CITY FISCAL CONDITIONS 2015

by National League of Cities

This year marks the 30th edition of the City Fiscal Conditions survey of city finance officers. Based on the rich historical data accumulated over three business cycles, this year's report provides an important retrospective and comparative analysis of fiscal impacts resulting from the 1990, 2001 and 2007 recessions, in addition to our annual analysis of current fiscal conditions. In 2015, the fiscal condition of U.S. cities continues to show modest improvement. City finance officers are more optimistic than ever, driven largely by an expansion of General Fund revenues. These recent gains, however, have not been substantial enough to restore the revenue declines of the six years prior. When compared to the 1990 and 2001 recessions, it is clear that the fiscal impacts of the 2007 recession are much more substantial, both in terms of depth and duration.

Key findings from National League of Cities' annual survey of city finance officers include:

- General Fund revenues registered their first post-recession gains in 2013, with consecutive but slower growth since. Revenues increased 1.3 percent in 2014 and are anticipated to grow .31 percent in 2015. Expenditures increased 1.5 percent in 2014, with continued growth anticipated into 2015.
- Property tax revenues increased a sizable 2.4 percent in 2014, with growth of 1.2 percent expected in 2015.
- Growth in sales tax revenues reached a post-recession high of 6.2 percent in 2012, registered 5.9 percent growth in 2013, 3.1 percent in 2014, and is expected to grow 2.3 percent in 2015.
- Income tax revenues have been the most volatile tax source during the recovery period. Growth reached a post-recession high in 2012, with a 4.4 percent increase over 2011. Cities experienced 3.6 percent year-over-year growth of income taxes in 2013, followed by a dip of -1.7 percent in 2014, and an anticipated return to growth in 2015 with 3.6 percent gains.
- Ending balances are anticipated to reach a 30-year high in 2015, budgeted at 25.2 percent of General Fund expenditures. Ending balances reached a post-recession low in 2010 at 16.5 percent of expenditures, but have grown consistently, standing at 22.8 percent in 2014.
- Infrastructure needs (48 percent), pensions (38 percent) and health care benefits (36 percent) are factors that are most constraining city budgets in 2015. Those having the most positive influences are the value of the city tax base (70 percent), health of the local economy (63 percent) and gas and oil prices (24 percent).

The capacity of city budgets remains weakened coming out of the Great Recession. As a result, evidence suggests that cities are more fiscally conservative than in recent years and are cautiously preparing for the next economic downturn. City fiscal conditions have proven remarkably resilient over the past three decades, but longer-term fiscal sustainability will depend not only on cities' ability to balance their budgets annually, but also to manage infrastructure and employee-related costs and volatilities such as gas and oil prices, inflation and state aid.

Meeting Fiscal Needs

City finance officers are confident that cities are in a better fiscal position this year than last.[1] Eighty-two percent of city finance officers report that their cities are better able to meet the financial needs of their communities in 2015 than in 2014.[2] This level of optimism amongst finance officers is the highest since the inception of the survey and reflective of widespread, incremental improvements amidst an on-going slow and long recovery.

A number of factors combine to impact the ability of cities to meet their fiscal needs. Each year, the survey presents city finance directors with a list of factors that determine revenue performance, spending levels and overall fiscal condition of cities.[3] Respondents are asked whether each of these factors increased or decreased from the previous year and which factors had the most positive and negative influence on the city's overall fiscal picture.

Gas and oil prices (62 percent), federal aid (38 percent) and state aid (32 percent) are the most widely reported budgetary factors that have declined over the past year. Employee wages and salaries (92 percent), infrastructure needs (87 percent) and prices, or costs of services (82 percent) are factors that have increased in the greatest number of cities.

When asked about the most impactful factors on their budgets, the value of the local tax base (70 percent), health of the local economy (63 percent) and gas and oil prices (24 percent) have the greatest positive influences. The decreased cost to fuel fleets, among other energy-related expenses, is having significant positive impacts on many local budgets. For cities with energy-based economies, however, the prospect may not be as optimistic. In some cities, the energy boom has led to substantial wear and tear on infrastructure and service demands that are outpacing revenues.[4]

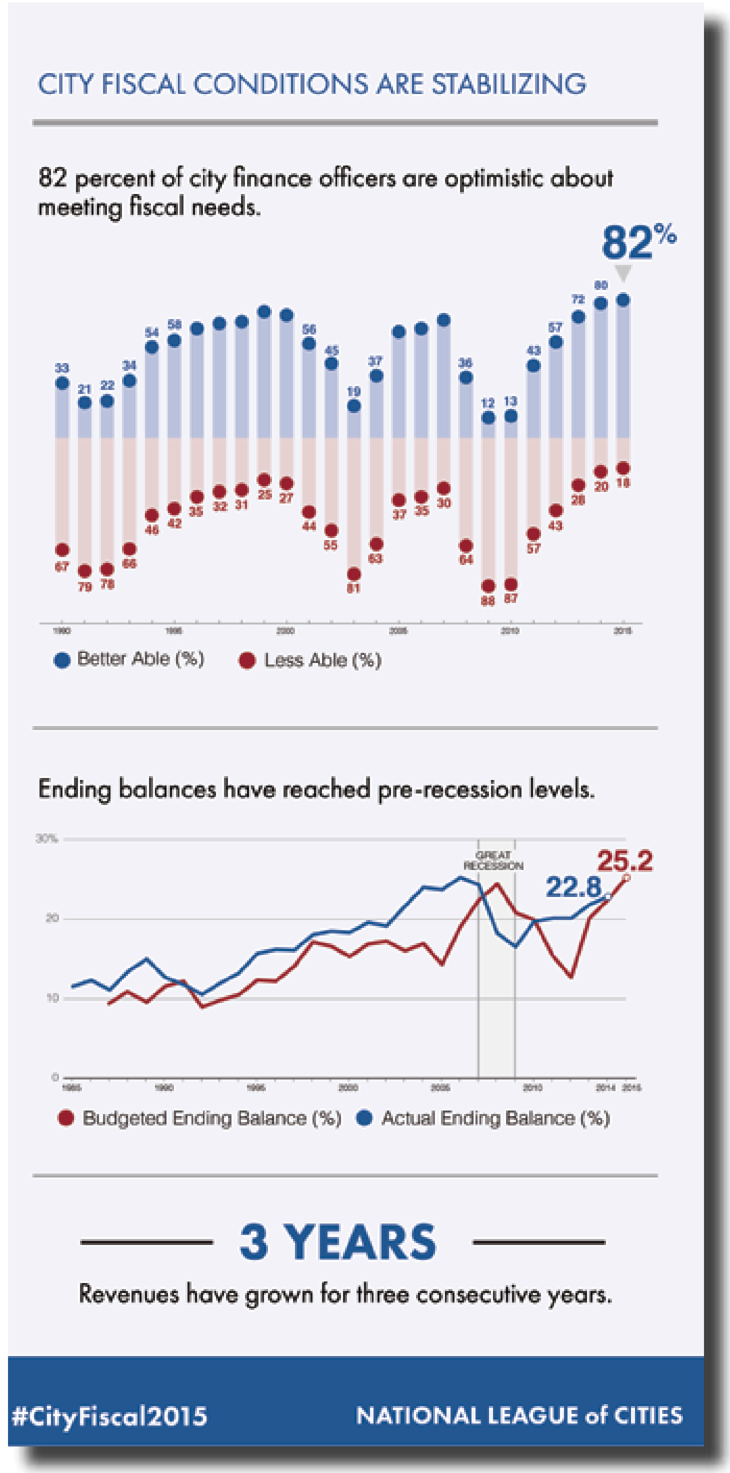
Infrastructure needs (48 percent), pension costs (38 percent) and health benefit costs (36 percent) are weighing most negatively on city budgets. Unfortunately, these are also factors that are likely to persist and worsen absent heavy investment.

Revenue And Spending Trends

Each year we ask city finance officers to provide information about the portion of their city's budget referred to as the General Fund. General Fund revenues are derived from property and other taxes, user fees and shared revenues. Given these sources, trends in General Fund revenues tend to reflect the changing economic and fiscal environment within which cities operate. Additionally, the General Fund provides funding to cities' general operations and constitutes more than 55 percent of total city spending. General Fund expenditures are mostly discretionary and can be allocated to services as city leaders see fit, such as police, fire, trash pick-up and economic development.

In constant dollars (adjusted to account for inflationary factors in the state-local sector), revenues grew 1.3 percent in 2014 over 2013.[6] Revenues are expected to continue to grow, but slow to a pace of .31 percent in 2015. This will be the third year of consecutive revenue growth.[7] Expenditures experienced growth in 2014 as well, increasing 1.5 percent over 2013. Looking to close 2015, city spending levels are projected to grow by 2.2 percent.

Taking a closer look at revenue behavior during the current business cycle, city budgets have registered positive revenue growth since 2013. Despite this recent growth, revenues have not yet reached pre-recession levels. After the start of the recession in 2007, cities faced six consecutive years of revenue decline. Recent growth has not restored these substantial losses. As of 2015, almost eight years after the start of the recession, cities are operating at only 91.6 percent of 2006 revenues.[8] If growth continues at its current pace, revenues will not reach pre-recession levels for several years.



When compared to the 1990 and 2001 recessions, it becomes clear that the fiscal impacts from the most recent recession are much more substantial, both in terms of depth and duration. During the 1990 recession, cities experienced three years of decline, restoring to pre-recession revenue levels in less than two years. During the 2001 recession, cities experienced revenue decline and volatility for four years, but fully recovered in two.

Tax Revenues

Understanding the performance of key tax sources and their connections to broader economic conditions helps explain the forces behind city revenue behavior during the business cycles discussed previously. The fiscal condition of individual cities varies depending on local tax structure and revenue reliance.[9] While nearly all cities have access to a local property tax, more than half are also reliant upon local sales taxes, and some cities (fewer than 10 percent nationally) are reliant upon local income or wage taxes.

Property Taxes. Local property tax revenues are driven by the value of residential and commercial property, with property tax bills determined by local governments' assessment of the value of property. Property tax revenues are considered more inelastic or less responsive to economic changes since it typically takes deeper, longer-term economic shifts to impact housing values.

Property tax revenues registered their first, albeit modest, gains in 2013. In 2014 property tax receipts increased 2.4 percent, the largest post-recession year-over-year growth. Growth is anticipated to continue in 2015 for the third consecutive year, but slow to 1.2 percent.

Sales Taxes. Sales taxes are considered more elastic than property taxes because consumer sales are generally quicker to respond to economic shifts. When consumer confidence is high, people spend more on taxable goods and services, and city governments with sales-tax authority reap the benefits through increases in sales tax collections.

Growth in sales tax revenues reached a post-recession high of 6.2 percent in 2012. Sales taxes have registered positive gains every year since, but the pace of growth has steadily slowed. Sales tax receipts registered 5.9 percent growth in 2013, 3.1 percent in 2014, and are anticipated to grow by 2.3 percent in 2015.

Income Taxes. Local income tax revenues are driven primarily by income and wages (not by capital gains). Like sales taxes, income taxes are a more elastic source of revenue because personal incomes respond more quickly to local economic circumstances.

The current recovery period has been marked by slow employment and wage growth, widening income inequality, and expansion of low-wage, part-time work and some high-wage jobs with a notable lack of growth in middle income employment. These troubling trends have direct impacts not only on workers, but on city tax rolls, which have registered volatile income tax receipts in recent years.

After strong growth in 2012 and 2013, income tax receipts registered a decline in 2014 of -1.7 percent. For 2015, income tax revenues are projected to rebound and grow by 3.6 percent.

Ending Balances

One way that cities prepare for economic downturns 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. However, unlike states' reserves or "rainy day funds," there is no trigger mechanism – such as an increase in unemployment – to force release of the funds; instead, reserves are available for spending at any time or for saving for a specific purpose.

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City 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 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 in annual debt service costs. Finally, as federal and state aid to cities has become a smaller proportion of city revenues over time, cities have become more self-reliant and are much more likely to set aside funds for emergencies or other purposes.

Ending balances reached a post-recession low in 2010 at 16.5 percent of General Fund expenditures. Since that time, ending balances have grown steadily. In 2014, ending balances were 22.8 percent of expenditures and budgeted at 25.2 percent for 2015. Importantly, actual ending balances often register at higher levels than projected ending balances so we anticipate even stronger growth this year, making 2015 a banner year for ending balances. The solid growth of ending balances signals cities' desire to be more prepared for future fiscal downturns and recognition that key tax revenues, along with state and federal aid, have become less reliable.

Fiscal Policy Actions

Most cities are required to balance their budgets on an annual basis. This means that they are actively adjusting revenues and expenditures throughout the year. To better understand these fiscal policy responses, we asked city finance officers about specific revenue and spending actions taken in 2015.

As has been the case for much of the past two decades, regardless of the state of national, regional or local economies, the most common action taken to boost city revenues has been to increase fees charged for services. Two in five (42 percent) city finance officers report that their city has raised fee levels. Approximately one in five cities increased the number of fees that are applied to city services (22 percent).

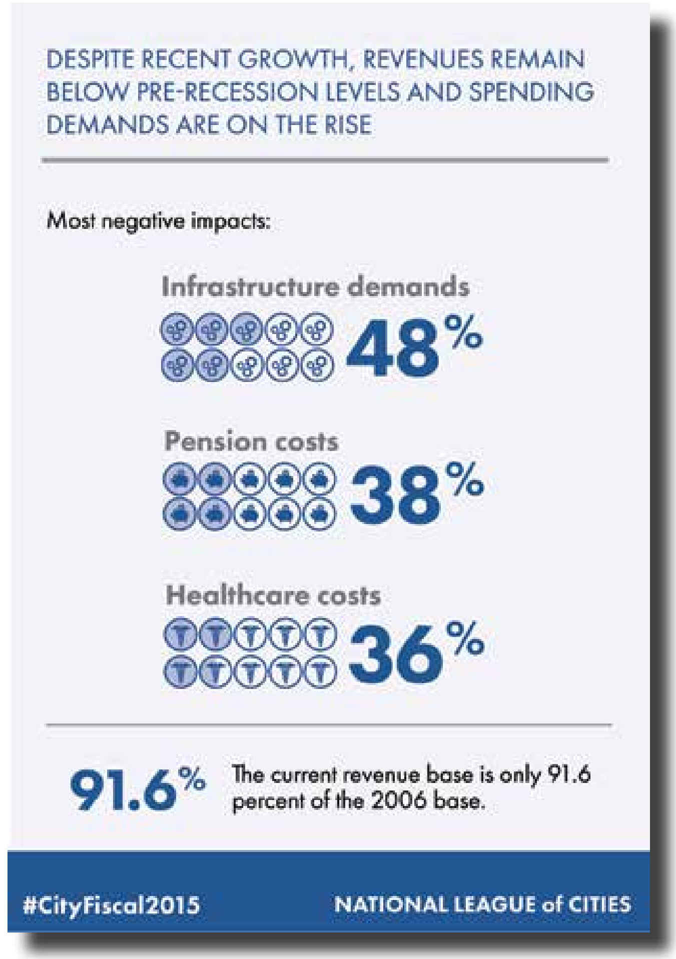
Twenty-one percent of cities increased the local property tax in 2015. Since the mid-1990's, irrespective of economic conditions, the percentage of city finance officers reporting increases in property taxes in any given year has been reported at about this same level, reflecting state- and voter-imposed restrictions on local property tax authority as well as the political challenges of raising property tax rates. Increases in sales, income or other taxes are even less common, as continued to be the case in 2015.

When asked about expenditure actions taken in 2015, most cities increased employee wages (83 percent), public safety expenditures (80 percent) and infrastructure spending (71 percent). During the recession, spending on employee wages, both wage levels and total municipal employment, declined sharply. Given the role of city staff in service provision, notably public safety, reinvestments in these critical areas are an important sign of service restoration.

The strong majority of cities also report increased spending on infrastructure. Spending levels, however, have not returned to pre-recession levels and are likely insufficient to resolve the back log of infrastructure needs.[12]

Conclusion

City fiscal conditions continue to improve, but remain weakened nearly eight years after the start of the Great Recession. As fiscal year 2015 draws to a close, revenues have experienced three consecutive years of growth. This is an indication that city budgets are stabilizing, however revenue bases are still below pre-recession levels. Growth is slow and fiscal challenges are likely to continue due to rising spending demands.

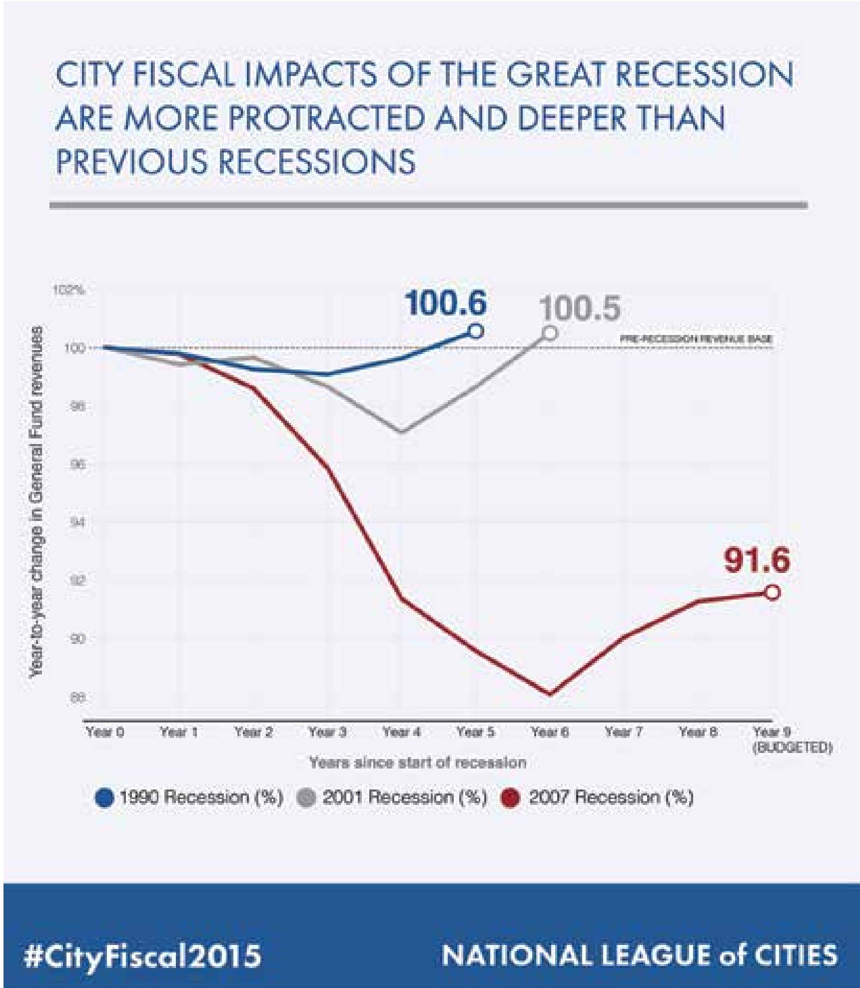


Will recovery of General Fund revenues come too late?

Based on the recent pace of growth, it is quite possible that revenues will not fully recover before the next recession hits. Economists predict that the U.S. will see the next downturn somewhere around 2018.[13] Based on conservative estimates of one percent revenue growth, and holding all other conditions constant, revenues would not return to pre-recession levels until 2024. Using more generous estimates of two percent growth (General Fund revenues have rarely grown larger than two percent in recent history), revenues would hit prerecession levels in 2020. In either scenario, it is probable that city revenues will not return to their previous levels before the next recession. Cities are aware of their precarious revenue situation, evidenced by their growing ending balances.

What is the fiscal condition of states, and its impact on cities?

The fiscal outlook for states varies widely, but most states are experiencing slow growth in revenues, coupled with new and expanding expenditures, including Medicaid. As a result, many states have reported budget shortfalls for the upcoming fiscal year.[14] This has been, and will continue to be, a challenge for cities because often the decisions that states make to balance budgets exacerbate negative fiscal and economic conditions in cities. Specific state actions that directly impact the fiscal stability of cities include cuts in general aid, cuts in state-shared and/or state collected



revenues, revocation or reduction of reimbursement programs or other transfers, cuts in funding for services that cities and other local governments deliver on behalf of state governments, transfer of state program responsibility, and reductions or limits to local taxing authority.

What is the longer-term impact of the drop in gas and oil prices on city budgets?

As large consumers of energy, the recent decline in gas and oil prices has meant positive budgetary impacts for many U.S. cities. However, it is likely that these prices are volatile and will fluctuate in the coming months. Based on this volatility, longer-term fiscal impacts will be decided by whether cities budget future energy expenditures based on current low prices and whether they allocate short-term savings to pay for long-term fixed costs (i.e., personnel). Oil is also a key ingredient in materials used to repair roads, having the residual benefit of making infrastructure improvements less costly. This, combined with low interest rates, suggests an ideal environment for cities to take on new debt to tackle extensive infrastructure repair and replacement backlog.

What is the outlook for infrastructure financing?

That the nation faces a massive infrastructure deficit is no longer news. Research clearly demonstrates that underfunding maintenance has reached critical proportions, and estimates of the backlog in infrastructure investment tops $3 trillion. Half of America's cities identified 'infrastructure' as one of the three most challenging issues confronting municipalities today, and that figure has been high for over 20 years. Although borrowing costs are quite low for most municipalities, the repayment schedule often means that debt repayment competes with basic operating needs of a city. The long-term economic and community growth potentials of cities could be compromised should cities, and other partners, not address the infrastructure crisis soon.

How big is the pension crisis, sector wide?

Public pension funding ratios registered their first post-recession improvements in 2014, and the outlook for the next several years suggests steady improvement unless plans experience lower than assumed asset returns.[15] Many cities have already made adjustments to their investment-return assumptions since the recession, which bodes well for future sustainability.[16] Beyond this, the pension challenges for cities are multifaceted and unique based on their underlying economy, tax capacity, state fiscal health and availability of policy choices. For example, Chicago has a very diverse and robust underlying economy and the tax capacity to address some issues. The major problem for Chicago is that the state of Illinois is cash-strapped, so any resource transfer from the state is unlikely. The Court also has forced the state and the city to address its financial problems but not to solve them on the backs of pensioners. As a result, the City of Chicago is exploring a property tax increase to help meet pension obligations.

These factors, along with another downturn likely within the next few years, portend more challenging times ahead for city budgets. Budgeting in this environment has been, and will continue to be, an ongoing process of revenue and expenditure choices that affect services, public employee welfare, and conditions for future economic growth. Although uncertainty marks the fiscal landscape, city leaders have learned how to cope with limited fiscal tools and revenue capacity and may be even more prepared for the next downturn given the build-up of ending balances. However, simply because they are able to manage under difficult circumstances does not mean that it will be easy, or without consequence. The choices cities are making involve tradeoffs, and it has become evident that investments critical to our nation's prosperity are at stake. In the years ahead, as cities continue to navigate their roles as fiscal stewards, stronger state and Federal partnerships will be critical to enabling the fiscal choices that will allow cities to grow, innovate, and propel our economy forward.❑

View the complete report and all footnotes at: http://www.nlc.org/Documents/Find%20City%20Solutions/Research%20Innovation/Finance/CSAR%20City%20Fiscal%20Conditions%202015%20FINAL.pdf.