The Challenges to Fiscal Leadership

- Four eras of municipal finance.
- Contemporary municipal finances
- Linking fiscal architecture and space
- Toward ‘sustainable’ fiscal structures.
Four Municipal Fiscal Eras

I. **pre-Great Depression**: Property-tax dependence of local governments; ownership of real estate signified wealth.

II. 1929 and extending until the end of the Great Society expansion of federal programs: municipalities diversified their tax base to include retail sales; the federal government provided an unprecedented amount of funding.

III. the advent of the ‘tax revolt’ of the late 1970s: a sudden decline in the share of property taxes; the dramatic reduction of direct federal aid to cities; rapid increase in user fees.

IV. The fourth era is unfolding at this very moment: from financial markets and real estate collapse an emerging new normal.

I. Property Tax Reigns: pre-1929

- In an agrarian economy, “...wealth and property are the same things and the ownership of property is closely correlated with income or ability to pay taxes.”

- States and localities were highly dependent on the property tax:
  - State governments in 1902 raised 45% of their own-source revenues from the property tax, while for all local governments the figure was 78%.
  - In 1929, the state property tax contributed only 15% of state funds and by the post-war era, it had dropped to under 3%.
II. The Great Depression and Revenue Diversification: 1930s to late 1970s

1929-1933: Unemployment nearly 1 in 4
           DJIA drops 89%.
           Bank failures: ~50%.
           Riots in cities and agricultural areas.
           Prices decline by ~ 25%

1930-1939: 4,770 municipal defaults.
Sales Tax

- New York City enacted the first sales tax in 1934 followed by New Orleans in 1936.
- 11-12% of own-source revenues by the 1960s
- By the late 1980s, sales tax revenues had reached nearly 18% of own-source revenues, where it has remained

Income tax

- Philadelphia (1938), St. Louis (1948), Pittsburgh (1954), and Detroit (1962)
- Since 1946, Ohio municipalities have exercised a power to levy a municipal income tax. Toledo was the first Ohio city to pass an income tax, followed in 1949 by Columbus, Dayton, and Youngstown; Cincinnati in 1954
- Income tax revenues constitute a relatively small amount of revenue compared to total municipal budgets nationwide
Fees and Property Tax

- constant-dollar property tax revenue per capita for municipalities declined by 45% from $456 per capita in 1942 to $255 in 1977, while constant-dollar user fees (including enterprise funds) increased from $252 to $349 or a 38% increase
- Property taxes in 1942 constituted 78% of cities’ own-source revenues; in 1977, 43%.

Feds
- federal aid to municipalities reached $25 billion (constant dollars) in FY78, amounting to nearly 15% of general municipal revenue.

- Fees and taxes
  - the escalation of user fees from 30% to 40% of own-source revenues between 1978 and 1982
  - Between 1978 and 2002, total fees and charges, including fees for enterprise-related services, jumped from $349 per capita (constant dollar) to $546 per capita (constant dollars), or an average annual increase of 6.5%.
  - General taxes between 1978 and 2002 grew at a 3.4% annual rate.
  - property tax revenue as a percent of municipal revenue, falling from 41% to 31% of own-source revenues

- Diversity
  - cities with populations greater than 50,000: roughly 34% have access to the property tax only; 8% have access to the income tax (in addition to having access to the property tax); and nearly 58% have some retail sales-taxing authority.
### The Changing Role of Fees and Charges in General Revenues
(Millions of 2002 Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Counties</th>
<th>Municipalities</th>
<th>Townships</th>
<th>School districts</th>
<th>Special districts</th>
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<td>$11,669</td>
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<td>1992</td>
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<td>$64,462</td>
<td>$4,194</td>
<td>$19,410</td>
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<tr>
<td>1997</td>
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<td>$75,479</td>
<td>$4,916</td>
<td>$22,818</td>
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<td>$80,436</td>
<td>$5,335</td>
<td>$26,498</td>
<td>$47,070</td>
</tr>
</tbody>
</table>
State Aid to Municipalities and to All Other Local Governments


**State Aid to Municipalities ($Millions)**:
- 1971-1972: $40,358
- 1976-1977: $45,450
- 1981-1982: $40,613
- 1986-1987: $46,470
- 1996-1997: $61,064
- 2001-2002: $71,887
- 2006-2007: $68,838

**State Aid to Local Governments, Excluding Municipalities ($Millions)**:
- 1971-1972: $127,806
- 1981-1982: $163,194
- 1986-1987: $194,268
- 2001-2002: $337,677
- 2006-2007: $335,011

*Millions of 2005 Dollars*
Federal Aid to Municipalities and to All Other Local Governments

- **Fed aid as Percentage of General Municipal Revenue**
  - 1971-1972: 7.3%
  - 1976-1977: 14.7%
  - 1981-1982: 12.0%
  - 1986-1987: 6.4%
  - 1991-1992: 4.6%
  - 1996-1997: 5.3%
  - 2001-02: 5.3%
  - 2006-07: 5.3%

- **Fed aid as Percentage of Total Local Government Revenue, Excluding Municipalities**
  - 1971-1972: 2.8%
  - 1976-1977: 6.2%
  - 1981-1982: 5.1%
  - 1986-1987: 3.7%
  - 1991-1992: 2.8%
  - 1996-1997: 3.0%
  - 2001-02: 3.6%
  - 2006-07: 3.5%

- **Federal Aid to Municipalities ($Millions)**
  - 1971-1972: $12,145
  - 1976-1977: $28,735
  - 1981-1982: $23,500
  - 1986-1987: $14,757
  - 1996-1997: $15,553
  - 2001-02: $17,511
  - 2006-07: $18,487

- **Federal Aid to Local Governments, Excluding Municipalities ($Millions)**
  - 1971-1972: $9,633
  - 1976-1977: $24,652
  - 1981-1982: $21,927
  - 1986-1987: $19,357
  - 2001-02: $31,966
  - 2006-07: $33,580
Notes: a Income or sales tax for selected cities. b Cities can levy a local income tax, but no locality currently does so. c A local income tax under certain circumstances. d Sales tax only; cities can levy a property tax for debt-retirement purposes only. e Cities can impose the equivalent of a business income tax. f Sales taxes for selected cities and/or restricted use only.

IV. The Future: 2009 and Beyond?

It’s not the Great Depression

✓ ~10% unemployment today v. ~25% in 1929-1933
✓ DJIA down 20-30% v. decline of 89%, 1929-1933
✓ No riots v. urban and rural riots during 1930s
✓ Prices steady v. price decline of around 25%, 1929-33
✓ Bank foreclosures around 10% v. 50% between 1929-33
✓ Municipal defaults very few v. 4,770 in 1930s

but ...

- Real estate market will be slow to recover
- Consumer spending beginning to rise
- Wages steady or declining
- Household savings up
- Employment shifts. Services and 501-c-3
- State fiscal crises
Bureau of Labor Statistics

Industry: Total Nonfarm

Data Type: ALL EMPLOYEES, THOUSANDS
Bureau of Labor Statistics
Industry: Manufacturing
Data Type: ALL EMPLOYEES, THOUSANDS
Bureau of Labor Statistics
Industry: Service-providing
Data Type: ALL EMPLOYEES, THOUSANDS
Bureau of Labor Statistics
Industry: Leisure and hospitality
Data Type: ALL EMPLOYEES, THOUSANDS
Shift from Goods to Services

Source: Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*
Estimated Total State and Local User and Sales Tax Revenue Loss

Value? 2.4% - 4.0% of collected sales taxes in 2007

Growth of 501-c-3

- The nonprofit sector accounts for roughly one-tenth of the U.S. economy, whether measured by employment or total spending.
- Houston recently adopted a “drainage fee” and didn’t exempt 501-c-3 organizations.
Figure 5: Estimated Value of Exempt Property Owned by Nonprofits as a Percent of Total Property Value

Note: These statistics should be viewed as rough estimates. Policy makers should exercise caution when drawing conclusions from these data, because the quality of assessments of exempt property is wide-ranging and often unreliable (Lipman 2006b).


PILOT Revenue as Percentage of Budget

- Pittsburgh
- Philadelphia
- Minneapolis
- Indianapolis
- Detroit
- Boston
- Baltimore

The New York Times
States Move to Revoke Charities’ Tax Exemptions (February 27, 2010)

Provena-Covenant Medical Center v. (Illinois)Dept. of Revenue (2010)

The Wall Street Journal
Pittsburgh Pushes Tax on College Students
**FIGURE 3**
Largest State Budget Shortfalls On Record

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Total Budget Shortfall (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>-$40</td>
</tr>
<tr>
<td>2003</td>
<td>-$75</td>
</tr>
<tr>
<td>2004</td>
<td>-$80</td>
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<tr>
<td>2005</td>
<td>-$45</td>
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<tr>
<td>2009</td>
<td>-$110</td>
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<tr>
<td>2010</td>
<td>-$130*</td>
</tr>
<tr>
<td>2011</td>
<td>-$113*</td>
</tr>
<tr>
<td>2012</td>
<td>-$140 Estimates</td>
</tr>
</tbody>
</table>

*Reported to date
Source: CBPP survey, revised December 2010.

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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. 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.
Percentage of Cities "Better Able/Less Able" to Meet Financial Needs in Current Year

- Less able
- Better able

Recession (peak to trough)
July 1990-March 1991
-67%
-79%
-78%
-66%

Recession
March-November 2001
-44%
-55%
-81%
-63%

Recession
December 2007 – June 2009
-88%
-87%
-64%

Percentage of Cities "Better Able/Less Able" to Meet Financial Needs Next Year

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

Recession
- December 2007 – June 2009
- July 1990 – March 1991
- March – November 2001

Recession
December 2007 – June 2009
Recession March – November 2001

Percentage of Cities Reporting Item Had Among the Most Negative Impacts on Budget

- Infrastructure
- Pensions
- Health benefits
- Economy

Recession December 2007 – June 2009
March – November 2001

% of Cities
Selected City Actions

Percentage of Cities

- Reduce Operating Budget
- Reduce Capital Spending
- Contract Out
- Reduce City Government Employment
- Reduce City Service Levels
- New Interlocal Agreements
- Increased Productivity

Recession
- July 1990 - March 1991
- March - November 2001
- December 2007 - June 2009
Increased Fees/Charges

New Fees/Charges

Development Fees

Increased Property Tax Rate

Expenditure Actions
(% of city finance officers listing factor)

City Spending Cuts in 2009 and 2010

- Personnel Cuts
- Delay/Cancel Capital Projects
- Cuts in Other Services
- Modify Health Care Benefits
- Public Safety Cuts
- Across the Board Services Cut
- Renegotiate Debt
- Modify Pension Benefits/Plans
- Human Services Cuts

Revenue Actions
(\% of city finance officers listing factor)

Revenue Actions in 2010

Ending Balances as a Percentage of Expenditures (General Fund)

Actual Ending Balance
Budgeted Ending Balance

Recession July 1990-March 1991
Recession March –November 2001
Recession December 2007 –June 2009

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Spatialization of Revenue Structures

Why promote development or a certain type of development at a particular location?

Given a choice, parcels will be identified for development that maximize revenues or minimize costs. The ‘mini–max incentive’ embedded within the context of a city’s revenue structure manifests itself spatially in the design, land–use designations and development patterns of the city, or the spatialization of revenue structure.
Property-tax cities think strategically about development based on the market value of the development and on the possibility of shifting service-delivery costs to other jurisdictions (fiscal externalities).

STRATEGIC BEHAVIOR OF SALES-TAX CITIES

Sales-tax cities think strategically about development based on their mental constructs of “shopping sheds” and on which market transactions are taxable.
Income-tax cities think strategically about development based on their assessment of the income growth potential of the individual or firm.
Policy Questions?

1. Sprawl and transportation.

Low density growth is caused by numerous factors (e.g., transportation and land costs), but might sprawl also be encouraged because of cities’ pursuit of revenues. For example, if sprawl is an outgrowth of sales-tax cities’ demand for resources, would a different revenue mix curb or diminish sprawl?
2. Regional cooperation.

Do revenue structures influence cooperative behavior among local governments? What immediate gains to a municipality with undeveloped land near it would cooperation with a neighboring municipality generate? Unless forced by the state to adopt a cooperative face, the revenue logic of cities, especially sales-tax cities, might discourage cooperation.
3. **Revenue Structures and Land Use.**

If land use/zoning follows the logic of spatialization of revenue structures, zoning and land use would change with the introduction of a different revenue system.
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Don’t Waste a Crisis: The economic shock of 2007 to the present ought to encourage a political discourse about reforming the fiscal architecture of municipalities:

1. If States Want Cities to be Responsible for Their Actions, States Should Give Them Adequate Tools. Diversify. Authorize access to taxes. Eliminate TELs.

2. The Fiscal Mismatch Is Weakening Cities. Reform the tax structure: Tax structures might be designed that link closer to cities’ underlying engines of growth or to income and wealth. Tax on income/wages. Is a tax on income at the place of employment (such as Ohio’s, Kentucky’s) or a gross receipts tax (such as Washington state’s Business and Occupation Tax) a more accurate measure and reflection of a city’s tax base?
Cincinnati and Dayton

(Data for FY2000)
Don’t Waste a Crisis

**Broaden the sales tax base.** As the retail sales tax base has narrowed as a percent of consumer spending, is it time to reconsider a sales tax on services?

**Restructure the property tax.** As real estate loses much of its value, as vacant properties lie fallow, and as the number and value of tax-exempt properties increase, might cities consider moving from a uniform to a split-rate system? What’s lost and gained by exempting so much property from the tax roles?
3. **Jointly Provide Services and Share Service Delivery Costs.** The metropolitan region is increasingly the demographic as well as the economic unit of local life and global competitiveness. The new “glocal” nature of regions requires infrastructure delivery at new and flexible scale.

Create regional taxing powers. Municipalities will be looking for regional partners and allies in designing a system that is less destructive to the region’s long-term interests and fairer in distributing the costs to the users.
4. **Pricing Drives Behavior. Seize It!** Cities can create better and innovative financial systems that ensure (1) **efficiency** is met and the benefits principle followed; (2) **equity** is met and users pay for services and infrastructure, and an ability-to-pay principle is followed; (3) full-cost pricing of infrastructure construction and operations that include the costs of maintenance into the **pricing structure**. (The costs of an asset are not only the initial construction costs and later the renovation costs. Operating and maintaining the facility require planning for day-to-day use and adequate funding.)

Approximating the market value of city-delivered services would possibly reduce subsidies to free-riders. Mileage fee? Fee for service?
Infrastructure

- The state regularly conducts a thorough analysis of its infrastructure needs and has a transparent process for selecting infrastructure projects.
- The state has an effective process for monitoring infrastructure projects throughout their design and construction.
- The state maintains its infrastructure according to generally recognized engineering practices.
- The state comprehensively manages its infrastructure.
- The state creates effective intergovernmental and interstate infrastructure coordination networks.
3. The state maintains its infrastructure according to generally recognized engineering practices.

✓ The state adopts a life-cycle approach to asset management.
✓ The state employs current condition assessments in setting priorities for infrastructure maintenance and renewals
✓ The state funds maintenance at a level that minimizes a facility's life-cycle costs and that ensures defined levels of service and safety standards are met.
## Infrastructure Criteria
### Government Performance Project, 2008

<table>
<thead>
<tr>
<th>Criterion</th>
<th>STRENGTH</th>
<th>MID-LEVEL</th>
<th>WEAKNESS</th>
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<tr>
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<td>Intergovernmental</td>
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Change in Constant Dollar Expenditures (General Fund)

Change in Constant Dollar Capital Spending

Crumbling Assets

- First, maintenance is sacrificed in the face of a fiscal slowdown.
- Second, the deferral decision is invisible or undetected in short term.
- Third, budget processes for operating and capital expenditures often are not linked effectively.
5. **Revisit the Social Compact.** The social compact of the last century that bound generations, socio-economic classes, neighborhoods, cities and regions needs to be reconsidered in light of demographic shifts, the transformation of the underlying economy, the forces of globalization, and an irrepressible resolve to enhance the human condition.
Leadership and Government Fiscal Challenges

Public Finance Conference
Wichita, Kansas
17 February 2011

Thank you.