Research Brief on America's Cities

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City Fiscal Conditions in 2008

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Confronted with declining economic conditions driven by downturns in housing, consumer spending, and jobs and income, city finance officers report that the fiscal condition of the nation's cities has weakened dramatically in 2008.[2] Among the findings of the National League of Cities' latest annual survey of city finance officers are:

- Two in three city finance officers (64%) report that their cities are less able to meet fiscal needs in 2008 than in the previous year;
- Final tallies for 2007 reveal that city revenues, when accounting for inflationary factors, remained flat (growth of 0.1%), while spending increased by 3.0%;
- As finance officers look to the close of 2008, they predict that revenues and spending will decline in inflation-adjusted terms, with revenues decreasing by 4.3% and spending decreasing by 1.5%;
- Property tax revenues increased by 6.3% in 2007, but are predicted to decline by 3.6% by the close of 2008;
- Spending pressures stem from rising costs, such as energy and fuel prices, public safety and infrastructure needs, and employee-related costs for health care, pensions, and wages;
- To balance annual budgets and meet ongoing spending needs, many cities are increasing fees and charges for services; and,
- Ending balances, or "reserves," remain at high levels and will provide a buffer against the current downturn.

Ability to Meet Fiscal Needs

In 2008, nearly two in three (64%) city finance officers report that their cities are less able to meet fiscal needs than in 2007. City finance officers' assessment of their cities' fiscal conditions in 2008 has decreased significantly from their 2007 assessment, when 70 percent of city finance officers said their cities were better able to meet fiscal needs than in 2006. Pessimism about the ability to meet city fiscal needs in 2008 is similar to levels reported during previous periods of economic decline from 2002-04 and 1990-93 period.

Finance officers in cities that are reliant upon property taxes are more likely to say that their cities are less able to meet fiscal needs in 2008 (75%) than finance officers in cities reliant upon sales taxes (52%) or income taxes (60%). City

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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.

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 23nd edition of the survey, which began in 1985.

National League of Cities

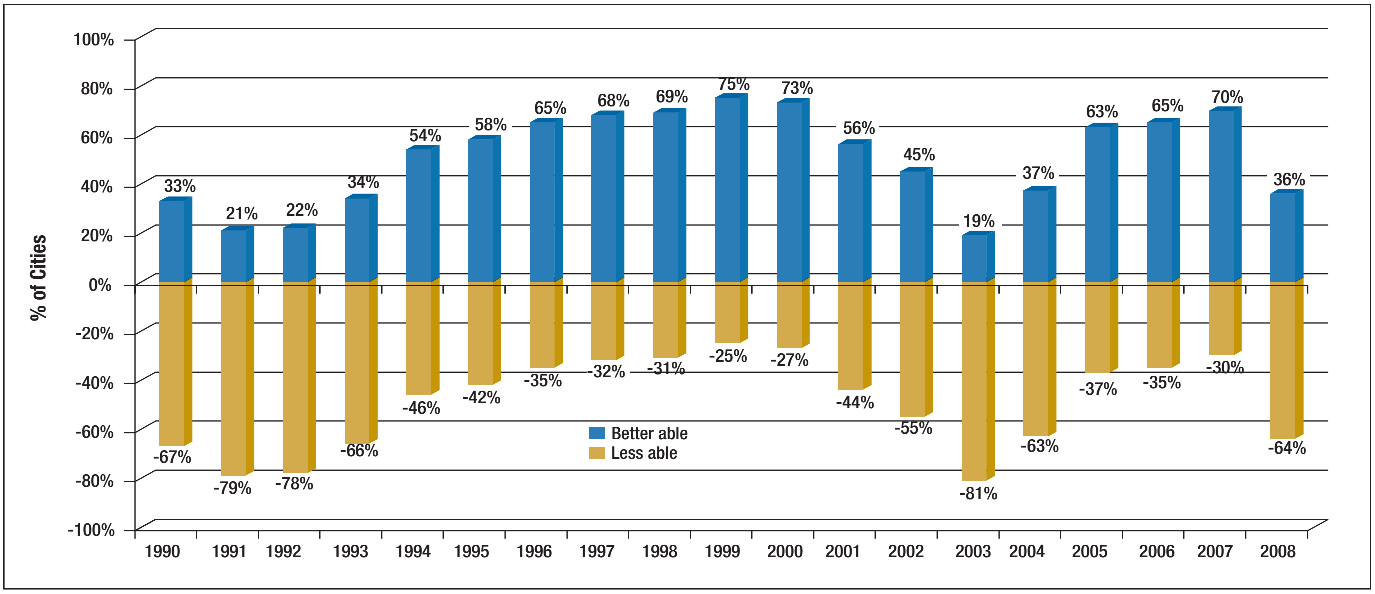


FIGURE 1
Percent of Cities that Are "Better Able/Less Able" to meet Financial Needs in FY 2008

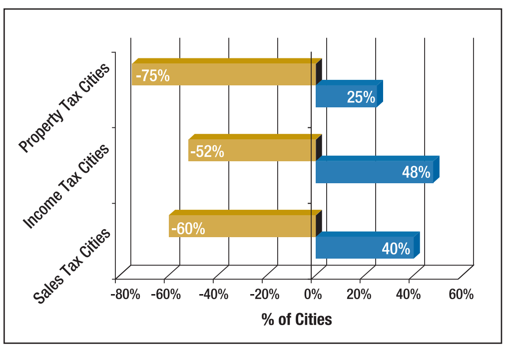


FIGURE 1A
By Taxing Authority

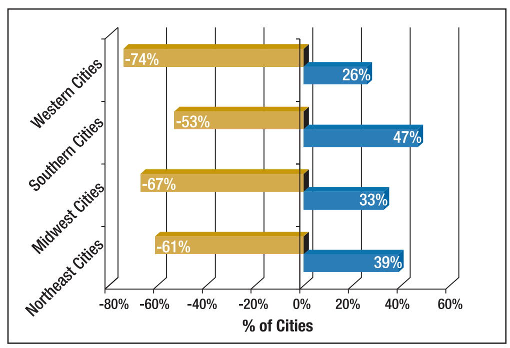


FIGURE 1B
By Region

finance officers in the West (74%) are most likely to say that their cities are worse off in 2008, compared to cities in the Midwest (67%), Northeast (61%), and South (53%).[3] Approximately two in three finance officers in cities with populations greater than 300,000 (69%), between 100,000-299,999 (68%), and between 50,000-99,999 (65%) report lessening ability to meet fiscal needs. Three in five (60%) finance officers in cities with populations below 50,000 say they are less able to meet needs.

Revenue and Spending Trends

Cities closed the books on 2007 with solid growth in year-to-year general fund revenues, but that growth was eroded by the influence of inflationary factors in the state and local government sector.[4]

In current dollars, not adjusted for inflation, the year-to-year change in general fund revenues in 2007 was 4.5% over 2006 revenues. Looking to the close of 2008, city finance officers are expecting year-to-year revenue growth to slow to 1.1%.

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.

4 The General Fund is the largest and most common fund of all cities, accounting for approximately two-thirds of city revenues across the municipal sector.

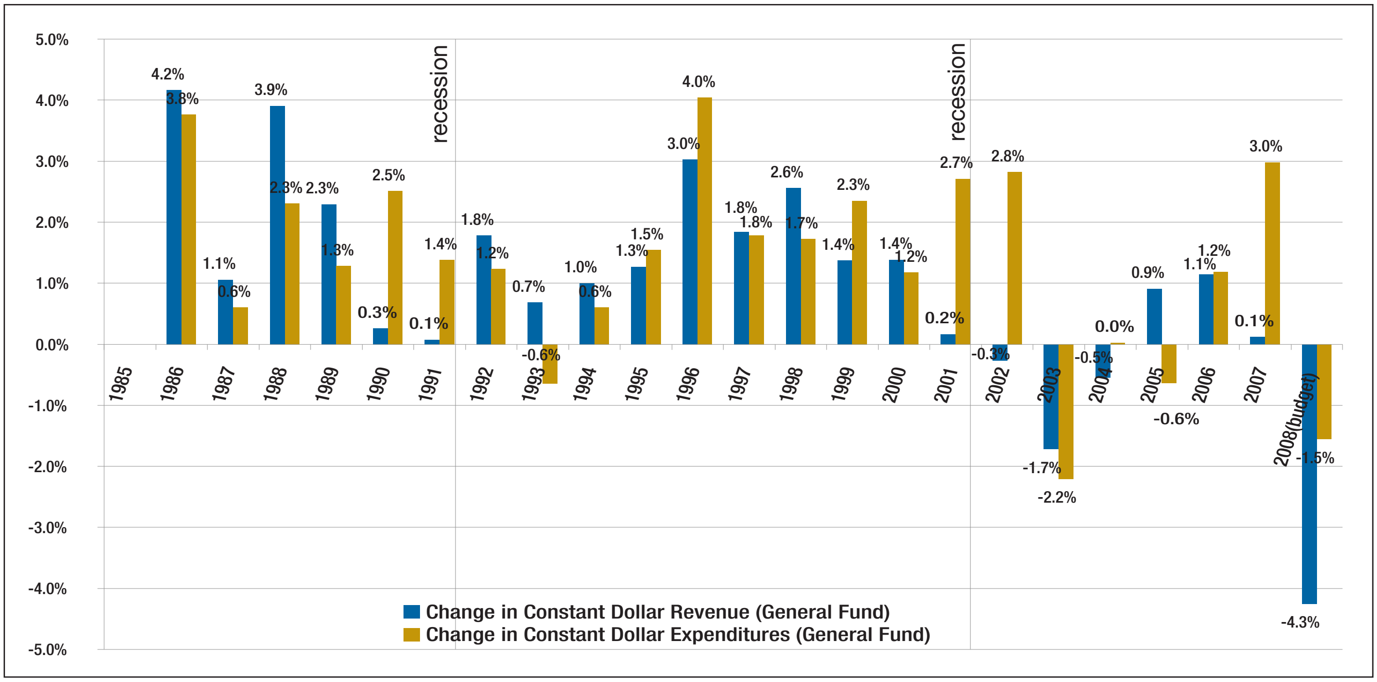


FIGURE 2
Year-to-Year Change in General Fund Revenues and Expenditures (Constant dollars)

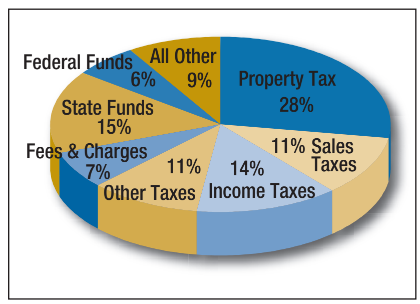


FIGURE 3
Municipal General Fund Revenue Composition

While the 2007 current-dollar revenue results suggest a positive picture of city finances, the purchasing power of city revenues was actually smaller than it appears. When adjusting for inflationary factors, the constant dollar, year-to-year increase in city revenues from 2006 to 2007 was 0.1%.[5] The 2007 level represents the fifth year in a row that city revenues increased at relatively slow rates, or actually declined, from one year to the next. For 2008, city finance officers project that general fund revenue growth will decline at a more significant level – by 4.3% in constant dollars.

Current-dollar growth in city spending for 2007 was 7.4%, resulting in actual year-to-year growth in constant-dollar spending of 3.0%. Yet, projected spending growth for 2008 is 3.8% over 2007 levels in current dollars, or in constant-dollar terms, spending levels are projected to actually decrease by 1.5%.

Taken together, city finance officers' projections for 2008 revenue and spending point to a budget gap of 2.8% (4.3% decrease in revenues and a 1.5% decrease in spending) in constant dollars. Since city governments are required to balance their budgets under state law, this budget gap suggests that many city governments are confronted with decisions in 2008 about raising revenues, reducing spending, or dipping into their reserves.

Tax Revenues and the Economy

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 and the connections to broader economic conditions. [6]

5 "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.

6 For more information on variation in local and state tax structures, see Cities and State Fiscal Structure, NLC (2008) at http://www.nlc.org/resources_for_cities/publications/1637.aspx.

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 in the market. As a result, current property tax bills and property tax collections typically reflect values of property from eighteen months to two years ago.

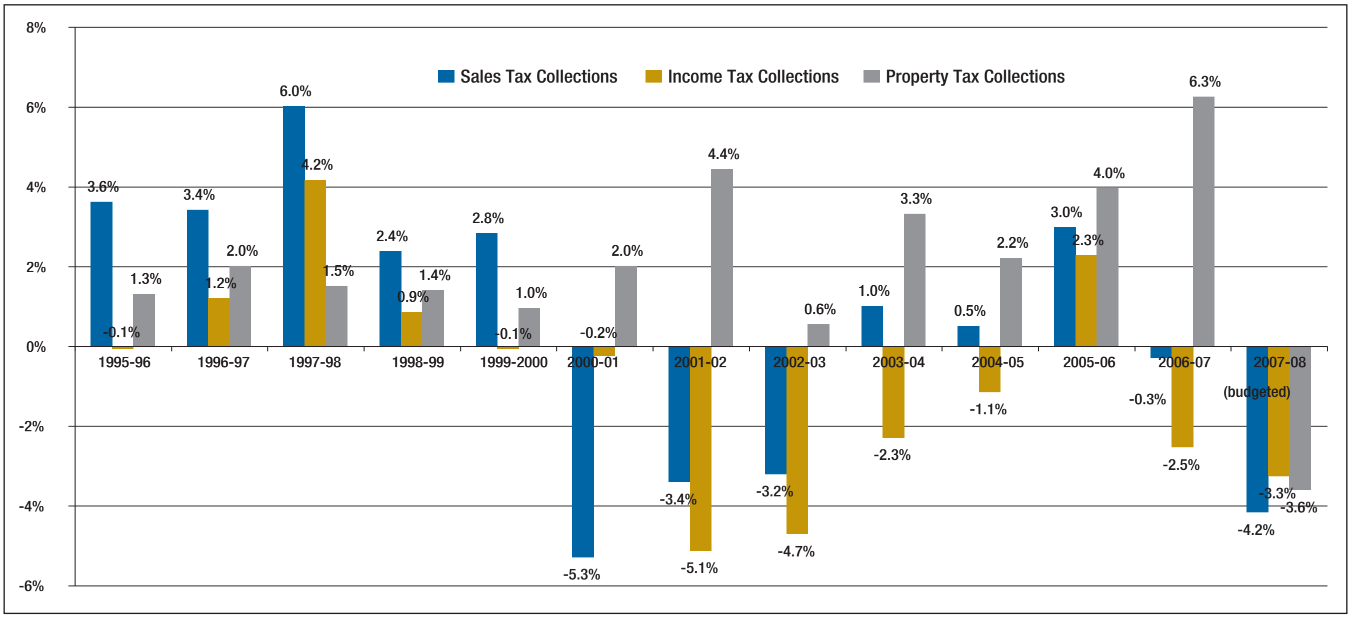


FIGURE 4
Year-to-Year Change in General Fund Tax Receipts (Constant Dollars)

The effects of the well-publicized downturn in the real estate market over the past year are becoming increasingly evident in city property tax revenues. Collections for 2007 revealed strong revenue growth as assessments caught up with the previous growth in the real estate market. Property tax revenues increased in 2007 by 10.7% compared to 2006 levels, or in constant dollars, an increase of 6.3%. Projected property tax collections for 2008, however, point to the impact of the downturn in real estate values. Property tax revenues for 2008 are projected to grow in current dollars by 1.8%, which amounts to an actual decline of 3.6% in constant-dollar terms.

The projected decline in property tax revenues in 2008 is noteworthy because it represents evidence of the impact of the subprime and housing finance problem and declining real estate values. The survey asked finance officers for information on the number of foreclosures in cities for each year from 2006 to 2008. Many cities do not have this information readily available because the information is collected by another level of government (counties, for instance) or because they have not tracked this information in the past. Forty cities responded with information for the period in question. For these 40 cities, the number of foreclosures increased by 60% from 2006 to 2008. While the response rate makes generalizing about these results difficult, the stark increase in foreclosures in these 40 communities provides a snapshot of the difficulties facing cities on the housing front during this period.

Looking forward, it is likely that the full effects of changing housing conditions will not be felt by cities for another six to twelve months (as the subprime impact on city finances began to be experienced approximately 12 months ago) and that the negative impact on property tax revenues will continue through 2009-10 as property tax assessments and revenues catch up to changes in the market.

Changes in economic conditions are also evident in terms of changes in city sales tax collections. When consumer confidence is high, people spend more 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. Evidence of the struggling economy and the declining real estate market can now be seen in lower levels of consumer confidence, resulting in less consumer spending and, as a result, slower growth or decline in sales tax revenues. City sales tax receipts improved in 2007 over previous year receipts by 4.1% in current dollars or a slight decline of 0.3% in constant dollars. Projections for 2008 are for only 1.2% current-dollar growth, which represents a decline of 4.2% in constant dollars.

City income tax receipts have been fairly flat, or have declined, for most of the past decade in constant dollars. Income tax revenues are driven primarily by income and wages. The lack of growth in these revenues suggests that 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. In current dollars, 2007 city income tax revenues increased by 1.9% (a decline of 2.5% in constant dollars). Projections for 2008 are for current dollar growth of 2.1%, or constant-dollar decline of 3.3%.

City finance officers are therefore predicting a decline in all three major sources of tax revenue for cities in 2008. With national economic indicators pointing to continued struggles, the impacts of those economic conditions on local revenue sources, and the lag between declining economic conditions and local revenue impacts, all indications point to worsening city fiscal conditions in 2009 and 2010.

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.[7] Respondents were asked whether each of the factors had *increased* or *decreased* between 2007 (regardless of fiscal impact) and 2008 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 is prices and inflation (98%), such as energy and fuel prices that impact the cost of delivering city services. Infrastructure (85%) and public safety (83%) are specific service needs noted as increasing. Employee-rated costs, including wages (95%), health benefit costs (86%) and pensions (79%) also increased over the previous year.

7 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.

Leading factors that city finance officers report to have decreased are the health of the local economy (52%), the amount of federal aid (40%) and the amount of state aid (35%).

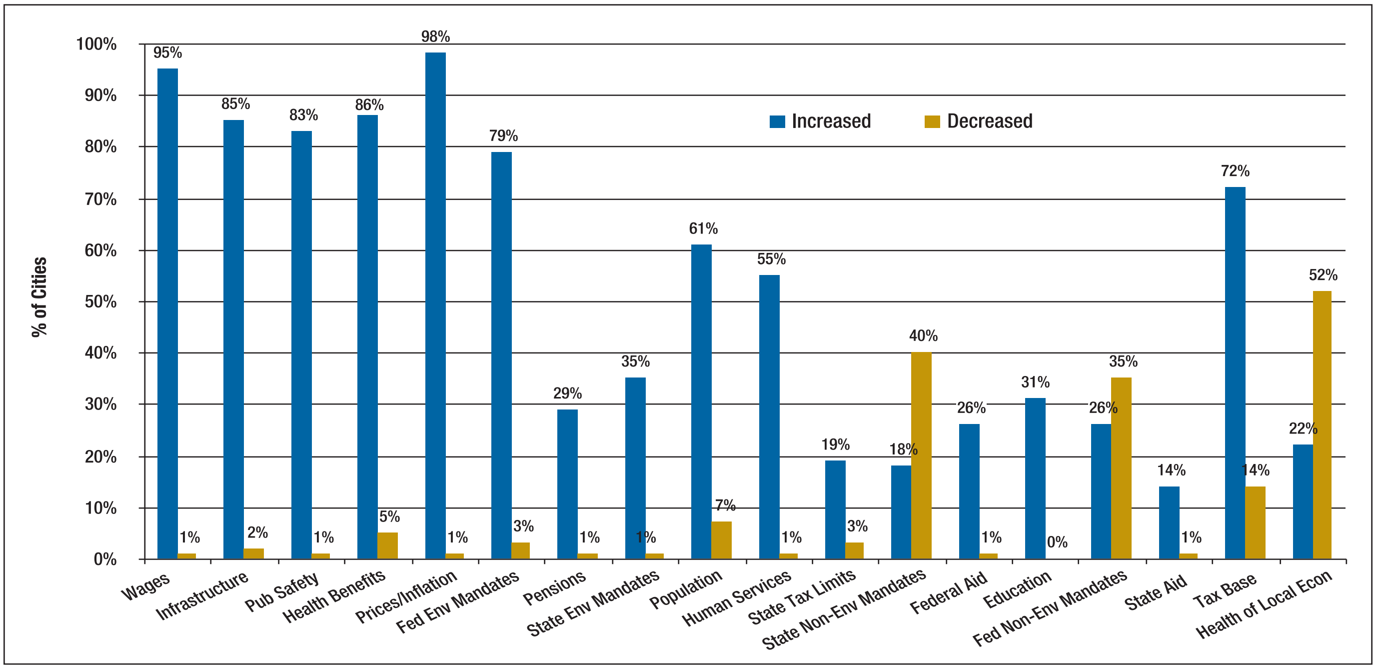
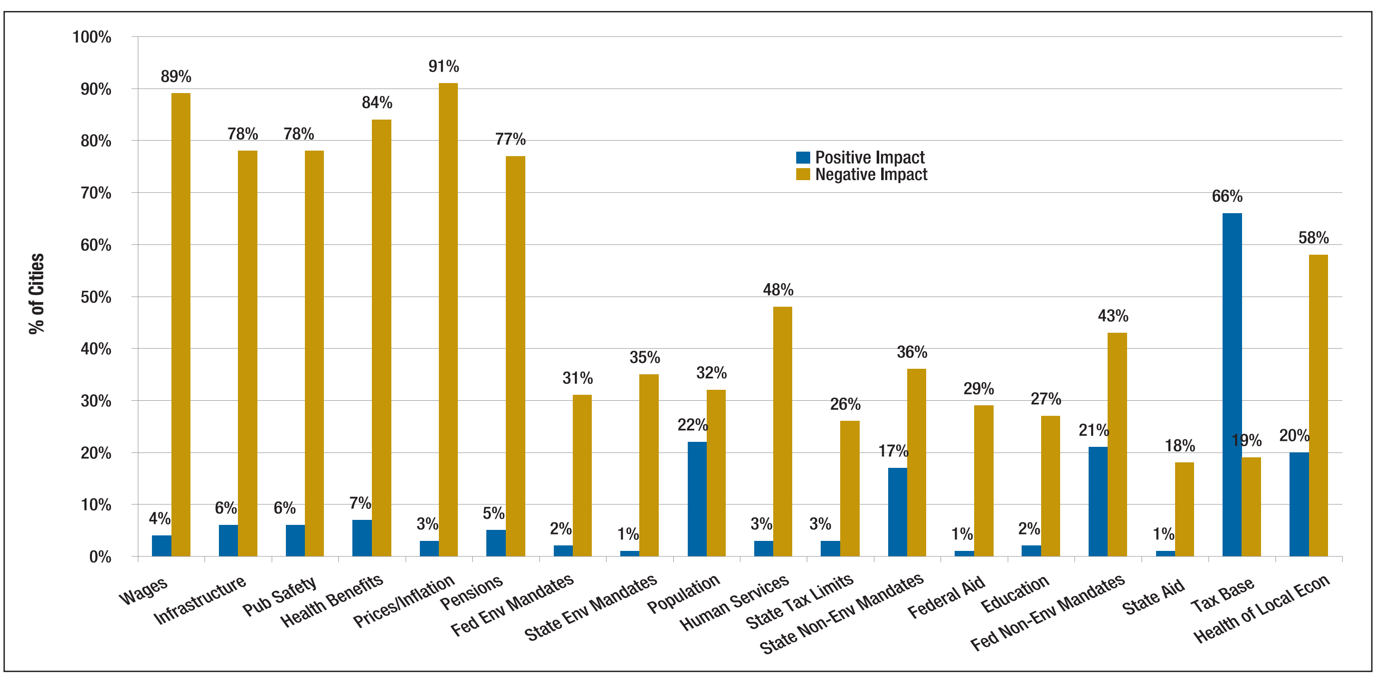


Figure 5
Change in Selected Factors From FY 2007

When asked about the *positive* or *negative impact* of each factor on city finances in 2008, nine in ten city finance officers cite prices and inflation (91%) as having a negative impact, with infrastructure (78%) and public safety (78%) again leading the way in terms of service needs. Employee-related costs for wages (89%), health benefits (84%) and pensions (77%) are also frequently cited by city finance officers as negatively impacting city budgets. Nearly six in ten (58%) report that the health of the local economy is having a negative impact on city finances.

Figure 6
Impact of Selected Factors on FY 2008 Budgets & Ability to Meet Cities' Overall Needs



When city officials were asked to identify three items that are having "the most negative impact" on their ability to meet city needs, the top vote-getters are the costs of city workers' health benefits (cited by 54% of city finance officers), employee wages (42%), and infrastructure (34%) and public safety (32%) needs.

Fiscal Actions

City finance officers were also asked about specific revenue and spending actions taken in 2008.

The most common action taken to boost city revenues during 2008 has been to increase the levels of fees for services. Half (49%) of the responding city finance officers report that their city has taken this step. One in four cities also increased the number of fees (28%) or the level of impact and development fees (23%).

City finance officers are equally likely to report increases (24%) and decreases (24%) in city property tax rates. Increases in sales tax rates (5%), income tax rates (0%), and other tax rates (8%) are less common.

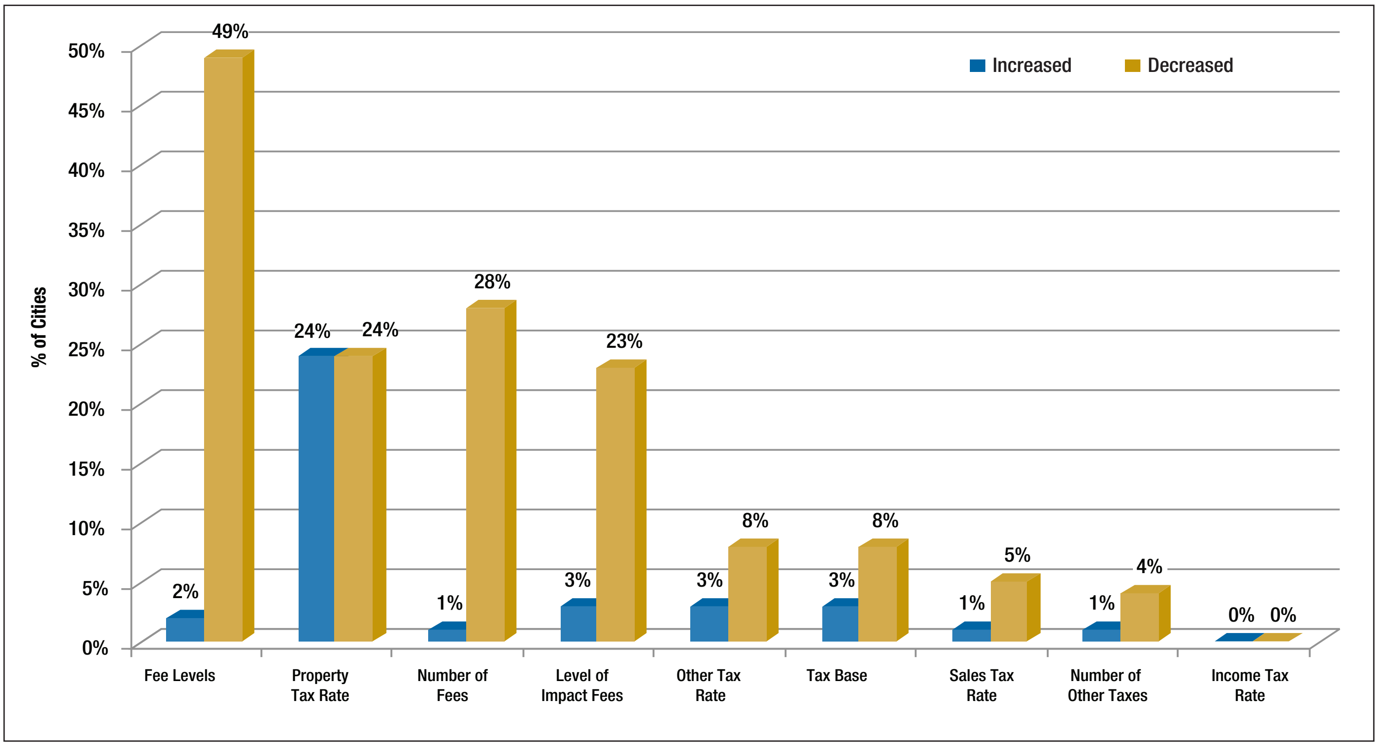


FIGURE 7
Revenue Actions in 2008

On the spending side, three in four (73%) city finance officers report increases in public safety spending in 2008, 52 percent report increases in infrastructure/capital spending, and 35 percent report increases in human service spending. Forty-two percent say that their cities' general operating spending has increased and 33 percent cite increases in spending on the municipal workforce.

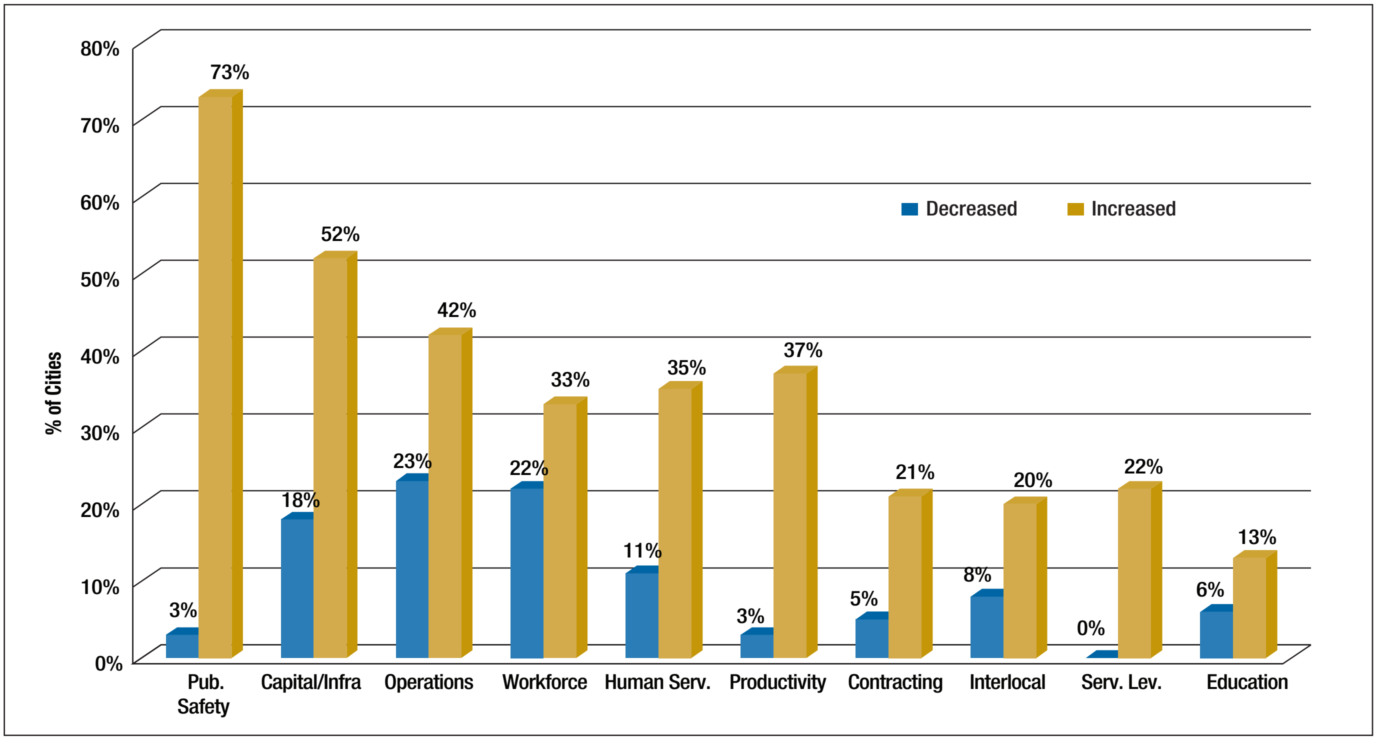


FIGURE 8
Expenditure Actions in 2008

Ending Balances

One way that cities prepare for future fiscal challenges is to maintain high levels of general fund ending balances, or what are often referred to as "reserves." Ending balances are similar to states' "rainy day funds" in that they provide a financial cushion for cities, but unlike states' rainy day funds, there is typically no 'trigger' for the automatic disbursement of the reserves. Despite recent cyclical changes in economic and fiscal conditions, city ending balances have grown in recent years. In 2007, as cities began preparing for the coming downturn, city ending balances, as a percentage of general fund expenditures, reached an historical high for the NLC survey of 28 percent. City finance officers budgeted ending balances for 2008 at just over 24 percent of general fund expenditures.

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 they 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 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 likely to set aside funds for emergency or other purposes.

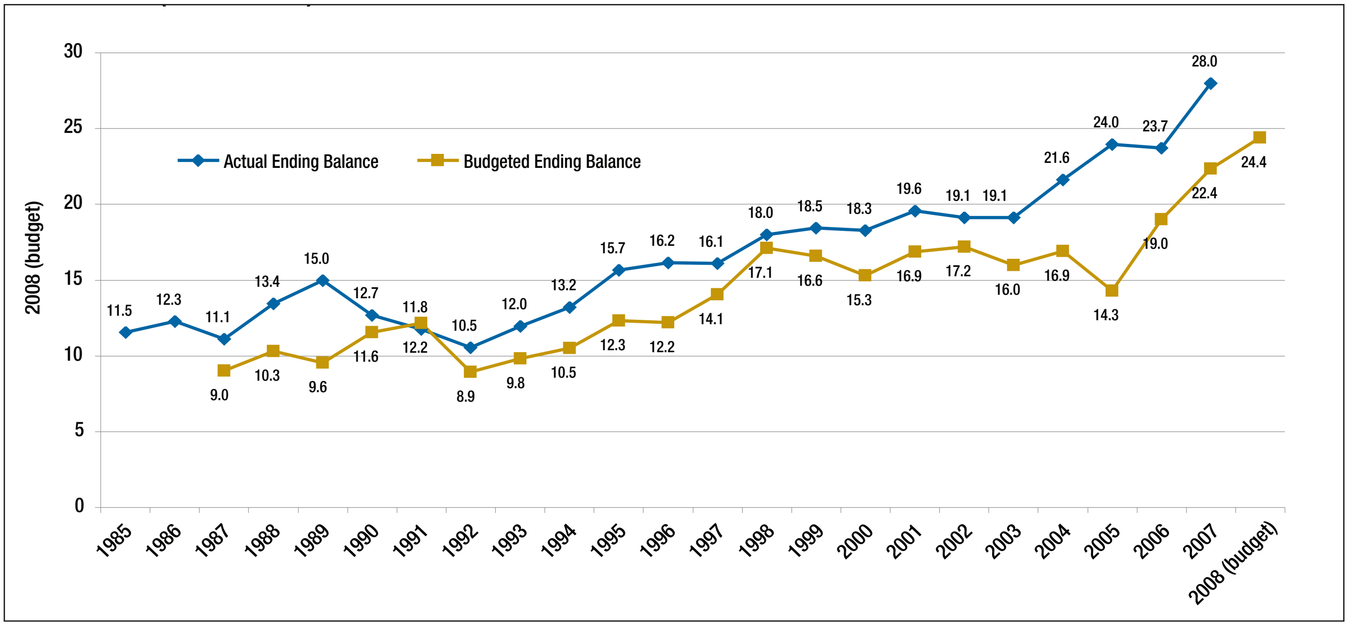


FIGURE 9
Ending Balances as a Percentage of Expenditures (General Fund)

Looking to 2009-10

2008 represents a critical marker in city fiscal conditions. The impacts of the current economic downturn are evident in city finance officers' assessments of their ability to meet fiscal needs, in projections for 2008 revenues, and in the actions taken in response to changing conditions. Since city fiscal conditions tend to lag national economic conditions, the effects of a declining real estate market that most experts think has yet to hit bottom, low levels of consumer confidence, and little growth in jobs, wages, and income will likely play out in cities well into future years. National economic forecasts are not projecting immediate and substantial improvements in the nation's economic conditions, meaning that the nation's cities will most likely still be realizing the effects of the current downturn in 2009 and 2010.

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

- City tax bases and collections for 2008 are declining and inflationary factors, such as energy and fuel prices, will continue to increase costs and reduce the purchasing power of city revenues.
- The real estate market tends to be slow to recover from downturns, meaning that a rapid rebound in property tax revenues in the future cannot be expected in the next few years.
- Other economic conditions – consumer spending, jobs, and income growth – are also struggling and will weigh heavily on future city revenues.
- Federal and state budget difficulties mean that additional aid to local governments is unlikely.
- 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.

- Facing revenue and spending pressures, cities are likely to tap into ending balance levels that are at historically high levels.
- Public reactions to declining economic conditions often are manifested in increased resistance to government taxes and spending, often limiting the tools available to public officials to offset declining fiscal conditions.

Amid these concerns, it is not surprising that four in five (79%) city finance officers forecast that their cities will be less able to meet needs in 2009 than in 2008. The economic downturn will continue to translate into reduced city revenues, while demand for services and increases in costs will continue to put pressure on the spending side of the ledger.

The fiscal health of the nation's cities represents more bad news for the national economy. With state fiscal and economic conditions also struggling, the state-local sector of the economy, representing 13 percent of U.S. gross domestic product (GDP), is now in the midst of a downturn.

Faced with these pressures, local, state, and federal leaders will need to work together to ensure that their responses help to stabilize the economy and do not exacerbate the difficult conditions already confronting the nation's leaders.

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 2008. The 2008 survey data are drawn from 319 responding city finance officers, for a response rate of 30.2%. 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	27	45.8%
100,000-299,999	179	68	38.0%
50,000-99,999	315	99	31.4%
10,000-49,999	502	125	24.9%
Region			
Northeast	222	33	14.9%
Midwest	302	75	24.8%
South	277	108	39.0%
West	254	103	40.6%
Tax Authority			
Property	384	95	24.7%
Sales & Property	534	201	37.6%
Income & Property	110	23	37.6%

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. For more information on differences in state-local fiscal structure, see *Cities and State Fiscal Structure* (NLC 2008) at www.nlc.org.

The dollar amounts presented in this report are in either current or constant dollars. Constant dollars are adjusted 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 2007, the year prior (FY 2006), and the budgeted (estimated) amounts for the current fiscal year (FY 2008).

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.

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 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 to occur.

How long is the lag? The lag is typically anywhere from eighteen months to two years and it's related in large part to the lag in property tax collections. Because property tax bills usually refer to the value of the property in the previous year, a downturn in real estate prices may not be noticed until one to two years after the downturn began. Moreover, property tax assessment practices are not uniform and are also not annual. Consequently, property tax collections, as reflected in property tax assessments, lag economic changes (both positive and negative) by some period of time. Figure 2 (pg. 3), which shows year-to-year change in city general fund revenues and expenditures, also includes markers for the official U.S. recessions that occurred in 1991, with a low point, or "trough" in March 1991, and 2001, with a trough of November 2001 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 March 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 eighteen 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 picked the effects of changing economic conditions earlier. Nevertheless, our point, that the evidence of the effects of changing economic conditions tend to take 18-24 months to become evident, is borne out by the available data.

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.

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