# Economy's Impact on City Budgets

***June 2010***

Fiscal Year 2010 has rocked city budgets. Even though the general economic consensus is that the most recent recession ended a few months ago, Kentucky cities will continue to feel budgetary pain and pressures for many more months to come.

**National Perspective**

Cities nationwide faced an estimated budget shortfall of nearly three percent of their general fund budgets in 2009, according to a survey by the National League of Cities (NLC). Sales and income taxes had declined, but property taxes were relatively flat. However, local government tax collections typically lag economic conditions due to administrative delays, assessment changes and overall employment (which lags gross domestic product in economic cycles). As a result, NLC estimates that the municipal sector will face a revenue shortfall between $35 million and $53 million for fiscal years 2010, 2011 and 2012 combined.

> "Current economic indicators suggest that the U.S. economy has recently passed the low point of the current recession, which means that the low point for city fiscal conditions will likely be experienced sometime in 2011."
>
> *Research Brief on America's Cities,*
> *"City Budget Shortfalls and Responses: Projections for 2010-2012"*
> *National League of Cities*
> *December 2009*

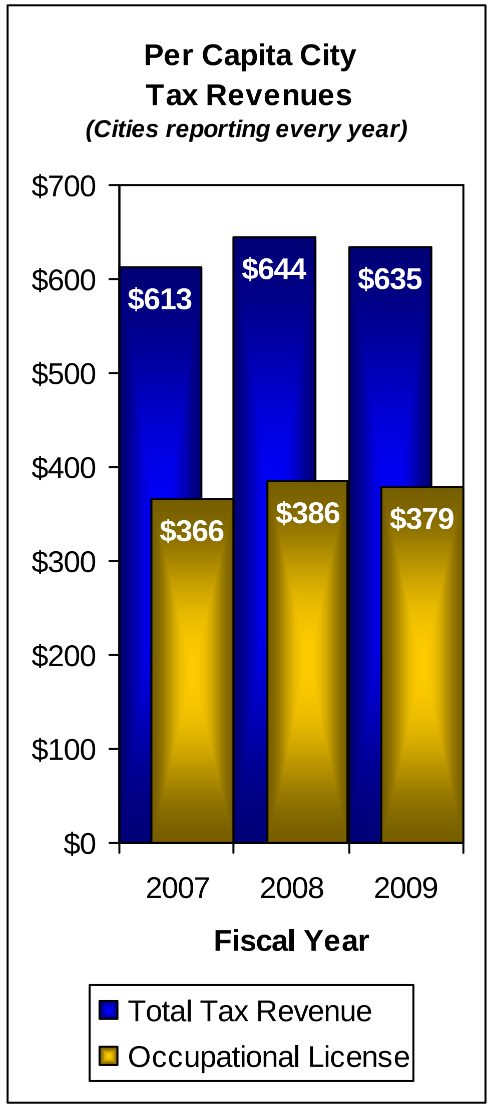
The U.S. Government Accountability Office (GAO) recently published a report entitled "State and Local Governments' Fiscal Outlook: March 2010 Update." The report indicates that the state and local government sector faces general fund declines largely as a result of declining tax revenues. The report also indicates that monies from the Recovery Act – the economic stimulus legislation passed in February 2009 – helped offset some of the near-term fiscal challenges. Since the GAO report combines state and local government budget information together, the Recovery Act money that went mostly to states to bolster their budgets skews the overall figures.

The GAO report outlines a grim view of state and local budgets through the next 50 years. The projected increase in health care costs is hurting cities in two ways: (1) increased insurance premiums for active employees and (2) increased costs for retired employees in defined benefit pensions that include healthcare coverage. Health-related costs are projected to increase at a rate higher than most other types of government expenditures, such as wages and capital investment, and unfunded liabilities in pensions will force employer contribution rates much higher. Kentucky cities in the County Employees Retirement System, a defined benefit pension plan with health insurance benefits, already are projected to contribute 26 percent (non-hazardous) and 52 percent (hazardous) of payroll by FY 2019, which are about double the rates paid in FY 2009.

> "…closing the fiscal gap (through 2060) would require action to be taken today and maintained for each and every year going forward equivalent to a 12.3 percent reduction in state and local government current expenditures. Closing the fiscal gap through revenue increases would require action of a similar magnitude through increased state and local tax receipts."
>
> *"State and Local Governments' Fiscal Outlook, March 2010 Update"*
> *U.S. Government Accountability Office*
> *March 2010*

**Statewide Perspective**

Kentucky city budgets are primarily funded through three types of general revenue taxes: (1) occupational taxes, (2) insurance premium taxes and (3) property taxes.  These three sources alone account for over half of all general revenues.




An analysis of annual financial reporting from FY 2007 through FY 2009 shows that Kentucky cities started feeling the impact of the economic downturn in FY 2009.  For cities that reported their revenues and expenditures for each of these three years on the Uniform Financial Information Reports (UFIR), total per capita tax revenue increased $31 from FY 2007 to FY 2008; however, it declined $9 from FY 2008 to FY 2009.

Occupational license taxes were largely the driver for these results.  From FY 2007 to FY 2008 occupational license tax revenues increased $20 per capita.  From FY 2008 to FY 2009 occupational license tax revenues dropped $7 per person.  This decline in occupational tax revenue is most closely linked to the significant loss of jobs throughout the state.  During FY 2009 the state's unemployment rate grew to double digits, increasing from 6.6 percent in June 2008 to 11.1 percent in June 2009.

Larger cities, which are centers of business activity and labor, typically rely more heavily on occupational taxes on payroll and business net profits.  The recession has hit these economic centers hard with high unemployment rates and lower business profits.  As unemployment goes up, payroll tax revenues go down.

- Occupational taxes are declining because of high unemployment and lower business profits.
- Insurance premium taxes are declining because residents are forgoing insurance or increasing risk to lower their premiums.
- Property taxes could decline as homes are reassessed resulting in lower home values.

Insurance premium tax revenues are also declining as residents choose to forgo insurance coverage and/or assume more risk (such as increasing deductibles) to lower premiums.  From FY 2008 to FY 2009 insurance premium tax revenues in Kentucky cities have declined about $6 per capita, from $94 to $88 per person.

Property taxes could decline or be forced up over the next year or two as more and more homes are reassessed.  From FY 2008 to FY 2009 property tax revenues increased only $3 per person from $165 to $168 per capita.  Real property tax revenues typically lag other tax sources due to the time it takes to reassess home values.

Cities are already dealing with declining and/or underperforming revenues by cutting spending. Unlike the federal government, cities must balance their budgets each year. Declines in revenue must be met with reduced expenditures, the infusion of onetime money from contingency funds (also known as rainy day funds), or increased taxes or fees. But, property and insurance premium tax rates cannot be changed during the course of the year, and increased occupational taxes could hurt the economic recovery within a city. As a result, most city leaders are choosing to cut services, lay off employees, eliminate positions, reduce pay or benefits (including furloughs), delay capital projects and/or tap rainy day funds.

**Conclusion**

Kentucky city leaders will face significant budgetary pressures and decisions in FY 2010 and for years to come. In the short term, unemployment is projected to remain high throughout the state, and residents will likely continue to seek ways of lowering or eliminating insurance premiums. A jobless recovery will continue to hurt city tax revenues while increasing the demand for city services. Long-term stability will be hurt most notably by the increase in healthcare and pension costs. Serious planning and evaluation will help community leaders determine local priorities and make tough budgetary decisions.

*Questions? Contact the KLC research team at 1-800-876-4552.*