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Cities Confront Tough Choices as Fiscal Conditions Decline – Economic Recovery Threatened

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Overview

America's city officials face tough choices as fiscal conditions decline in cities across the nation. The outlook is that the situation will worsen in the near future. As choices are made about how to weather the current fiscal crisis – through cuts in services, tax and fee increases, or deferring costs to later years – the recovery of the economy is threatened.

Budget deficits and widespread layoffs of police officers, firemen, teachers, and other city personnel in cities like New York, Boston, Chicago, Philadelphia, Minneapolis, and Seattle are dramatic examples of the challenges confronting city policy makers. Similar challenges are evident in cities of all sizes, forcing city leaders to make decisions about what to cut: fewer cops and firemen or fixing roads? Close the library or cut after-school programs? Raise taxes or increase fees?

As city officials wrestle with these choices, they are unlikely to see any additional support from their state and federal partners. Instead, they are more likely to be forced to get by with less aid than in previous years. In 2003, state governments face budget shortfalls of $29.9 billion. Headed into 2004, state shortfalls will rise to $78.4 billion.[1] State officials confront their own set of choices as they struggle to balance their budgets by July 1 (the beginning of the next fiscal year). City officials know that they and their residents will be forced to shoulder a share of the burden. Meanwhile, federal officials debate the size and structure of federal tax cuts that will further constrain state and local budgets, and further impact their ability to meet the needs of residents.

The fiscal crisis that pervades all levels of government is only in part the result of a national economy that is struggling to recover from the recession of 2001. The continued fiscal struggles of state and local governments will be a further drag on an already-wavering economy, increasing the prospect of a government-led double-dip recession

To gauge the extent of the crisis at the city level, the National League of Cities conducted a survey of city finance officers in February 2003.[2] Among the findings:

- In 2002 and 2003, cities are experiencing the largest gap between revenue and expenditure growth in the last decade.
  - City revenues are declining, dropping by one percent in constant dollars between 2002 and 2003.[3]
  - City spending pressures are increasing, with city finance officers expecting spending to increase by three percent in constant terms in 2003, driven by homeland security and public safety spending.

[1] State Budget Update, National Conference of State Legislatures, April 2003.

[2] "Cities" refers to municipal corporations.

[3] All references to specific years are for fiscal years.

This brief is based on a national mail survey of finance officers in U.S. cities conducted in February 2003. Survey data are taken from 330 responding cities.

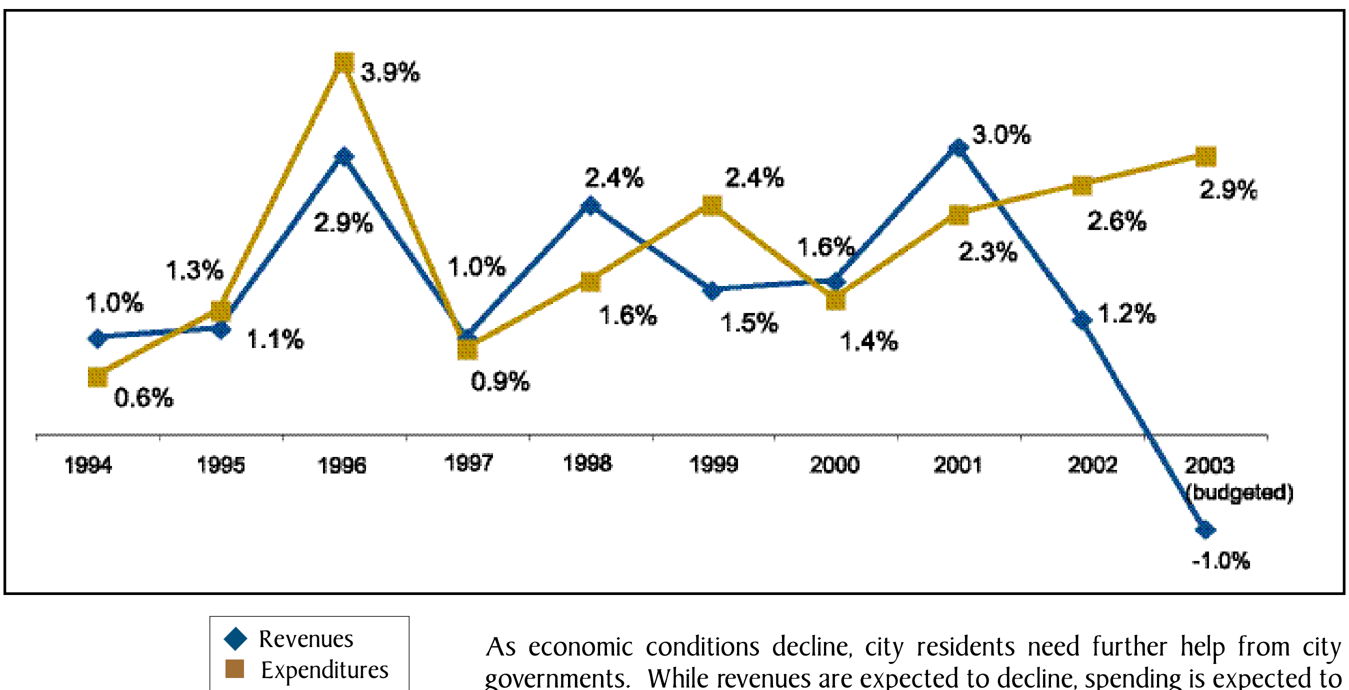
National League of Cities

- State aid to cities is expected to decline by 2.1 percent in 2003 and nearly half (45%) of city finance officers say their states are taking actions to further reduce state aid levels.
- Four in five (79%) city finance officers say their city is less able to meet financial needs in 2003 than in 2002, and a similar percentage (78%) predict that conditions will worsen further in 2004.
- City policy makers are responding by raising user fees for services, drawing down reserves, laying off city staff, and dramatically cutting investment in infrastructure and maintenance.
- Declining fiscal conditions threaten to undermine the quality of life of city residents – 40% of city officials say that the quality of life of their residents has already been negatively impacted.

Revenue and Spending Pressures

Recent growth in city General-Fund revenues is rather weak, tied as these revenues are to the underlying economic base of a city and region.[4] Plotting aggregate revenue and expenditure changes over the past decade reveals a generally strong and consistent level of growth for both until 2002. However, expenditure growth in 2002 exceeded revenue growth and, in 2003, revenue growth is expected to be the smallest in a decade. In constant dollar terms, revenues are expected to show a decline of 1 percent once cities close their books for 2003.

FIGURE 1
Changes in General-Fund Revenues and Expenditures
(Constant dollars)



As economic conditions decline, city residents need further help from city governments. While revenues are expected to decline, spending is expected to grow at nearly 3 percent in constant terms, marking the largest disparity in growth between revenues and expenditures over the last decade. Pressures to meet increasing public safety concerns, higher health insurance costs, increasing human service needs, and many other city needs led city leaders to prepare general-fund budgets for 2003 that increased spending by 2.9 percent.

[4] The General Fund is the primary annual operating fund for cities. It is the largest fund, accounting for an average of 50 percent of total city revenues in 2001.

The driving force behind increasing spending at the city level is higher public safety spending. Four in five city finance officers report that their city increased public spending in 2001 (85%), 2002 (82%), and 2003 (78%). In 2001 and 2002, actual public safety spending, in current dollars, exceeded cities' budgeted amounts by 4.1 percent and 3.6 percent respectively. Between 2001 and 2002, actual public safety spending increased by 4.1 percent and city officials budgeted for a 5.3 percent increase in public safety spending in 2003.

Increases in public safety spending are, in part, a result of homeland security costs incurred at the city level and heightened demand for traditional public safety services. Nearly four in ten (38%) city finance officers report that their city has increased public safety spending as a result of homeland security needs since September 11, 2001. Estimated up to the national level, for all cities, homeland security spending represents more than $2.75 billon between 2001 and 2003.

State Actions

Cities will not be able to turn to their state governments for help in covering the looming shortfalls between spending and revenues. City officials are more concerned that the states' needs to balance their own budgets will come at cities' and their residents' expense. To date, the fiscal impact of state budget shortfalls on cities has been no growth, or decline, in state aid between 2001 and 2003. For the 198 cities reporting state aid levels over this period, actual state aid grew at a rate of less than one percent (.3%) between 2001 and 2002, and city finance officers predicted a 2.1 percent decline in state aid in 2003.

When asked about what changes in revenues are having the largest impact on city budgets, city finance officers were most likely to list decreases in state aid levels. One in three city finance officers cited decreasing state aid in 2002 (33%) and 2003 (37%). Similarly, when asked about whether state governments have or will take actions that will reduce state aid to cities, nearly half (45%) of city finance officers report such actions in 2003, compared to 32 percent in 2002 and 17 percent in 2001.

By July 1, the impact on cities and their residents is likely to be even more severe. State actions are not limited to reductions in state aid levels. Other state decisions are already negatively impacting city budgets, and will likely worsen in the near future, including reduced transfers to cover city costs of providing state-mandated services, the imposition of state mandates that require additional spending at the city level, and cuts in support for state programs that result in people going to cities for assistance. The National League of Cities is currently engaged in an effort to track the impacts of state actions, forthcoming in a report in June 2003.

Economic and Fiscal Outlook

The economic outlook remains blurry. Real gross domestic product (GDP) grew at only 1.4 percent in the fourth quarter of 2002, down from four percent growth in the third quarter.[5] The unemployment rate, 6.0 percent in March 2003, is at the same level it was in November 2001, at the end of the recession.[6] Recently, signs of decelerating consumer spending – one of the

FIGURE 2
Sources of Revenue Producing Largest Decreases
(% of City Finance Officers Identifying a Particular Revenue Source)

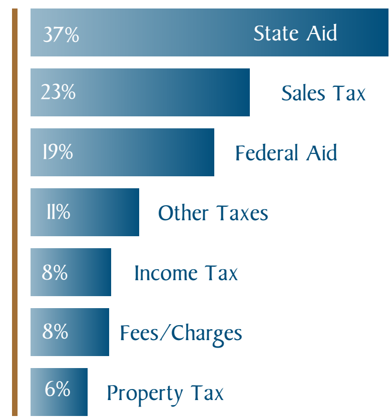
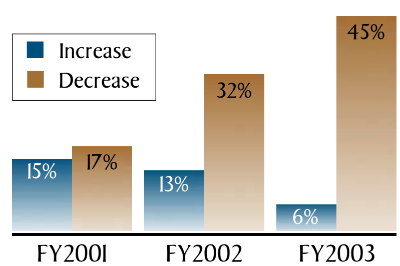


FIGURE 3
State Actions Increasing/Decreasing State Aid to Cities



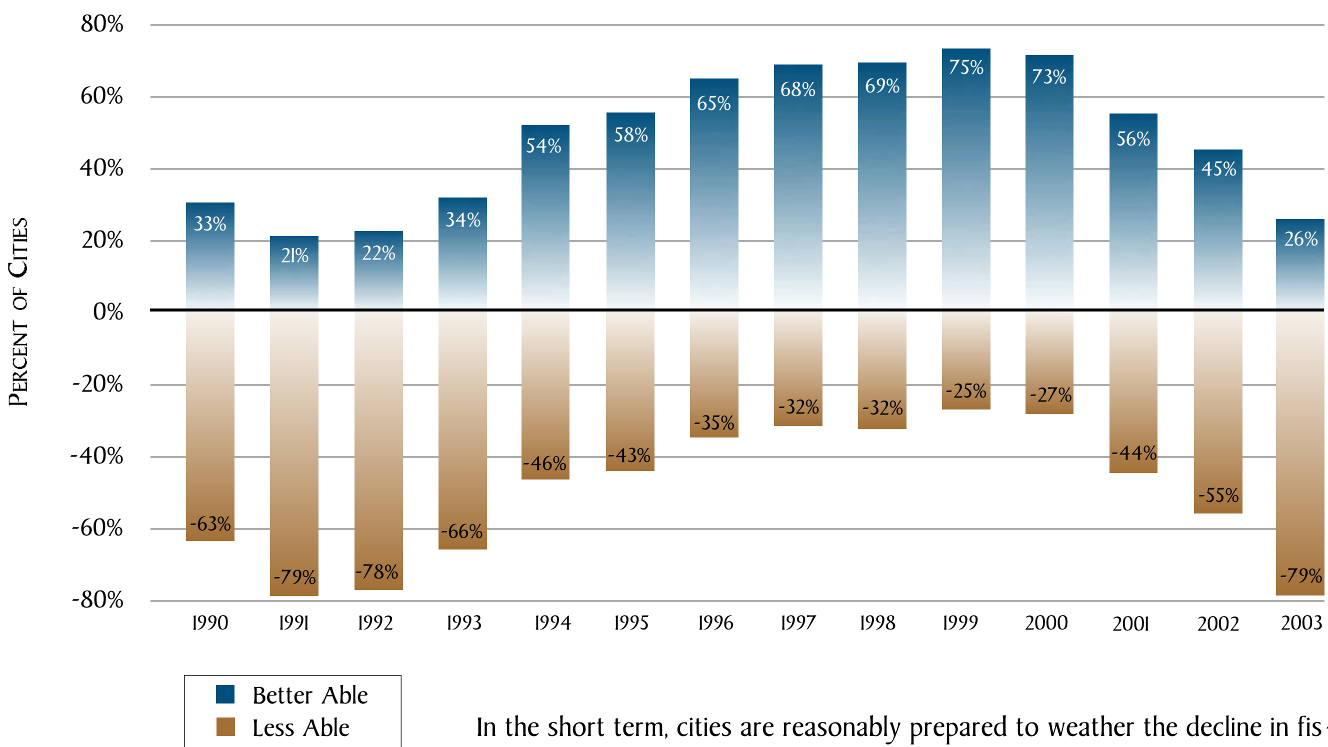
[5] Bureau of Economic Analysis, U.S. Department of Commerce.

[6] Bureau of Labor Statistics, U.S. Department of Labor.

two factors propping up the economy since 2001 (along with real estate investment) – suggest that the economy may struggle further.

Against this backdrop, city finance officers were asked whether their cities were better able to address their financial needs in the current fiscal year (2003) than in the preceding year (2002). Four in five city finance officers (79%) report that their city is less able to meet financial needs in 2003 compared to 2002. This is a substantial shift from the number of city finance officers reporting worsening conditions from 2001 to 2002 (55%) and equals the lowest point for city fiscal conditions reported by city finance officers since NLC's annual survey of City Fiscal Conditions began in 1985. City finance officers' negative assessment of their fiscal conditions is consistent across city size and region, but differs depending upon municipal tax authority.[7] Nearly all (98%) of responding city finance officers in cities that are reliant upon local income taxes say that they are less able to meet financial needs, compared to four in five (79%) city finance officers in sales tax-dependent cities, and 71 percent of city finance officers in property tax-only cities.

FIGURE 4
Percent of Cities That "Are Better Able/Less Able" to Meet Financial Needs This Year Than in Last Year



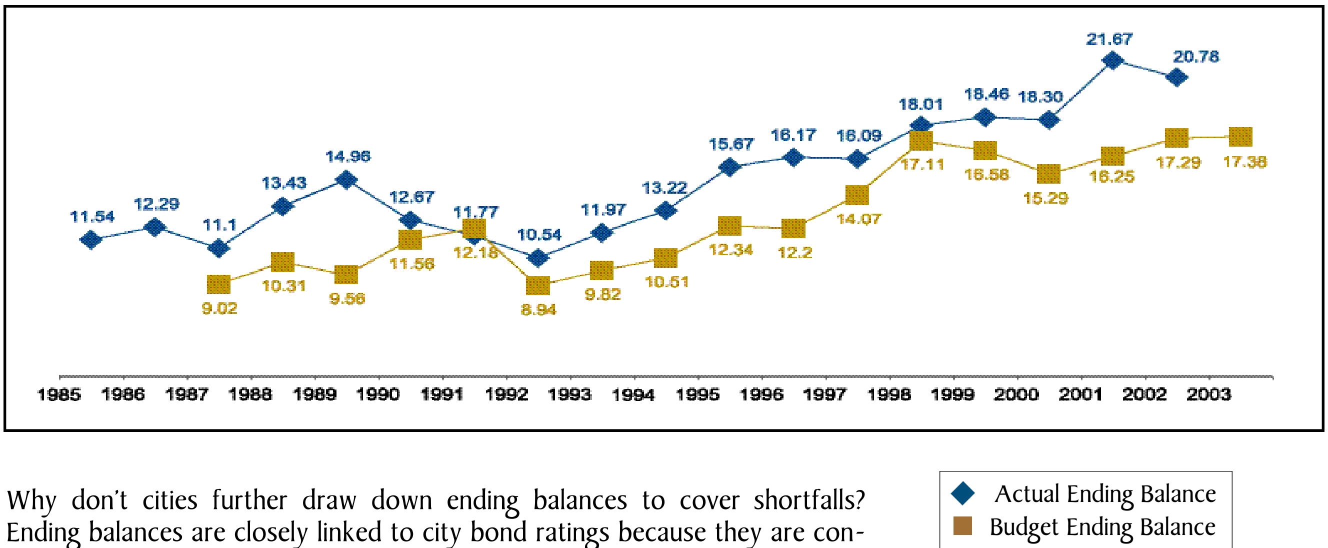
In the short term, cities are reasonably prepared to weather the decline in fiscal conditions. High ending balances, or "reserves," will provide a buffer for some cities in dealing with the effects of the economic downturn. Cities operate under balance-budget requirements, meaning that cities almost always plan on ending the fiscal year with a balanced to carry forward. This ending balance, often referred to as a "reserve," becomes available revenue for the next fiscal year. Reserves are planned for a variety of purposes, including the need to store funds in anticipation of an economic downturn and declining revenues. Between 1993 and 2001, cities' ending balances continued to build as the underlying economic bases of cities expanded rapidly. The actual growth rate in revenues for most cities exceeded the budgeted or predicted growth

[7] For specific categories by city size, region, and tax authority see City Fiscal Conditions in 2002 (National League of Cities, 2002), available online at www.nlc.org.

[8] "Municipal sector" refers to the sum of all responding cities' financial data included in the survey.

rate, allowing cities to not only build up their savings, but also to meet other needs. Measured as a percentage of expenditures in 2001, the ending balance for the municipal sector increased to 21.7 percent, its highest point since the fiscal survey was first administered in 1985.[8] For 2002, ending balances as a percentage of expenditures remained high at 20.8 percent. Looking toward the close of the current fiscal year, city finance officers predicted that ending balances would continue to stay at a high level of 17.4 percent of expenditures.

FIGURE 5
Ending Balances as a Percentage of Expenditures (General Fund)



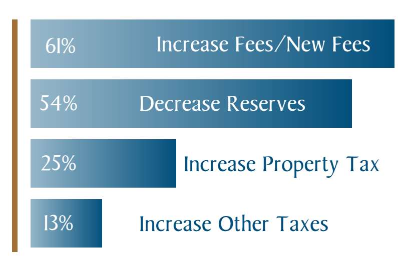
Why don't cities further draw down ending balances to cover shortfalls? Ending balances are closely linked to city bond ratings because they are considered a signal of cities' fiscal health and stability. As a result, city officials are cautious with drawing on reserves, fearful that they will send the wrong signals to the bond rating agencies and face higher borrowing costs. They are also contemplating worse times ahead.

Despite high ending balances, city finance officers are concerned about their city's ability to meet financial needs in 2004 – nearly four in five (78%) believe that their city will be less able to address financial needs in 2004 compared to 2003. Cities' abilities to meet their financial needs are, of course, closely linked to the ability to deliver needed services to residents – to improve their quality of life. Four in ten city officials (39%) say that the quality of life of residents in their cities has already worsened as a result of declining economic and fiscal conditions (54% indicate there has been no change).

City Responses

Cities are responding to shortfalls by drawing down reserves, raising fees for services, laying off city staff, and most significantly by dramatically scaling back capital budgets – cutting their investment in infrastructure and maintenance. When asked what actions their city has taken, or is taking, to alleviate fiscal pressures, more than half of city finance officers report that their city is raising user fees for services (61%) or drawing down reserves (54%) in 2003. These numbers have doubled or nearly doubled in comparison to 2001 (34% of city finance officers reported raising fees and 24% reported decreasing reserves).

FIGURE 6
City Fiscal Actions, 2003



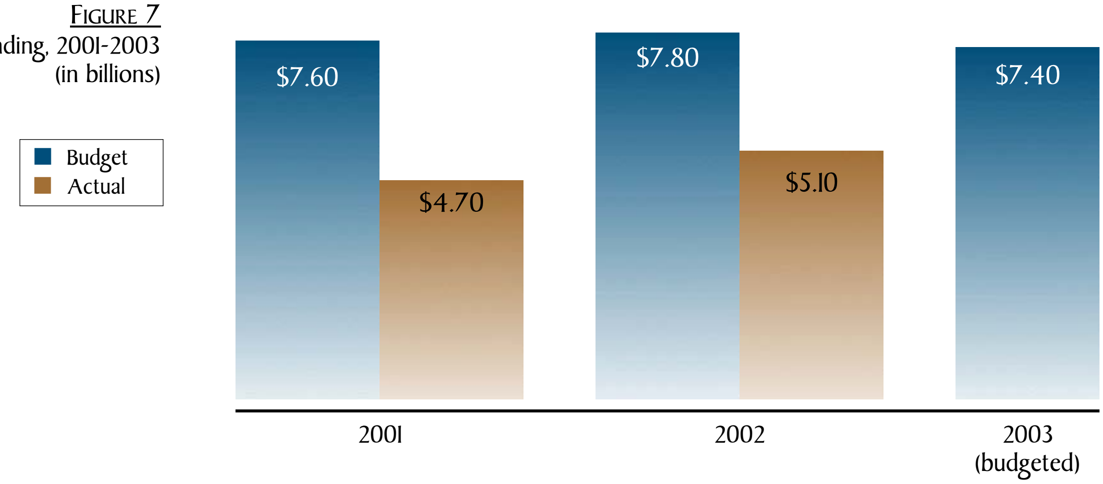
To help cover the gap between stagnating revenue growth and increased city spending, cities are also attempting to make cuts in spending on city government and administration, often by laying off city staff. Nearly one in five (17%) city finance officers report that their city is laying off city staff. Public safety personnel are not immune to personnel cuts. Of the city staff laid off in the responding cities, 24 percent were firefighters and police officers.

Capital Budgets

Cities adjust their capital budgets (devoted primarily to infrastructure investment) in response to their changing fiscal fortunes. Capital spending follows the vagaries of the city's fiscal intake quite closely. During the 1990s, year-to-year increases in city revenues were quite strong, averaging over 8 percent for some cities.

In 2000 and 2001, as city revenue collections slowed in response to the sluggish underlying economy, cities adjusted their capital spending plans as radically as they adjusted them during the 1990s. This time, however, the adjustment has been to reduce the planned levels of capital spending. City finance officers reported a wide disparity between the amount of money their cities expected to spend on infrastructure in 2001 and 2002 compared to what they actually spent. Nearly half of the respondents (45%) reduced their actual capital spending plans in 2001 and 54 percent reduced their capital spending in 2002. These reductions amounted to 40 percent of the budgeted amount in both years. In absolute dollars, the 230 responding cities reduced actual capital spending by $2.9 billion in 2001 and $2.7 billion in 2002 below their budgeted amounts. Even though the amount budgeted for 2003 indicates a substantial increase over the actual spending levels in 2002, the likelihood that actual outlays will approach the budgeted amount is slim.

FIGURE 7
Capital Spending, 2001-2003
(in billions)



What Can Government Do?

City fiscal conditions are declining, with real impacts and negative implications for the quality of life of city residents – residents shared by state and federal governments. There is no indication that the next fiscal year will be any different. Economic indicators are increasing concerns about the prospect of a double-dip recession. But there may be another reason for a double-dip recession, one that can be at least influenced by sound fiscal policy decisions at the federal, state and city levels. Nearly half of all cities and almost all states begin their fiscal years on July 1, a time that will mark the beginning of the "austere" budget years for states as well as for cities, and a time for a sharp decrease in state and local government spending. The result will be higher unemployment, lower incomes, and declining construction.

Why should we be concerned? The state and local sector employs more than fifteen million people (FTE) and spent $1.36 trillion in 2002, the latest year for which data are available.[9] Amid state budget shortfalls, and the surging spending needs of cities coupled with declining revenues, layoffs and spending reductions are imminent. The layoffs and spending reductions will hit at precisely the time when the economy might be lifting its head above water, thus pushing it back down for a second time. The typical spending behavior of state and local governments has often exacerbated the downside of the economic cycle by raising taxes (dampening consumer spending) and reducing spending (increasing unemployment). Now is the time to re-think typical behavior and act to forestall a government-led double-dip recession. What can government do?

Federal Government: Infrastructure projects are still ready to go, even if they have been unfunded for the past two years. The federal government should use its pump-priming powers and provide municipalities with infrastructure support. If available, 76 percent of city finance officers say that their city would devote this support to infrastructure investment.

- Congress should fast-track a fiscal stimulus package for states and localities.

Local Government: The costs of borrowing have rarely been better for cities. Cities should borrow now, invest in infrastructure expansion, and pay off the costs later. In combination with federal support, city borrowing could help meet infrastructure needs and be a stimulus to the economy.

- Cities should help finance mounting infrastructure needs from debt.

State Government: In the short-term, states should make every effort not to devolve the state fiscal crisis to local government. Over the medium- and long-term, states can help improve the state and local finance system by broadening tax bases and affording cities the opportunity to diversify their revenue portfolios. These longer-term recommendations would help spread the burden more equitably across the economy. States should:

- Minimize impact of state deficits on city budgets and city residents;
- Broaden the taxable economic base (e.g., service tax);
- Allow cities to collect revenue from users of the city services (e.g., payment in lieu of property and sales taxes for non-profit and government organizations, commuter income tax);
- Remove unfair tax advantages (e.g., exemptions and abatements); and

[9] Census of Governments, 1997. U.S. Census Bureau.

- Diversify city revenue portfolios (like investment bankers instruct their clients) by allowing and implementing local-option taxes (e.g., retail sales tax, local income taxes).

The complex fiscal linkages among the partners of the intergovernmental system require action at all levels to address the impending fiscal catastrophe, and to meet the needs of the residents they all share. Inaction might further drag the economy down, exacerbating an already bad situation and making a double-dip recession more likely. Action at all levels might provide the necessary stimulus to allow the national and regional economies to continue their climb from the depths of the recession, improving the quality of life of America's citizens.

About the Survey

Since 1985, the National League of cities has conducted a national mail survey of finance officers in U.S. cities. The City Fiscal Conditions Survey is conducted annually in the spring. In 2003, in response to reports of declining city fiscal conditions, NLC conducted a supplement to the annual survey in February. Survey data are taken from 330 responding cities.

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