

City Fiscal Conditions in 2010

The nation's city finance officers report that the fiscal condition of the nation's cities continues to weaken in 2010 as cities confront the effects of the economic downturn.² 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 cutting personnel, infrastructure investments and key services. Findings from the National League of Cities' latest annual survey of city finance officers include:

- Nearly nine in ten city finance officers report that their cities are less able to meet fiscal needs in 2010 than in the previous year;
- As finance officers look to the close of 2010, they report declining revenues and spending cutbacks in response to the economic downturn;
- Property tax revenues are beginning to decline in 2010, after years of annual growth, reflecting the gradual, but inevitable, impact of housing market declines in recent years;
- City sales tax revenues declined dramatically in 2009 and are declining further in 2010;
- Fiscal pressures confronting cities include declining local economic health, public safety and infrastructure costs, employee-related costs for health care, pensions, and wages, and cuts in state aid;
- To cover budget shortfalls and balance annual budgets, cities are making a variety of personnel cuts, delaying or cancelling infrastructure projects, and cutting basic city services; and,
- Ending balances, or "reserves," while still at high levels, decreased for the second year in a row as cities used these balances to weather the effects of the downturn.

MEETING FISCAL NEEDS

In 2010, nearly nine in ten (87%) city finance officers report that their cities are less able to meet fiscal needs than in 2009 (See Figure 1). City finance officers' assessment of their cities' fiscal conditions in 2010 is essentially at the same level as their 2009 assessment, when 88 percent of city finance officers said their cities were less able to meet fiscal needs than in 2008. Concern about cities' fiscal health remains at the highest level in the history of NLC's 25-year survey. Finance officers in cities that rely upon property taxes and sales taxes – the two most common local tax sources – are equally likely to say that their cities are less able to meet fiscal needs in 2010

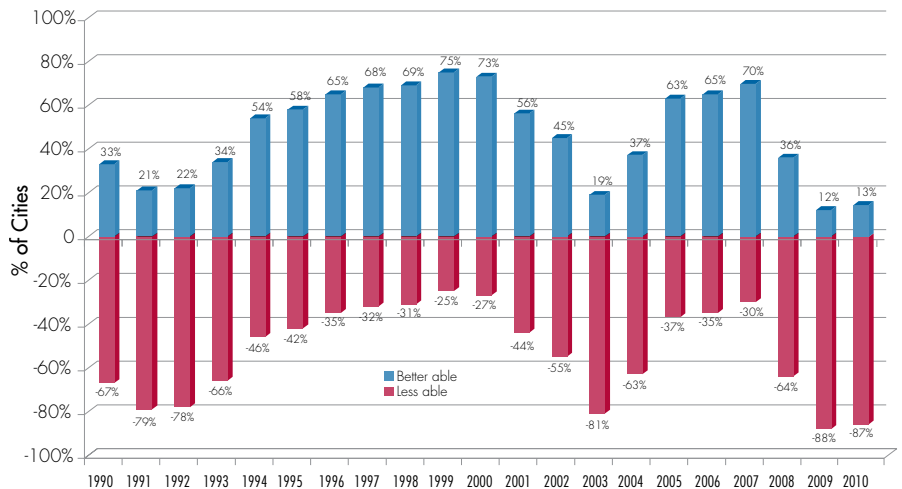


Figure 1: Percent of Cities "Better Able/Less Able" to Meet Financial Needs in FY 2010

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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 and online survey of finance officers in U.S. cities conducted in the spring-summer of each year. This is the 25th edition of the survey, which began in 1986.

(See Figure 1A). Finance officers in the West are slightly more likely to say that their cities are worse off in 2010 than finance officers in cities in other regions (See Figure 1B).³ Relatively similar levels of concern were expressed across cities of varying sizes.

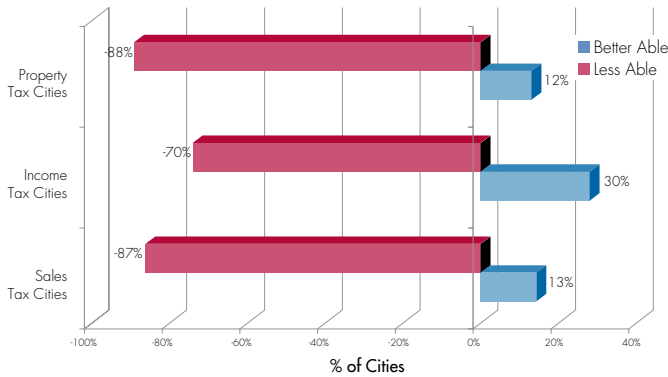


Figure 1A: Percent of Cities “Better Able/Less Able” to Meet Financial Needs in FY 2010 by Tax Authority

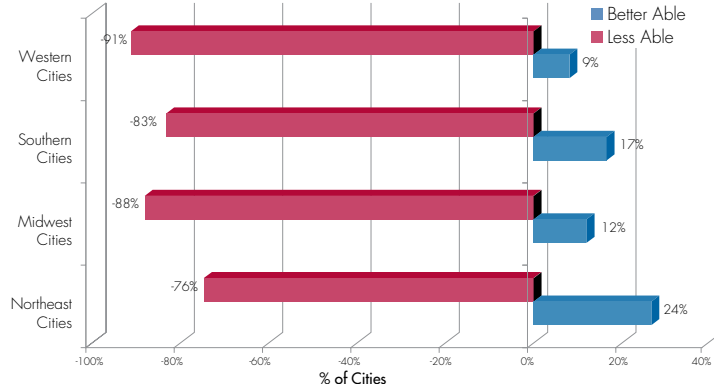


Figure 1B: Percent of Cities “Better Able/Less Able” To Meet Financial Needs in FY 2010, by Region

REVENUE AND SPENDING TRENDS

Cities ended fiscal year 2009 with year-to-year general fund expenditures outpacing general fund revenues.⁴ In constant dollars (adjusted to account for inflationary factors in the state-local sector), general fund revenues in 2009 declined -2.5% over 2008 revenues, while expenditures increased marginally by 0.7%.⁵ Looking to the close of 2010, city finance officers project that general fund revenues will decline by -3.2% and expenditures will decline by -2.3% (See Figure 2).

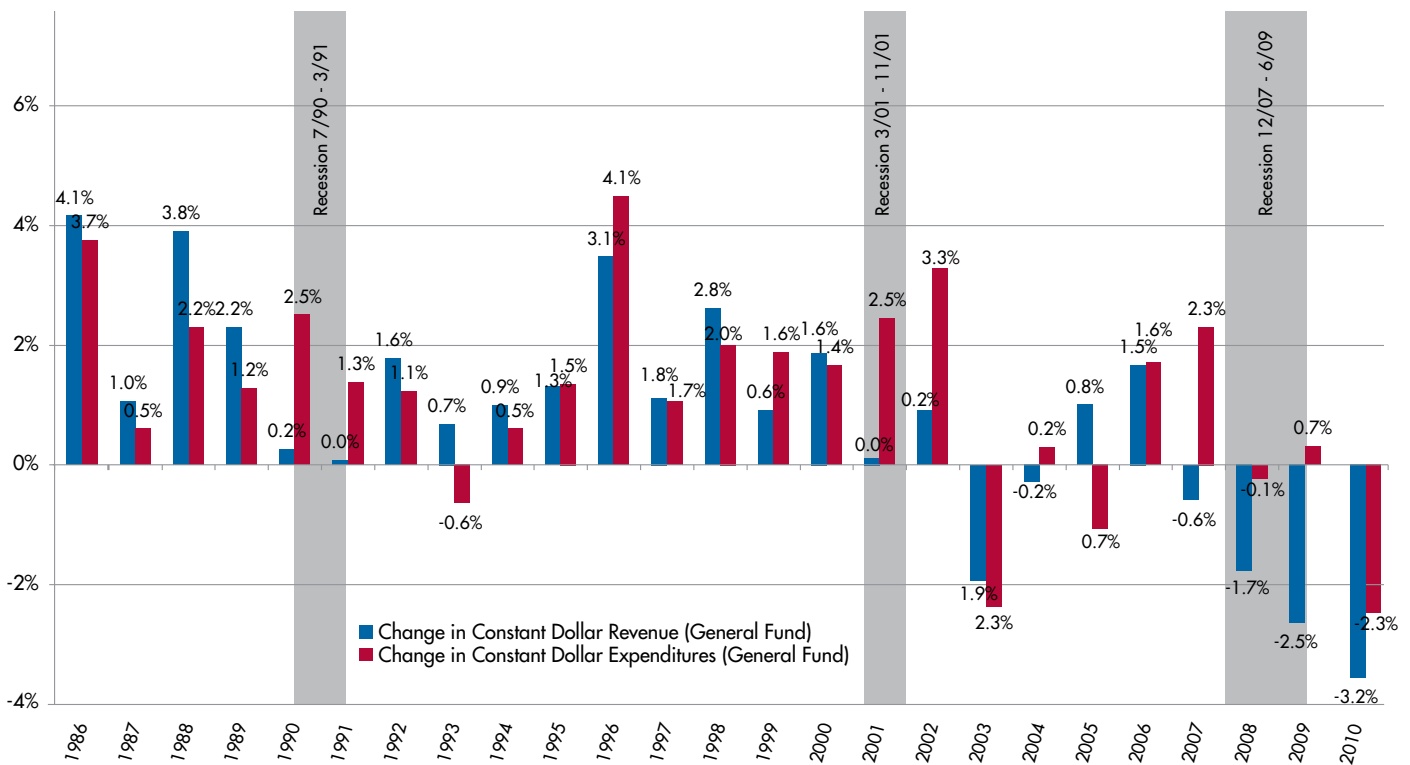


Figure 2: Year-to-Year Change in General Fund Revenues and Expenditures (Constant Dollars)

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.

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.

Revenue and spending shifts in 2009 and 2010 paint a worsening fiscal picture for America's cities. The declines in 2010 represent the largest downturn in revenues and cutbacks in spending in the history of NLC's survey, with revenues declining for the fourth year in row (since 2007). In comparison to previous periods, the most recent decade, with recessions in 2001 and 2008-09, was one characterized by little stability in city fiscal conditions, and the effects of the current downturn are already more significant for city budgets than for the previous recessions tracked in NLC's survey. City budgets tend to lag economic conditions by 18 months to several years, which suggests that 2011 will likely confront further revenue declines and cuts in city spending. (For more on the lag between economic changes and city revenues see page 7).

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 are reliant upon local income taxes. Understanding the differing performance of these tax sources and the connections to broader economic conditions helps explain the forces behind declining city revenues.⁶

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 anywhere from eighteen months to several years prior.

The effects of the well-publicized downturn in the real estate market in recent years are now evident in city property tax revenues, but do not yet reflect the full effects of the economic downturn. Collections for 2009 continued to reveal strong revenue growth as assessments caught up with the previous growth in the real estate market. Property tax revenues increased in 2009 by 4.2%, compared with 2008 levels, in constant dollars. Projected property tax collections for 2010, however, point to some of the impact of the downturn in real estate values. Property tax revenues for 2010 reveal the first constant dollar decline (-1.8%). The full weight of the decline in housing values has yet to hit the budgets of many cities and property tax revenues will likely decline further in 2011 and 2012 as declining property values continue to be reflected in city property tax assessments and collections (See Figure 3).

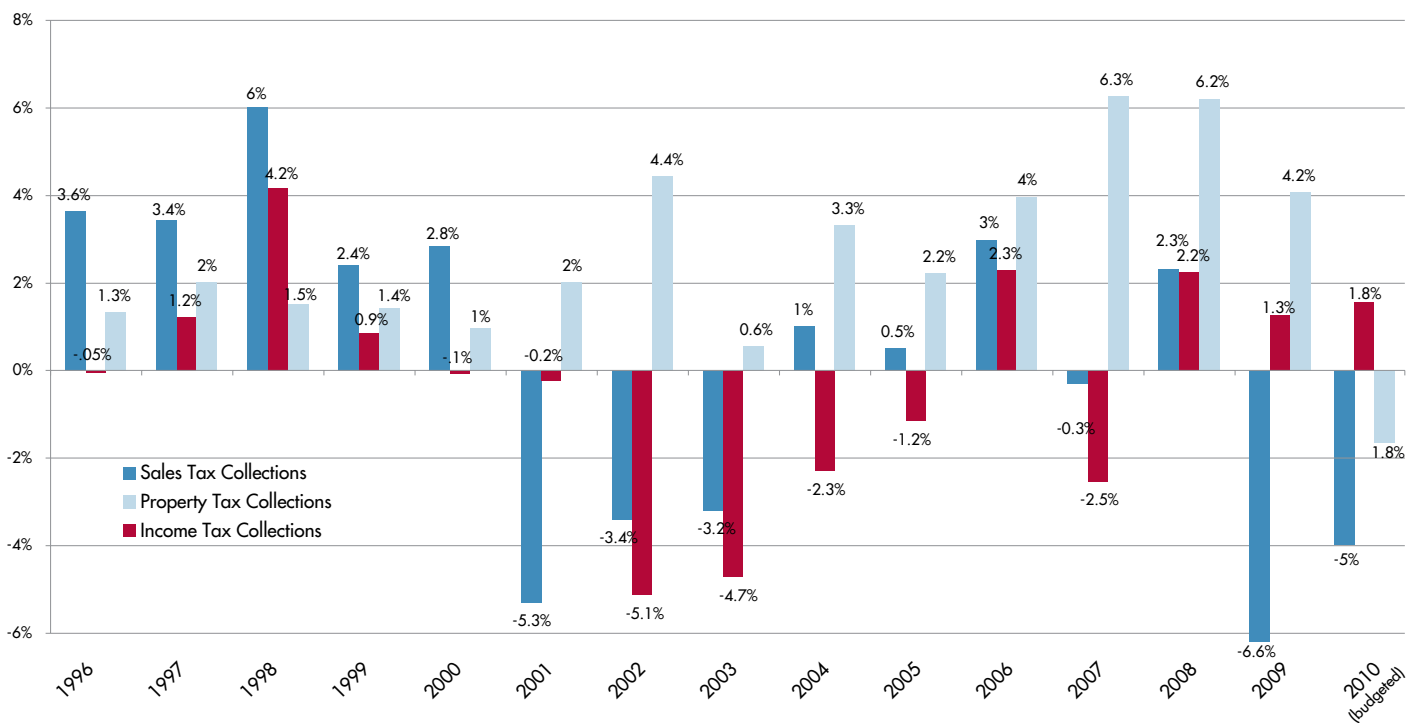


Figure 3: Year-to-Year Change in General Fund Tax Receipts (Constant Dollars)

⁶ For more information on variation in local and state tax structures, see *Cities and State Fiscal Structure*, NLC (2009) at http://www.nlc.org/resources_for_cities/publications/1637.aspx.

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 2009 over previous year receipts by -6.6% in constant dollars and city finance officers project further decline in 2010 by -4.9%.

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 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 2010 are for an increase of 1.8%. These small, but seemingly counter-intuitive, results are likely the function of a couple of factors. First, because relatively few cities have a local income tax, the results from a few larger cities can often drive overall trends. Second, there is often a considerable lag between economic changes and shifts in income tax collections. Unemployment often lags other economic indicators and the effects of high unemployment on wages and compensation will likely intensify in future years. For 2010, for instance, the City of Columbus implemented a voter-approved increase in the city's local income tax. The City of Indianapolis' and many other Indiana cities' income tax distributions from the state increased in 2010, but many are projected to decrease significantly in 2011.

City finance officers are therefore predicting little growth or actual declines in all three major sources of tax revenue for cities in 2010. 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 2010 and 2011.

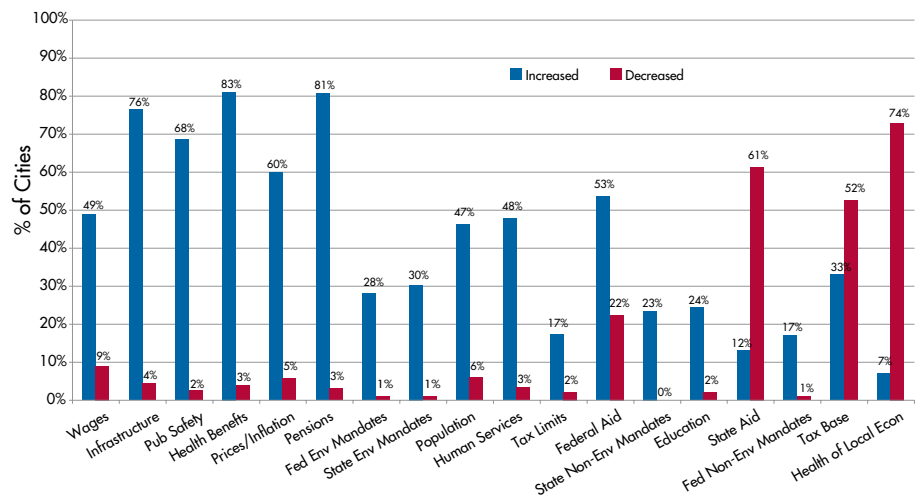


Figure 4: Change in Selected Factors From FY 2010

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.⁷ 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 (83%) and pension costs (81%). Infrastructure needs (76%) and public safety (68%) costs were most often noted as increasing among

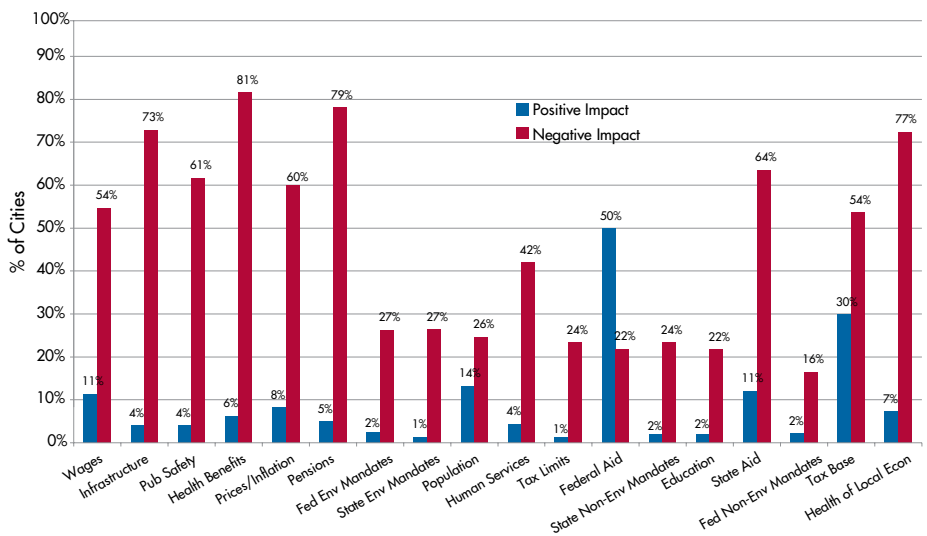


Figure 5: Impact of Selected Factors on FY 2010 Budgets and Ability to Meet Cities' Overall Needs

⁷ 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.

specific service arenas. Leading factors that city finance officers report to have decreased are the health of the local economy (74%) and levels of state aid to cities (61%) (See Figure 4).

When asked about the positive or negative impact of each factor on city finances in 2010, four in five city finance officers cited employee health benefit costs (81%), pension costs (79%) and the health of the local economy (77%) as having a negative impact. Three in five or more city finance officers also cited infrastructure costs (73%), the level of state aid (64%), and public safety costs (61%) as having a negative impact (See Figure 5).

SPENDING CUTS AND REVENUE ACTIONS

When asked about the most common responses to prospective shortfalls this fiscal year, by a wide margin the most common responses were instituting some kind of personnel-related cut (79%) and delaying or cancelling capital infrastructure projects (69%). Two in five (44%) reported that their city is making cuts in services other than public safety and human-social services – types of services that tend to be higher in demand during economic downturns. One in three (34%) reported modifying health care benefits for employees. For all of the listed cuts, in comparison to 2009, the percentages of cities taking action 2010 increased (See Figure 6).

The 2010 survey also asked about specific types of personnel-related cuts made in 2010. The most common cut was a hiring freeze (74%). Over half (54%) of cities reported salary or wage reductions or freezes and one in three (35%) cities reported employee layoffs. Cuts were also made in employee development-related activities, including reducing or eliminating travel budgets (59%) and reducing or eliminating professional development budgets for training, education, and skill building (46%) (See Figure 7).

City finance officers were also asked about specific revenue and spending actions taken in 2010. The most common action taken to boost city revenues has been to increase the levels of fees for services. Two in five (40%) of the responding city finance officers reported that their city has taken this step. One in four cities also increased the number of fees (23%) or increased the local property tax (23%). Increases in sales, income, or other tax rates were far less common (See Figure 8 on the next page).

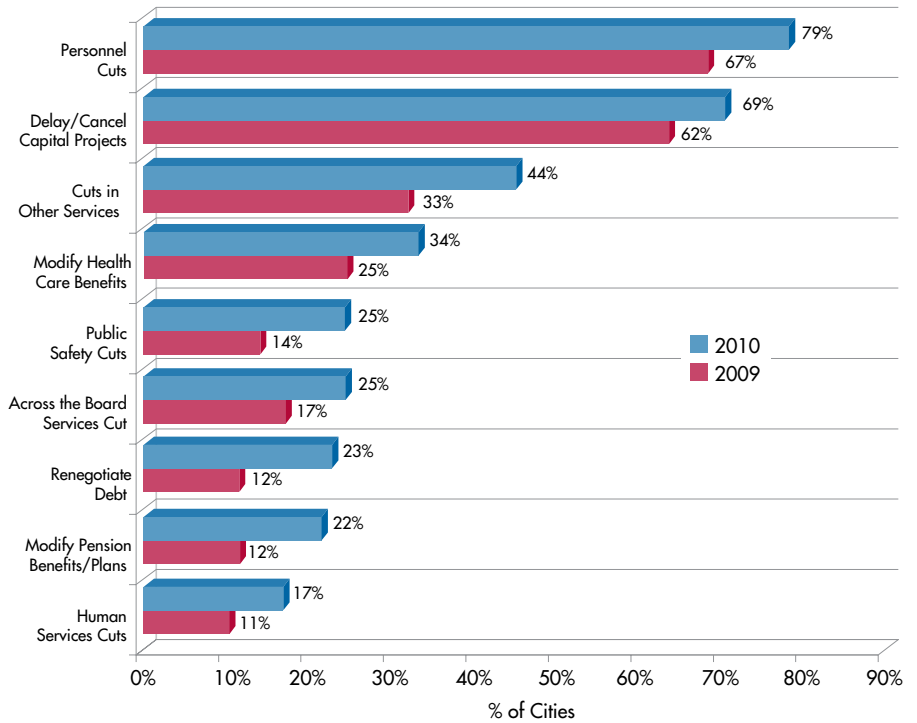


Figure 6: City Spending Cuts in 2009 and 2010

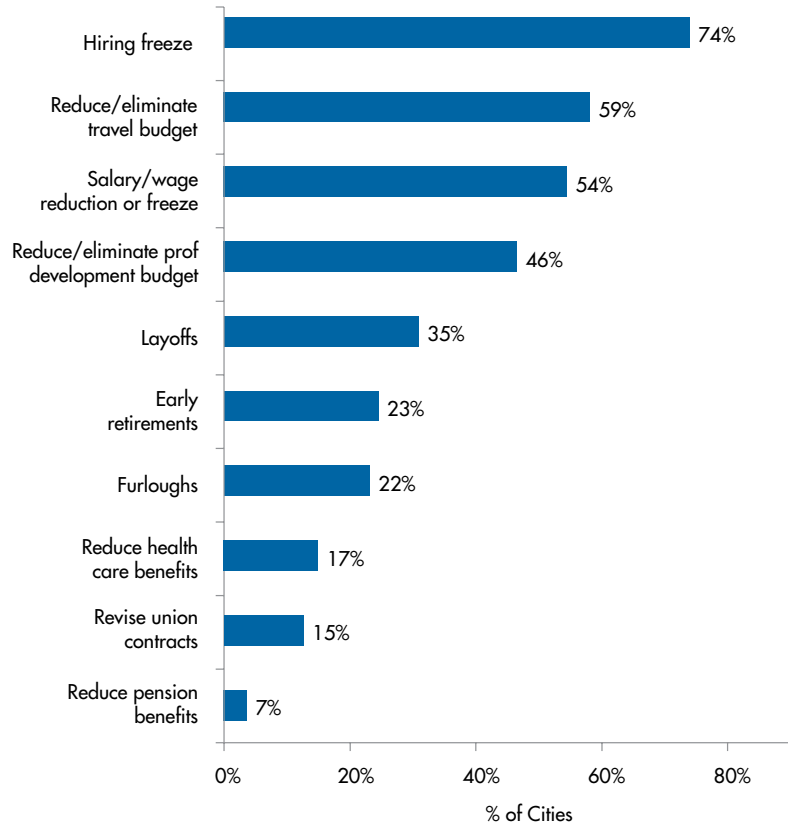


Figure 7: City personnel-Related Cuts 2010

ENDING BALANCES

One way that cities prepare for future fiscal challenges is to maintain high levels of general fund ending balances. Ending balances are similar to reserves, or what are often referred to as “rainy day funds,” in that they provide a financial cushion for cities in the event of a downturn or the need for an unforeseen outlay. 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, and were a comparable 24 percent in 2009. However, as economic conditions have made balancing city budgets more difficult in 2009 and 2010, ending balances have been utilized to help fill the gap. City finance officers projected ending balances for 2010 at just under 20 percent of general fund expenditures (See Figure 9). In total, since the high point in 2007, cities have drawn down total ending balances by about 20 percent (from the high of 25.2% to 2010’s 19.9%).

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 and state aid to cities have become smaller proportions of city revenues cities have become more self-reliant and are much more likely to set aside funds for emergency or other purposes.

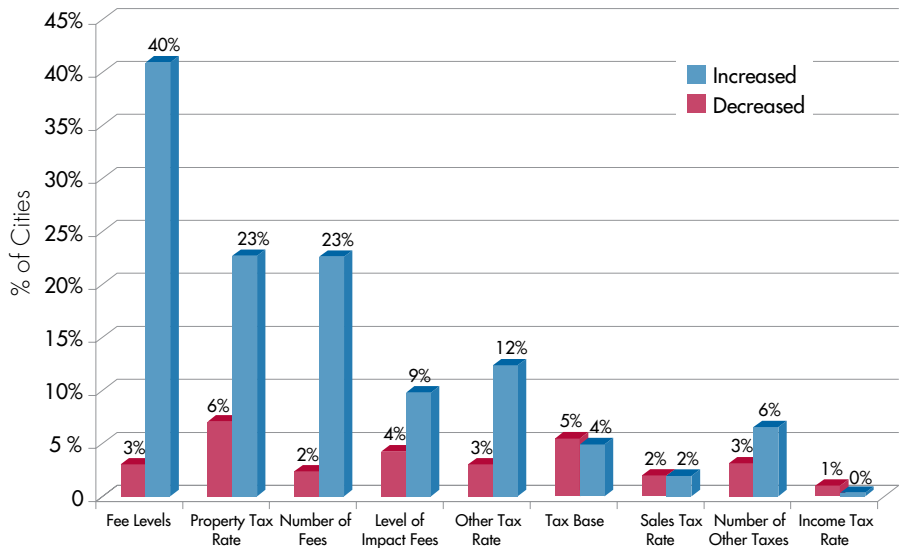


Figure 8: Revenue Actions in 2010

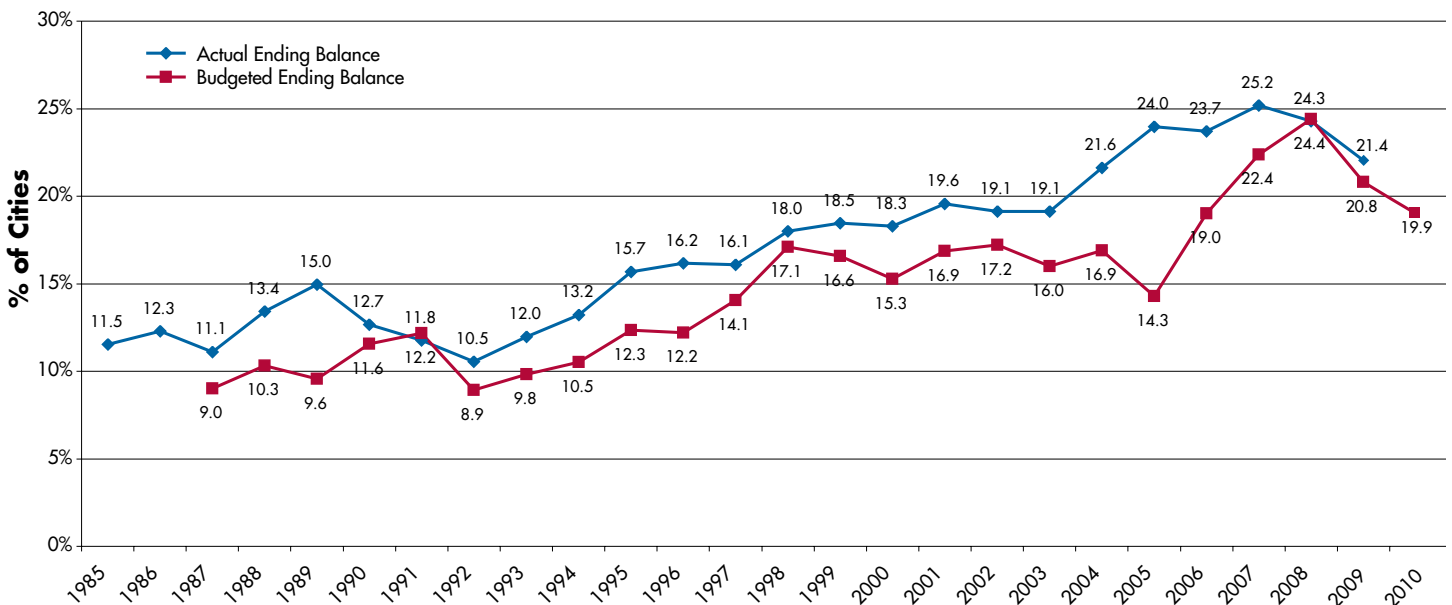


Figure 9: Ending Balances as a Percentage of Expenditures (General Fund)

BEYOND 2010

2010 reveals a number of downward trends for city fiscal conditions. The impacts of the economic downturn are becoming increasingly evident in city projections for final 2010 revenues and expenditures, and in the actions taken in response to changing conditions. The local sector of the economy is now fully the midst of a downturn that will be several years in length. The effects of a depressed real estate market, low levels of consumer confidence, and high levels of unemployment will likely play out in cities through 2010, 2011, and beyond. The fiscal realities now confronting cities include a number of concerns:

- Real estate markets continue to struggle and tend to be slow to recover from downturns, which is proving to be the case this time around, meaning that cities will be confronted with declines or slow growth in future property tax revenues;
- 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 2010 and 2011 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.

Confronted with these issues, 80 percent of city finance officers forecast that their cities will be less able to meet needs in 2011 than they were in 2010.

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.

How long is the lag? The lag is typically anywhere from eighteen months to several years, and it is related in large part to the lag in 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.

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 and 2001, with low points, or “troughs” in March 1991 and 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 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 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 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 2010. The 2010 survey data are drawn from 338 responding cities, for a response rate of 32.0%. 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	31	52.5%
100,000-299,999	179	63	35.2%
50,000-99,999	315	97	30.8%
10,000-49,999	502	147	29.3%
REGION			
Northeast	222	21	9.5%
Midwest	302	77	25.5%
South	277	118	42.6%
West	254	122	48.0%
TAX AUTHORITY			
Property	384	81	21.1%
Sales & Property	534	236	44.2%
Income & Property	110	21	19.1%

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 2009) at www.nlc.org.

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 2009, the year prior (FY 2008), and the budgeted (estimated) amounts for the current fiscal year (FY 2010).

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.