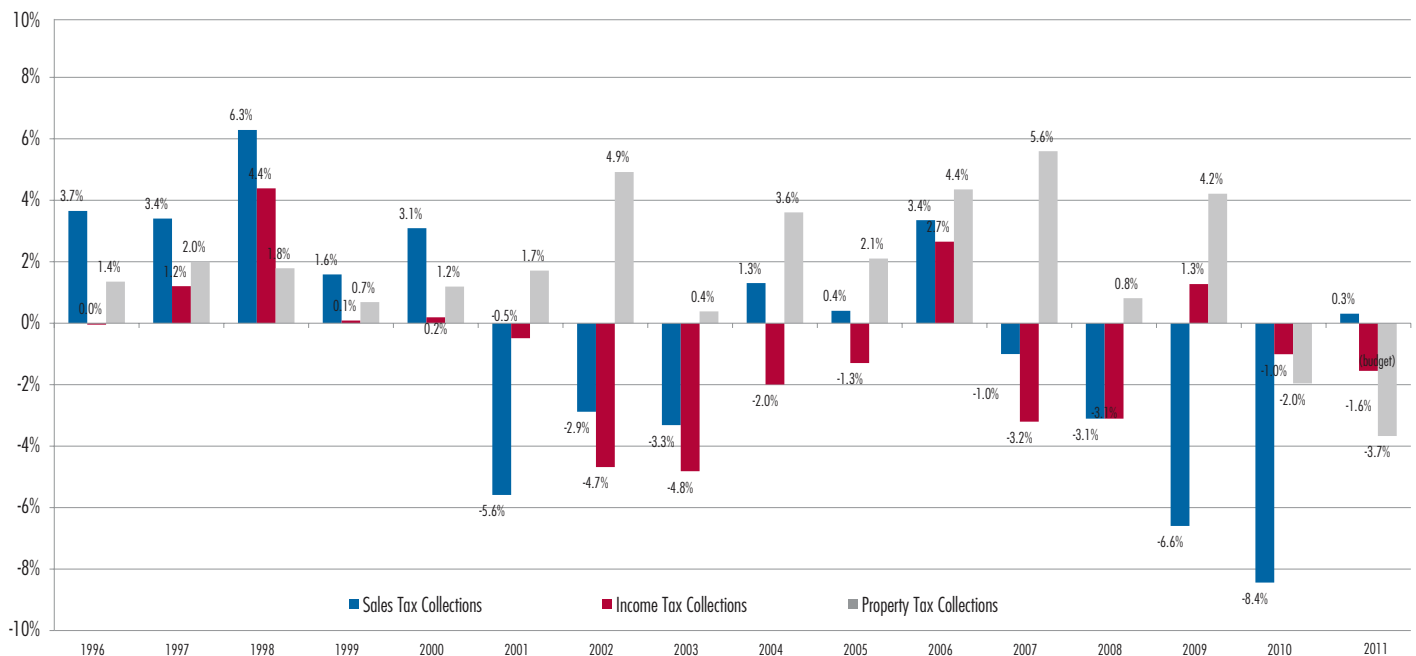


Figure 3: Year-to-Year Change in General Fund Tax Receipts (Constant Dollars)

**Sales Taxes.** Changes in economic conditions are also evident in terms of changes in city sales tax collections. When consumer confidence is high, people spend more on goods and services and city governments with sales-tax authority reap the benefits through increases in sales tax collections. For much of this decade, consumer spending was also fueled by a strong real estate market that provided additional wealth to homeowners. The struggling economy and the declining real estate market have reduced consumer confidence, resulting in less consumer spending and declining sales tax revenues. City sales tax receipts declined in 2010 over previous year receipts by -8.4 percent in constant dollars, the largest year-to-year decline in 15 years. However, in 2011, city sales tax revenues are projected to essentially remain flat (increase of 0.3%) over 2010 levels.

**Income Taxes.** City income tax receipts have been fairly flat, or have declined, for most of the past decade in constant dollars. Local income tax revenues are driven primarily by income and wages, not capital gains. The lack of growth in these revenues suggests that the economic recovery following the 2001 recession was, as many economists have noted, a recovery characterized by a lack of growth in jobs, salaries and wages. Projections for 2011 are for a decrease of -1.6 percent in constant dollars, as wages and salaries continue to reflect local job losses and with a national unemployment rate hovering around 9 percent.

City finance officers are therefore predicting decline or little growth in all three major sources of tax revenue for cities in 2011. With national economic indicators pointing to continued struggles, and the lag between changing economic conditions and local revenue collections, all indications point to continuing challenges for city budgets in the coming years.

## FACTORS INFLUENCING CITY BUDGETS

A number of factors combine to determine the revenue performance, spending levels and overall fiscal condition of cities. Each year, NLC's survey presents city finance directors with a list of factors that affect city budgets.<sup>6</sup> Respondents are asked whether each of the factors increased or decreased from the previous year and whether the change is having a positive or negative influence on the city's overall fiscal picture. Leading the list of factors that finance officers say have increased over the previous year are employee health benefit costs (86%) and pension costs (84%). Infrastructure (79%) and public safety (63%) demands were most often noted as increasing among specific service arenas. Increases in prices, in general, were also oft-mentioned (84%). Leading factors that city finance officers report to have decreased are levels of state aid to cities (60%), the local tax base (53%) and the health of the local economy (42%) (See Figure 4).

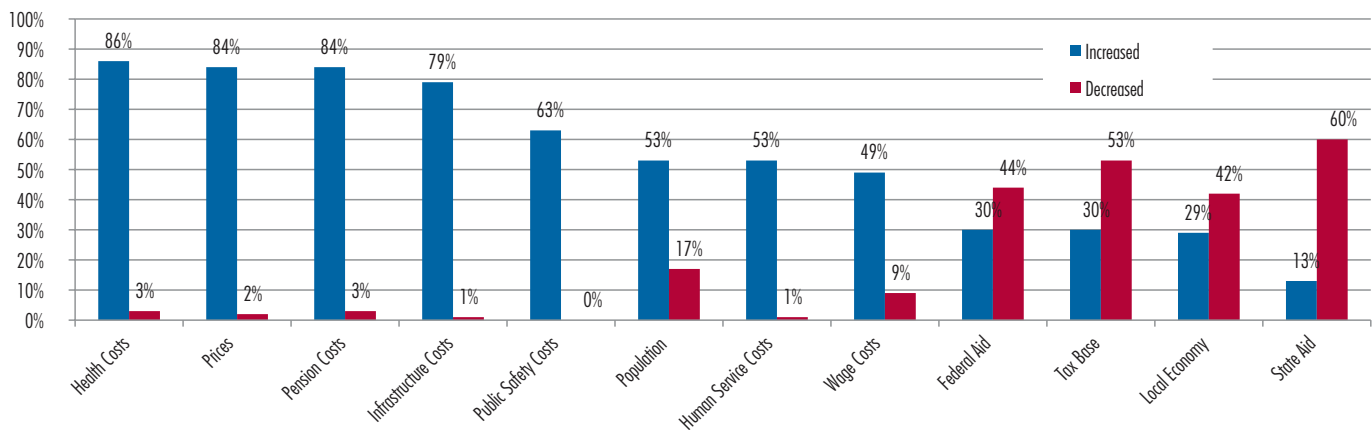


Figure 4: Change in Selected Factors in FY 2011

When asked about the positive or negative impact of each factor on city finances in 2011, at least seven in 10 city finance officers cited employee health benefit costs (82%), pension costs (80%), prices (78%) and infrastructure demands (70%) as negatively effecting city budgets. A majority of city finance officers also cited the level of state aid (58%), employee wage costs (56%) and public safety costs (54%) as having a negative influence (See Figure 5).

## REVENUE ACTIONS AND SPENDING CUTS

City finance officers were also asked about specific revenue and spending actions taken in 2011. As has been the case for much of the past two decades, regardless of the state of the economy, the most common action taken to boost city revenues has been to increase the levels of fees for services. Two in five (41%) city finance officers reported that their city has taken this step. One in four cities also increased the number of fees that are applied to city services (23%). Twenty percent of cities increased the local property tax in 2011. Since the mid-1990s, irrespective of economic conditions, the percentage of city finance officers reporting increases in property tax rates in any given year has been at about this same level. Increases in sales, income or other tax rates have been far less common, as continued to be

<sup>6</sup> The 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.

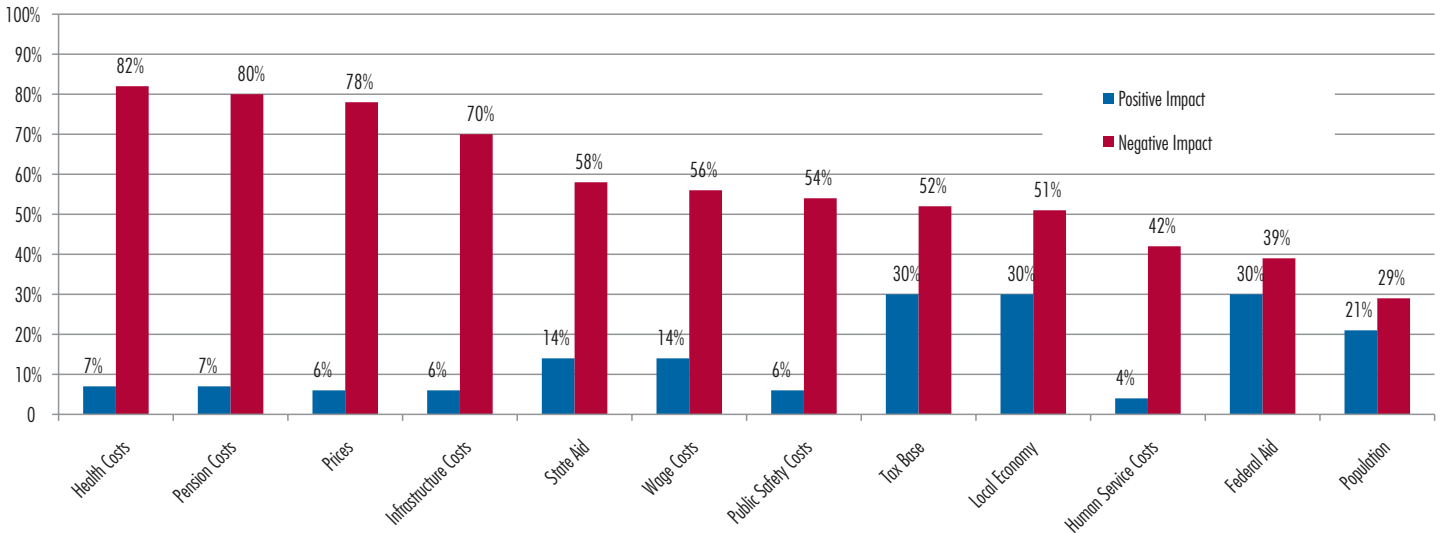


Figure 5: Impact of Selected Factors on 2011 Budgets

the case in 2011 (See Figure 6).

When asked about the most common responses to prospective shortfalls this fiscal year, by a wide margin the most common responses were instituting personnel-related cuts (72%) and delaying or cancelling capital infrastructure projects (60%). Two in five (42%) reported that their city is making cuts in services other than public safety and human-social services (services that tend to be higher in demand during economic downturns), such as public works, libraries, parks and recreation programs. One in three finance officers (36%) reported modifying health care benefits for employees (See Figure 7).

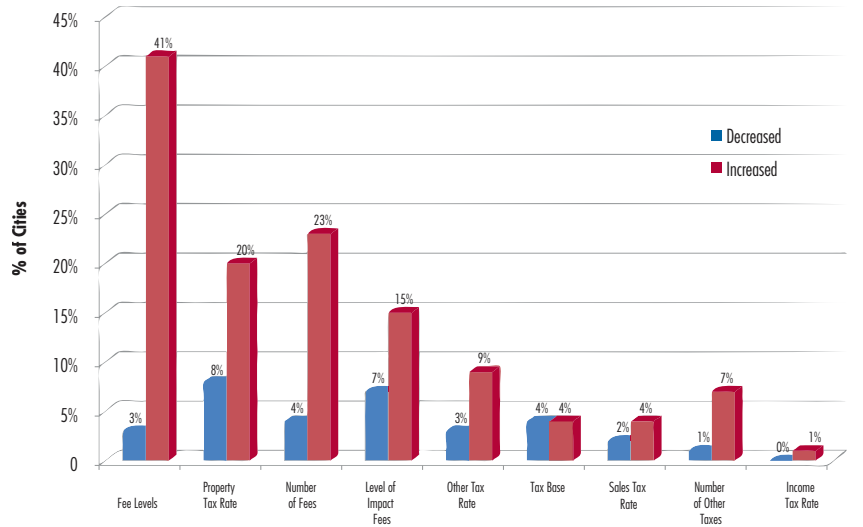


Figure 6: City Revenue Actions in 2011

The 2011 survey also asked about specific types of personnel-related cuts made in 2011 (See Figure 8). The most common cut was a

hiring freeze (68%). Half (50%) of cities reported salary or wage reductions or freezes and nearly one in three (31%) cities reported employee layoffs or reducing employee health care benefits (30%). Other personnel actions included early retirements (25%) and furloughs (19%). Many cities have used some combination of these types of actions in an effort to reduce personnel costs. The combination of these personnel-related cuts is resulting in a significant reduction in the size of local government workforces. In 2010, a separate NLC survey on local jobs projected a total reduction in city and county employment of nearly 500,000 positions from 2009 to 2011.<sup>7</sup> More recently, the U.S. Bureau of Labor Statistics' latest national unemployment numbers, as of August 2011, revealed that total local government employment in the U.S.

7 See "Local Governments Cutting Jobs and Services" (NLC, 2010) at <http://www.nlc.org/File Library/Find City Solutions/Research Innovation/Finance/local-governments-cutting-jobs-services-rpt-jul10.pdf>.

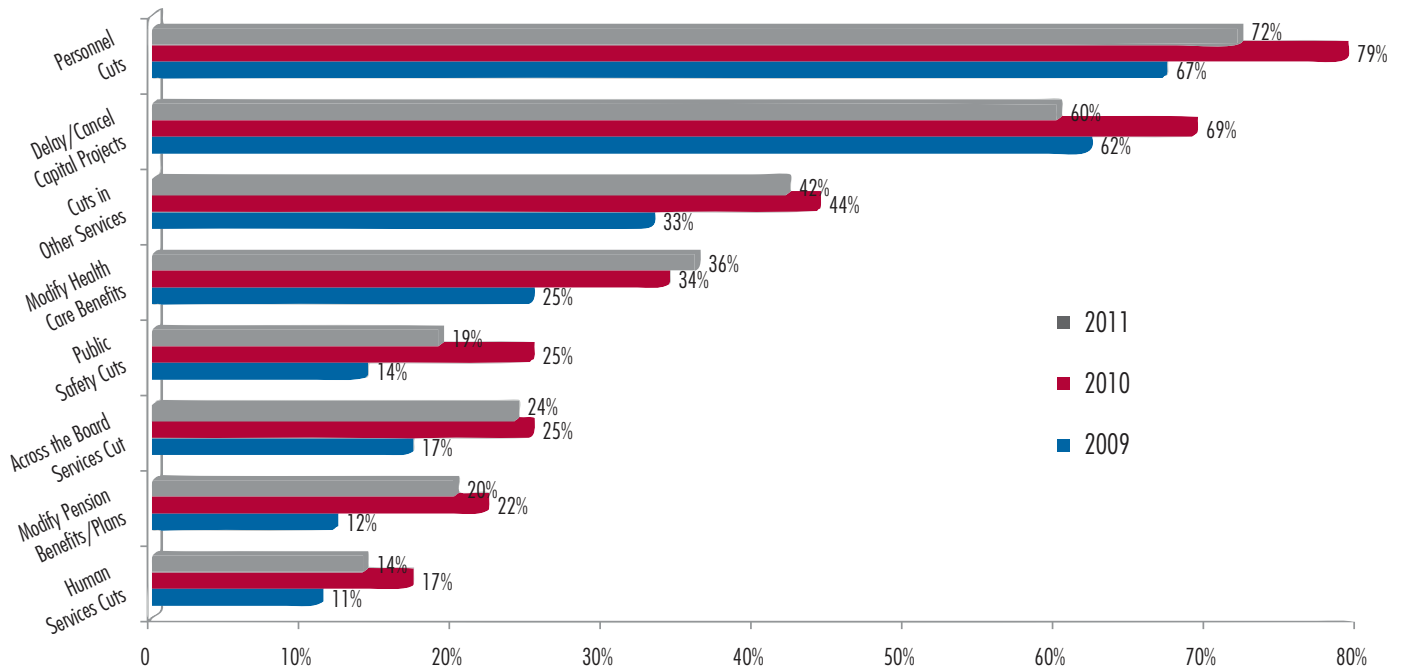


Figure 7: City Spending Actions 2009-2011

had decreased by 550,000 jobs from peak levels in 2008.<sup>8</sup>

## STATE ACTIONS

State budgets have also been confronted with several years of shortfalls and constraints. The Center on Budget and Policy Priorities reports that states are facing their fourth year in a row of budget-cutting, with the 2012 cuts being deeper than in previous years.<sup>9</sup> In many cases, the cuts that states are making reduce aid and transfers to city governments. NLC's 2011 survey asked city finance officers about the types of state actions they've encountered since 2009, including cuts in general aid (50%), cuts in state-shared and/or state-collected revenues (49%), revocation or reduction of reimbursement programs or other transfers (32%), cuts in funding for services that cities and other local governments deliver on behalf of state governments (22%) and transfer of state program responsibility (17%). Amid the politics of state budget-balancing, sometimes state actions are also taken that reduce or limit local authority (13%).

This mix of state actions taken by state leaders to balance state budgets adds to the cyclical economic pressures and constraints that cities and other local governments are confronting. Looking across state and local actions in response to fiscal stress reveals the pro-cyclical nature of state-local fiscal

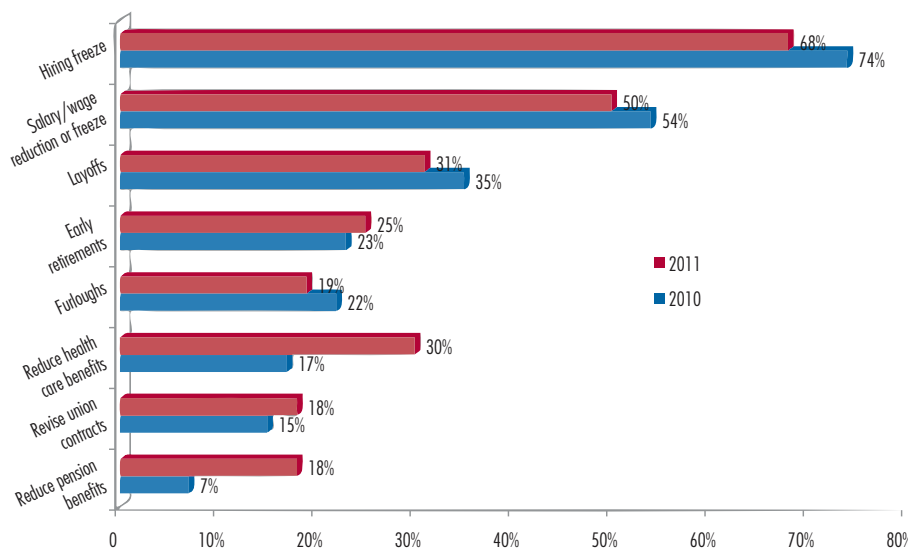


Figure 8: City Personnel-Related Cuts 2010 & 2011

<sup>8</sup> See <http://www.bls.gov/news.release/empsit.nr0.htm>.

<sup>9</sup> See <http://www.cbpp.org/cms/index.cfm?fa=view&id=3526>.

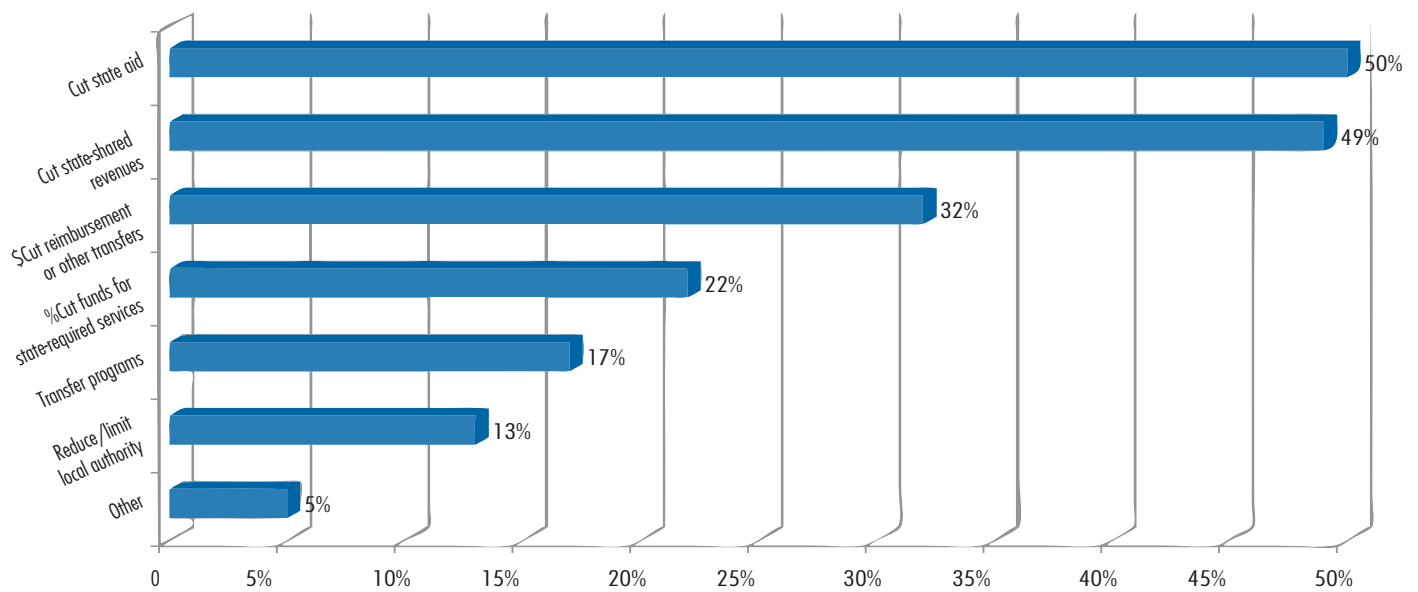


Figure 9: State Actions Since 2009

actions — that during economic downturns, the decisions that state and local leaders make to balance budgets often exacerbate the effects of the downturn for other levels of government, for jobs and for the quality of life and well-being of individuals and communities.

## ENDING BALANCES

One way that cities prepare for future fiscal challenges is to maintain adequate levels of general fund ending balances. Ending balances are similar to reserves, or what might be thought of as cities' equivalents to "rainy day funds," in that they provide a financial cushion for cities in the event of a fiscal downturn or the need for an unforeseen outlay. Unlike states' "rainy day funds," there is no trigger mechanism — such as an increase in unemployment — to force release of reserves; instead, reserves are available for spending at any time or for saving for a specific purpose. Ending balances, which are transferred forward to the next fiscal year in most cases, are maintained for many reasons. For example, cities build up healthy balances in anticipation of unpredictable events such as natural disasters and economic downturns. But ending balances are also built up deliberately, much like a personal savings account, to set aside funds for planned events such as construction of water treatment facilities or other capital projects. 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 and state aid to cities has become a smaller proportion of city revenues, cities have become more self-reliant and are much more likely to set aside funds for emergency or other purposes.

Prior to the recession, as city finances experienced sustained growth, city ending balances as a percentage of general fund expenditures reached an historical high for the NLC survey of 25 percent. However, as economic conditions have made balancing city budgets more difficult in recent years, ending balances have been increasingly utilized to help fill the gap. In 2010, cities reduced their ending balances to 17.4 percent of expenditures, and in 2011, city finance officers projected ending balances at 15.4 percent of expenditures (See Figure 10). If this projection holds, since the high point in 2008, cities will have drawn down total ending balances by nearly 40 percent (from the high of 25.2% to 2011's 15.4%).

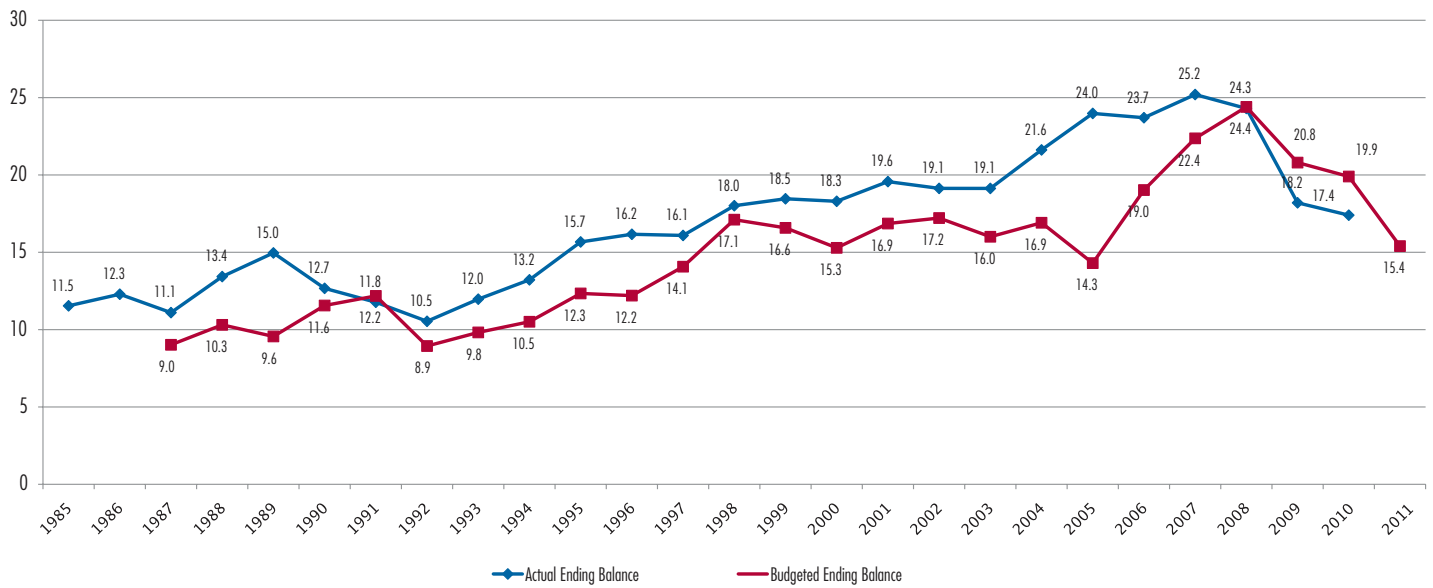


Figure 10: Ending Balances as a Percentage of Expenditures (General Fund)

## BEYOND 2011

2011 reveals a number of continuing and troubling trends for city fiscal conditions. The impacts of the economic downturn are clear in city projections for final 2011 revenues and expenditures and in the actions taken in response to changing conditions. The local sector of the economy is now fully in the midst of realizing the effects of the recession from 2007-2009 and the, to date, anemic economic recovery. The effects of depressed real estate markets, low levels of consumer confidence and high levels of unemployment will continue to play out in cities through 2011, 2012 and beyond. The fiscal realities confronting cities include a number of persistent concerns:

- Real estate markets continue to struggle and tend to be slow to recover from downturns; projections indicate a very slow recovery of real estate values, meaning that cities will be confronted with declines or slow growth in future property tax collections not just in 2011 but most likely through 2012 and 2013;
- Other economic conditions — consumer spending, unemployment and wages — are also struggling and will weigh heavily on future city sales and income tax revenues;
- Large state government budget shortfalls in 2011 and 2012 will likely be resolved through cuts in aid and transfers to many local governments;
- Two 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 and pensions. Underfunded pension and health care liabilities will persist as a challenge to city budgets for years to come; and
- Facing revenue and spending pressures, cities are likely to continue to make cuts in personnel and services, and to draw down ending balances in order to balance budgets.

## THE LAG BETWEEN ECONOMIC & CITY FISCAL CONDITIONS

We often refer to the lag between changes in the economic cycle and the impact on city fiscal conditions.

What does this mean? The lag refers to the gap between when economic conditions change and when those conditions have an impact on reported city revenue collections. In fact, cities likely feel the impacts of changing economic conditions sooner. However, because reporting of city fiscal conditions occurs, in most cases, on an annual basis, whether through annual budget reporting or NLC's annual survey, those impacts tend to not become evident until some point after the changes have started.

How long is the lag? The lag is typically anywhere from 18 months to several years, and it is related in large part to the timing of property tax collections. Property tax bills represent the value of the property in some previous year, when the last assessment of the value of the property was conducted. A downturn in real estate prices may not be noticed for one to several years after the downturn began, because property tax assessment cycles vary across jurisdictions: some reassess property annually, while others reassess every few years. Consequently, property tax collections, as reflected in property tax assessments, lag economic changes (both positive and negative) by some period of time. Sales and income tax collections also exhibit lags due to collection and administration issues, but typically no more than a few months.

Figure 2 shows year-to-year change in city general fund revenues and expenditures. It also includes markers for the official U.S. recessions from 1991, 2001 and 2007-2009, with low points, or "troughs," occurring in March 1991, November 2001 and June 2009, respectively, according to the National Bureau of Economic Research (NBER). Comparing the dates of the recessions to the low point of city revenue and expenditures as reported in NLC's annual survey (typically conducted between April and June of every year), we see that the low point for city revenues and expenditures after the 1991 recession occurred in 1993, approximately two years after the trough of the U.S. economic recession (March 1991 to March 1993). After the 2001 recession, the low point for city revenues and expenditures occurred in 2003, approximately 18 months after the trough of the U.S. economic recession (November 2001-April 2003). Our reporting on this lag is dependent upon when the annual NLC survey is conducted, meaning that there is some degree of error in the length of the lag — for instance, had the survey been conducted in November of 1992, rather than April of 1993, we might have seen the effects of changing economic conditions earlier. Nevertheless, the evidence suggests that the effects of changing economic conditions tend to take 18-24 months to be reflected in city budgets.

## ABOUT THE SURVEY

The City Fiscal Conditions Survey is a national mail and email survey of finance officers in U.S. cities. Surveys were mailed and emailed 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 2011. The 2011 survey data are drawn from 272 responding cities, for a response rate of 26 percent. The responses received allow us to generalize about all cities with populations of 10,000 or more.

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

CATEGORIES	NUMBER OF SURVEYS SENT	NUMBER RETURNED	RESPONSERATE
<b>TOTAL</b>	<b>1055</b>	<b>272</b>	<b>25.8%</b>
<b>POPULATION</b>			
>300,000	59	36	61.0%
100,000-299,999	179	64	35.8%
50,000-99,999	315	90	28.6%
10,000-49,999	502	82	16.3%
<b>TAX AUTHORITY</b>			
Property	384	82	21.4%
Sales & Property	534	165	31.0%
Income & Property	110	25	22.7%

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.<sup>10</sup>

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, the 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 2010, the year prior (FY 2009) and the budgeted (estimated) amounts for the current fiscal year (FY 2011).

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.

<sup>10</sup> For more information on differences in state and local fiscal structure see "Cities and State Fiscal Structure," (NLC, 2008) at <http://www.nlc.org/File Library/Find City Solutions/Research Innovation/Finance/cities-state-fiscal-structure-2008-rpt.pdf>.

## ABOUT THE NATIONAL LEAGUE OF CITIES

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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 1,600 member cities and the 49 state municipal leagues, representing 19,000 cities and towns and more than 218 million Americans. Through its **Center for Research and Innovation**, NLC provides research and analysis on key topics and trends important to cities, creative solutions to improve the quality of life in communities, inspiration and ideas for local officials to use in tackling tough issues and opportunities for city leaders to connect with peers, share experiences and learn about innovative approaches in cities.

## ABOUT THE AUTHORS

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