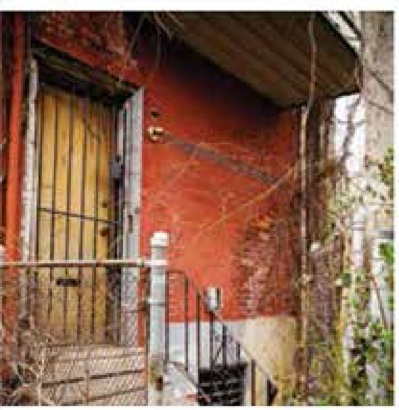

FISCAL STRESS IN THE SMALL POSTINDUSTRIAL CITY

CAUSES, CONSEQUENCES, AND IMPLICATIONS FOR COMMUNITY DEVELOPMENT

FEDERAL RESERVE BANK
OF PHILADELPHIA

A Special Report by the Community Development Studies and Education Department

FISCAL STRESS IN THE SMALL POSTINDUSTRIAL CITY

CAUSES, CONSEQUENCES, AND IMPLICATIONS FOR COMMUNITY DEVELOPMENT

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[1] I would like to thank Rob Greco, Mike Hopkins, Brett Kittrick, William Leinberger, Susan Longworth, Alan Mallach, Leonard Nakamura, Theresa Singleton, Gary Strathearn, and Kristen Wyckoff for their feedback and assistance in preparing this report. Any mistakes are mine, and the views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System. This report is available free of charge at www.philadelphiafed.org/community-development/publications/special-reports/.

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INTRODUCTION

Municipal finance can be a complicated subject, and developing a thorough understanding of a city's financial statements and accounting practices is not for the faint of heart. But fundamentally, and over the long term, a city's fiscal health hinges on the same simple arithmetic that underpins every household's financial stability: Is enough money coming in to pay the bills on time, to maintain the property, and to provide its members with a decent quality of life?

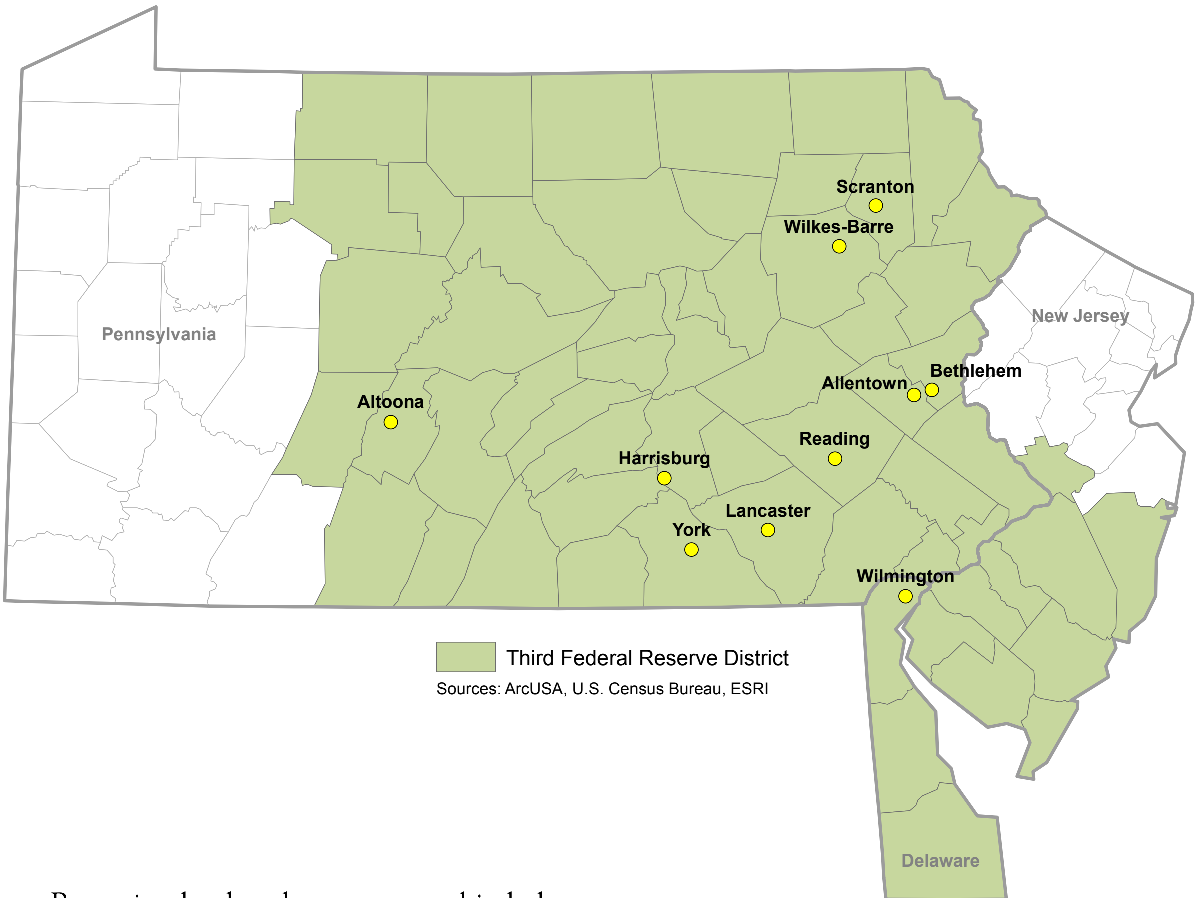
As is the case for many low- and moderate-income households, postindustrial cities across the country struggle to make ends meet, but their fiscal plight often flies under the radar. The issue garners national attention only when it rises to crisis levels and results in Chapter 9 bankruptcy, as it did in Detroit in July 2013. At that point, the city's fiscal issues and associated court battles with creditors are exposed to the light of day in every major national media outlet.

As a result, one would be forgiven for believing that only the cities that file for bankruptcy have significant fiscal challenges and for also believing the corollary: that every city with significant fiscal challenges files for bankruptcy. To the contrary, only 13 general-purpose governments have filed for Chapter 9 bankruptcy since 2008, and five of those were ultimately dismissed (Maciag 2013).[2] However, many more cities than these have experienced fiscal strain during this period, and the issue is more widespread than the headlines would indicate.

The Great Recession (2007–2009) and the slow recovery that ensued tested the fiscal health of cities across the nation. Unemployment, falling property values, and the near disappearance of real estate development created cyclical fiscal emergencies during and immediately after the recession (Mallach and Scorsone 2011). Because these issues impacted states as well, state aid to municipalities declined, compounding the blow of lower property tax revenues; as a result, these two important sources of revenue for municipal governments fell simultaneously between 2009 and 2010 — the first time this has happened since 1980 (Pew Charitable Trusts 2012). A survey of city finance officers suggests that, compared with the prior year, the majority considered their cities less able to meet their fiscal needs from 2008 through 2011, and general fund revenues fell in real terms from 2007 through 2012 (Pagano and McFarland 2013).

This report, however, is less concerned with the aftermath of the recent recession that affected cities across the board and more concerned with the endemic fiscal challenges that have long burdened many older postindustrial cities. Predating

[2] This excludes the bankruptcy filing of roughly 25 "special districts," such as utility authorities and school districts.



the Great Recession by decades, a structural imbalance — between the level of revenues that older industrial cities need to make their budgets work, on the one hand, and the revenues that they can reasonably generate, on the other — is at the heart of the problem in these cities. For many, this imbalance is caused by a number of issues related to their decades-long deindustrialization: the interrelated losses of jobs and population; greater levels of housing vacancy and abandonment; declining property values; and higher levels of poverty for the remaining population, which, in turn, lead to greater demands for services (Mallach and Scorsone 2011).

The subjects of this report are 10 cities in the Third Federal Reserve District that, to one degree or another, struggle daily to overcome a structural fiscal imbalance: Allentown, Altoona, Bethlehem, Harrisburg, Lancaster, Reading, Scranton, Wilkes-Barre, and York in Pennsylvania, and Wilmington in Delaware.[3] After using historic data to help explain the structural nature of their challenges, this report describes seven important indicators commonly used to assess fiscal health and applies them to recent financial data for the 10 cities. Following this analysis, special attention is given to the implications for public support of community development investments. The report closes with an overview of common municipal responses to budgetary strain and concluding remarks that introduce strategies, proposed by others, to improve the fiscal health of the postindustrial city.

[3] Located in eastern and central Pennsylvania and Delaware, these cities are among those identified by Mallach (2012) as the Third Federal Reserve District's small postindustrial cities. Mallach selected these cities based on their population in 1950 (between 50,000 and 150,000) and their historic reliance on manufacturing and related industries. The data used to evaluate recent fiscal health were not readily available for three of the cities identified by Mallach (2012) — Camden and Trenton in New Jersey and Chester in Pennsylvania — so this report excludes them.

DECADES IN THE MAKING

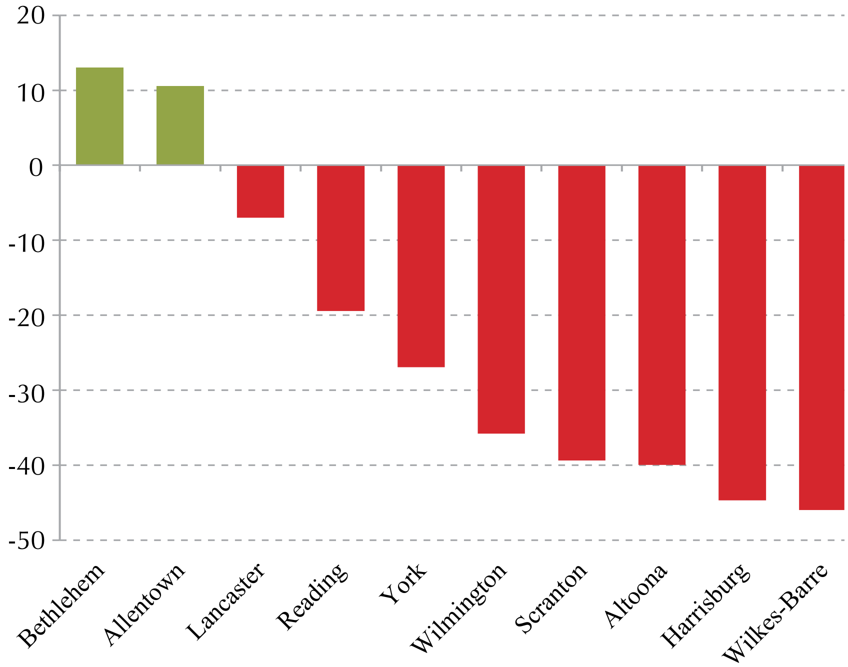
The recent recession caused financial hardships for many American cities. Tax receipts and state aid fell. The balance sheets of many American households were seriously compromised, leaving some financially vulnerable and in need of government assistance. And costs associated with ameliorating the effects of the foreclosure crisis skyrocketed. Far from being spared from these devastating processes in recent years, many of the District's former industrial powerhouses entered the recession with tax bases that had been eroded by demographic and socioeconomic trends rooted in their historic loss of industry. Many of these cities could not support their already high and still-rising costs in good economic times, much less during times of national crisis.[4]

Although influenced by policy and the quality of governance, a city's capacity to self-fund the services that its citizens expect and demand is inherently tied to the characteristics of its residents and its employment base. Reflecting this importance, municipal credit ratings are partly based on a city's economic strength, measured by indicators such as population and employment trends, poverty and unemployment rates, income, housing occupancy and vacancy rates, and building permit activity (see, for example, Moody's Investors Service 2013b). The remainder of this section uses three of these metrics to assess changes in these cities' relative economic strength over time.

Today, the 10 cities featured in this report are home to between 40,000 and 120,000 residents. As Figure 1 illustrates, eight cities lost population between 1950 and 2010, with six of them shrinking by a quarter or more. Because the physical footprint of these cities did not contract with their populations and demolition did not keep pace, vacancy rates are generally much higher today, compared with historic levels and with their states. Between 1950 and 2010, only Bethlehem and Lancaster saw vacancy rates rise by fewer percentage points than their state (see Figure 2); six of the cities had to contend with double-digit vacancy rates in 2010. Not only a symptom of population loss and falling residential demand, the proliferation of vacant housing imposes its own costs on municipal budgets (Econsult Corporation, Penn Institute for Urban Research, and May 8 Consulting 2010) — costs that can exacerbate already difficult fiscal situations.

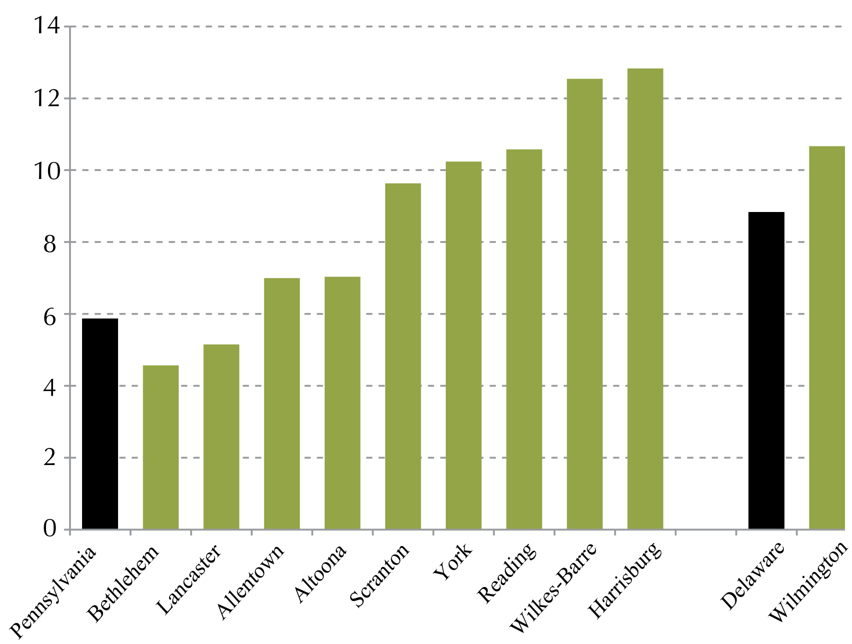
[4] A study by the Pennsylvania Economy League (2007) finds that 54 of the 56 cities in Pennsylvania had below-average levels of fiscal health as early as 1970, and in 2003, those with the highest levels of fiscal distress included five of the cities studied in this report: Harrisburg, Reading, Scranton, Wilkes-Barre, and York.

Figure 1: Population change, 1950–2010 (%)



Source: 1950, Census of Population, Volume I–Number of Inhabitants: Table 4; 2010, Decennial Census, Summary File 1: Table P1; prepared by the U.S. Census Bureau

Figure 2: Housing vacancy rate change, 1950–2010 (percentage points)

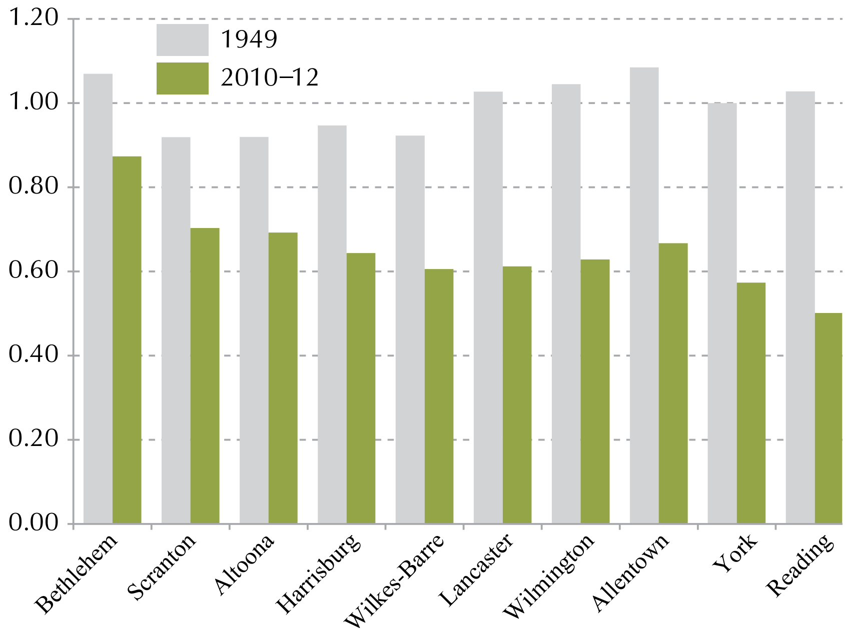


Source: 1950, Census of Housing, Volume I–General Characteristics: Table 1; 2010, Decennial Census, Summary File 1: Table H3; prepared by the U.S. Census Bureau

For the purposes of assessing a city's capacity to generate revenue, a city's population size is only part of the equation. The income profile of the population is also important. Is the city home to gainfully employed and well-compensated residents who contribute more in tax revenue than they consume? Or are these residents outnumbered by net beneficiaries of municipal services? As Figure 3 shows, the inhabitants of these cities have much lower incomes, in relative terms, than they did during the industrial period. Rather than having a median household income within 9 percent, plus or minus, of the state median income, as was true for all in 1949, the median income in these cities is closer to two-thirds of their state's today.

Decades of population loss, falling residential demand, and an increasingly poorer population profile have weakened the tax base on which these cities rely to generate revenue. Although historical data are not available, Figure 4 shows the current total market value for four of the 10 cities, calculated on a per capita basis to control for population

Figure 3: Ratio of city median household income to state median household income



Source: 1950, Census of Population, Volume II–Characteristics of the Population: Tables 32 and 37; 2010–12, American Community Survey: Table B19013; prepared by the U.S. Census Bureau

size. Because property tax is such an important tax-generating tool for most American cities, the total market value per capita provides a good indication of how effective this tool can be. It is clear that compared with the typical municipality, these cities are at a significant disadvantage when it comes to own-source revenue generation.[5]

A city with a diminished tax base generates less property tax revenue than a government applying the same tax rate to more valuable properties.[6] In other words, a city with depressed property values may choose to raise its property tax rate relative to a city with more highly valued properties in order to generate the same level of revenue — a prospect that, all else being equal, makes a city less competitive with neighboring jurisdictions in the eyes of a prospective homebuyer, entrepreneur, or relocating business. As Mallach and Scorsone (2011) note: "The economy of small cities, in particular, is highly sensitive to even small variations in fees and taxes, since alternatives to the city for residents and businesses in nearby suburban communities are close-by and often highly affordable" (p. 17).

Bolstering the tax base through the development of new taxable properties is another way that cities can attempt to generate additional revenue from a depressed market. Notwithstanding the difficulty of this proposition in the best of economic times, new development by itself would not be sufficient to make a tax base adequately robust in all cases, even if it were abundantly successful. As an example, an analysis conducted by the City of York indicates that its tax base would need to grow by $75 million each year — or the equivalent of eight taxable minor league ballparks — to fill the

[5] Six cities are excluded from this figure because estimates were not available for 2012 or due to concerns about data quality. However, data provided by Merritt Research Services, LLC, do not suggest that the omitted cities would change this general conclusion because there is no indication that any would materially exceed the value reported for Wilmington. Market value per capita figures from 2007 reported by the Pennsylvania Economy League, Central PA Division (2009) were below $27,000 for Lancaster, Reading, and York.

[6] A city's total market value is not the same as its taxable assessed value. Both are influenced by the frequency and timing of property value assessments, but the latter is also affected by the number and value of tax-exempt properties. According to data provided by Merritt Research Services, LLC, the total taxable assessed value is roughly 70 percent of the total market value for the typical city with a population of at least 40,000.

Figure 4: Total market value per capita (FY2012)

Source: Merritt Research Services, LLC, accessed using CreditScope software

Note: The median is calculated for all U.S. cities in the database with a population of at least 40,000.

gap created by its "structural financial deficits" (O'Rourke n.d.).[7]

The preponderance of tax-exempt properties in these cities also inhibits their ability to generate revenue from large swaths of their already developed land. More than one-half of the assessed property value in Harrisburg is exempt from property taxes (Pew Charitable Trusts 2013c), while the same is true for 37 percent of York's property valuation (O'Rourke n.d.), and 33 percent of Altoona's (City of Altoona 2012).[8] Although some cities receive payments in lieu of taxes (PILOTs) from exempt properties, the revenue is often substantially lower than the foregone property taxes (Brunori et al. 2005).[9]

As important as the issue is, it would be misleading to attribute all of the blame for these cities' fiscal challenges to a depressed and partially exempt tax base. City leaders tasked with navigating these challenges in recent decades have had their work cut out for them, but it is clear that some of today's problems are the product of yesterday's poor decisions. Recent efforts to upgrade Harrisburg's incinerator serve as an illustrative, if extreme, example. After being closed by the federal government for violations related to air pollution, the Harrisburg Authority, a component unit of the city, borrowed heavily to renovate and expand the city's incinerator with the hope that it would generate revenue for handling the solid waste of surrounding municipalities. The project proved much more costly and less lucrative than expected, saddling the City of Harrisburg, which backed the bonds issued for its construction, with hundreds of millions of dollars in debt that it could not repay (Cooper 2010) and ultimately con-

[7] While arguably good for a city in the long term, economic development, when it does occur, is often induced by short-term tax breaks, incentives, and exemptions that limit its impact on a city's bottom line relative to development that is completely market driven.

[8] An analysis of 11 fiscally distressed municipalities in Pennsylvania concludes that in nine cities, property owned by local governments (city, county, and school district) and authorities accounted for half or more of all tax-exempt property (Pennsylvania Legislative Budget and Finance Committee 2009). The issue of ownership does not diminish the fact that a significant share of the property in these cities does not generate property tax revenue.

[9] A recent study of PILOTS finds that at least seven of the 10 cities discussed in this report received PILOTs in 2010 or 2011. With only one exception, the revenue voluntarily contributed by nonprofits accounted for no more than 0.5 percent of each city's general revenue; in Lancaster, PILOTs represented 2.5 percent of general revenue (Langley, Kenyon, and Bailin 2012).

tributing to the city being placed in state receivership for more than two years.

In addition to ill-advised capital projects, others note the deleterious effect on today's budget of yesterday's generous pensions and health-care coverage for retirees (Glaeser 2012). And no report on fiscal challenges would be complete without a reference to bad governance: A recent study highlighting distressed municipalities in several states, including Pennsylvania and New Jersey, documents "mismanagement, political infighting, and poor financial judgment," as well as isolated instances of political corruption, as exacerbating the already significant fiscal challenges facing some cities (Pew Charitable Trusts 2013c, p. 32).

In summary, there should be no doubt that the fiscal strain characterizing many of the District's postindustrial cities today is not simply a symptom of the recent two-year recession and the slow recovery that followed. Economic downturns certainly make it difficult to balance a budget, but the fiscal difficulties facing these cities have much deeper roots. Although the following fiscal metrics cover only the most recent five years for which data are available, the fiscal challenges facing these cities have been decades in the making.

SEVEN FISCAL INDICATORS

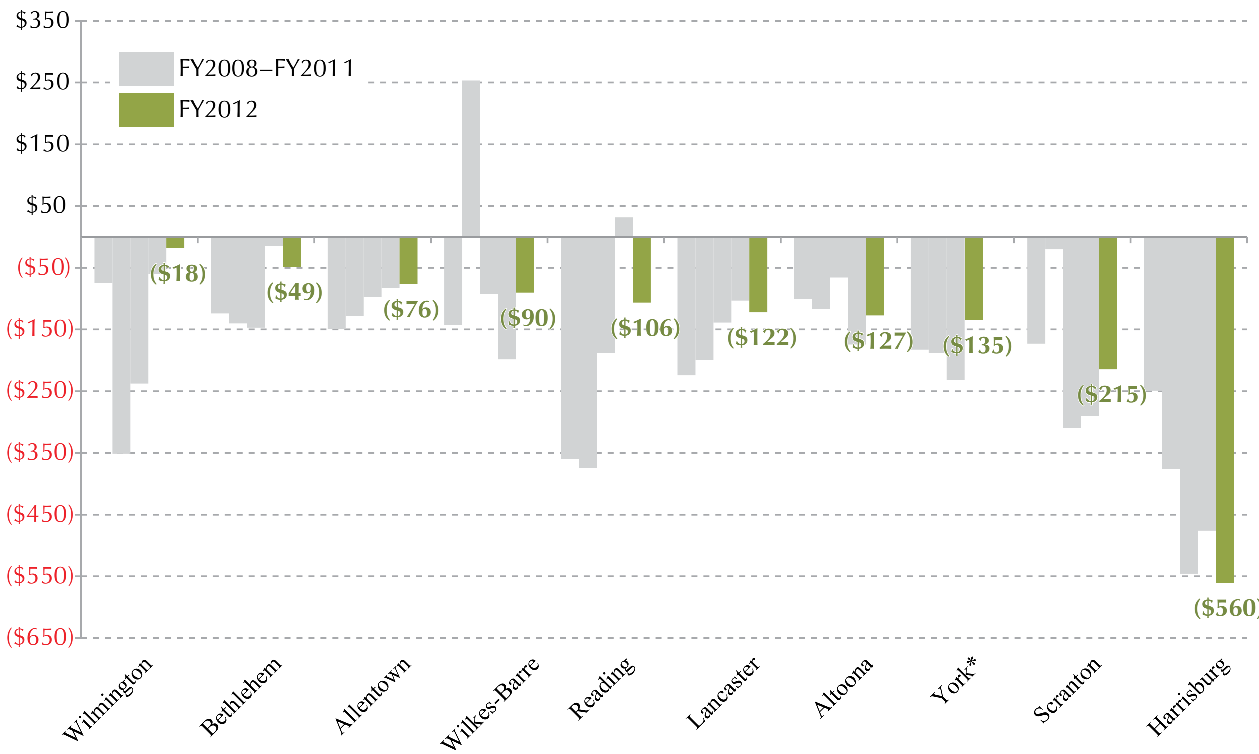
Because municipal fiscal health is such a complex and multifaceted issue, no one calculation can distill it in its entirety and any number of financial statistics could be used in its evaluation. In an effort to tell a well-rounded, if not comprehensive, story for these 10 cities, the following pages use seven indicators to help answer seven important questions related to fiscal health. This analysis uses standardized financial data for these municipalities provided by Merritt Research Services, LLC, and accessed through the CreditScope software package offered by Investortools, Inc.[10] Following Maher and Nollenberger (2009), the performance on each of these seven measures is not aggregated into a composite score for the cities because the real value in this analysis lies in assessing the measures individually rather than in attempting to develop a summary statement on each city's fiscal status.

This report is far from the first analysis of municipal fiscal health. Some of its predecessors have used a jurisdiction's social and economic characteristics to measure the gap between its ability to generate revenue and the cost of its service demands (Zhao 2010), while others have simply chosen different indicators and data sets (see Maher and Nollenberger (2009) for an example). It is only fair to recognize that the use of alternative indicators in this report might have led to different interpretations regarding one particular aspect of fiscal health or another, but it is unlikely that any alternate analysis would have led to materially different overall conclusions: To varying degrees, these 10 cities face very serious fiscal challenges.

[10] For more information on Merritt Research Services, LLC, Investortools, Inc., and CreditScope, see http://www.merrittresearch.com/credit_scope/ and http://www.invtools.com/creditscope.htm.

QUESTION 1: Does the city receive enough revenue from taxes, fees, grants, and assistance from federal and state governments to cover its annual expenses?

Figure 5: Per capita difference in revenues and expenses for governmental activities
(adjusted for inflation to 2012)



Source: Author's calculations using electronic comprehensive annual financial report (CAFR) data provided by Merritt Research Services, LLC, accessed using CreditScope software

Note: Expenses and revenues for governmental activities are reported in the Statement of Activities. Revenues reported as capital grants and contributions are excluded, as are transfers and special items. The difference in revenues and expenses is divided by the same-year population as reported in the data set. All values are adjusted for inflation to 2012 using the gross domestic product (GDP) price deflator for state and local government consumption expenditures and gross investment, published by the Bureau of Economic Analysis (BEA) on November 7, 2013.

* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

Technically, a budget is balanced when revenues are at least equal to expenses. However, a budget is sustainably balanced only when traditional revenue streams are considered. When transfers from other funds, asset sales, or other nonrecurring revenue is required to meet expenses, a budget cannot be said to be structurally balanced (Government Finance Officers Association 2012). Therefore, the figures presented in Figure 5 exclude capital grants and contributions, net transfers with business-type activities operated by the government, and revenues and expenses that do not typically occur in order to better assess whether the government's expenses and revenues are in balance or, alternatively, imbalanced. They are also calculated on a per capita basis to normalize values for cities of different sizes.

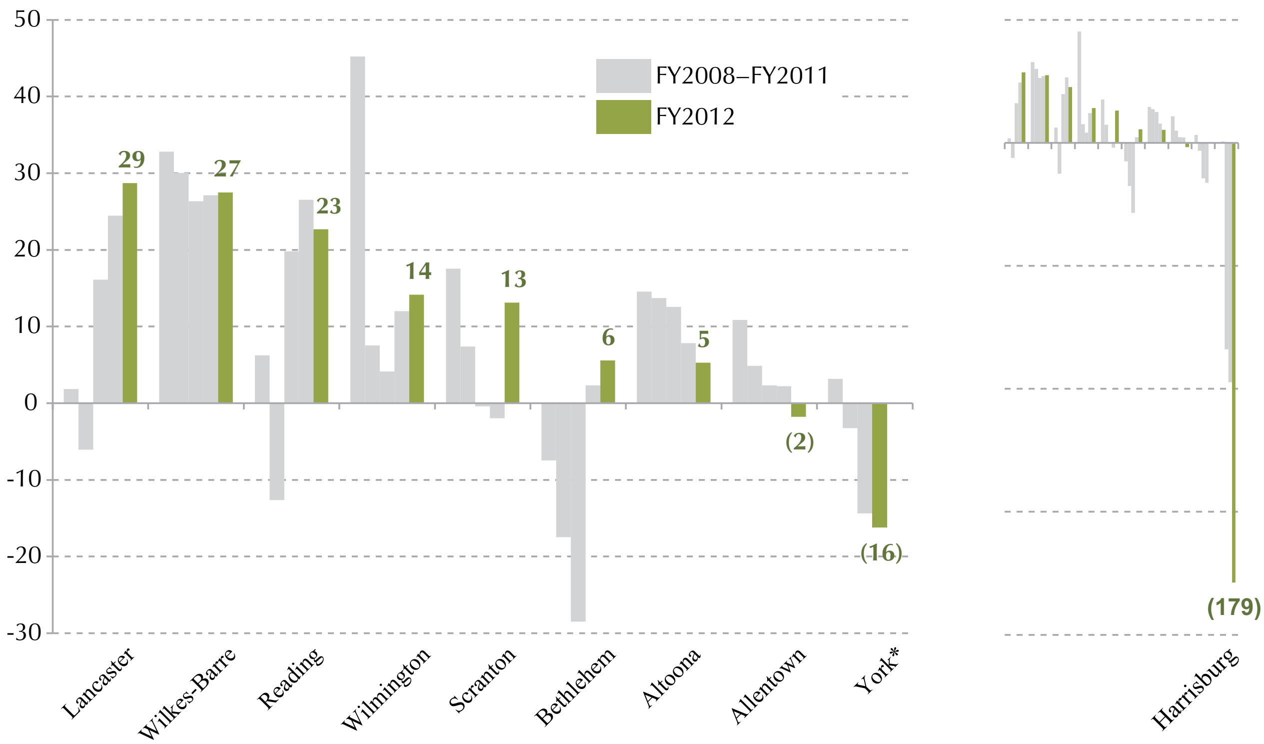
The most important conclusion to be drawn from Figure 5 is that in only two city-year combinations — Wilkes-Barre in 2009 and Reading in 2011 — did revenues exceed expenses for governmental activities, owing to a significant increase in operating grants and contributions in Wilkes-Barre and anomalously high levels of several revenue streams in Reading. For the five-year period, the median per capita difference between revenues and expenses for these 10 cities was a deficit of $140, after adjusting for inflation. For seven of the cities, the per capita deficit improved during the period, indicating movement toward greater equilibrium in revenues and expenses.[11]

[11] The finding that expenses routinely exceed revenues when transfers from enterprise funds (e.g., utilities) and other "operational supplements" (e.g., asset sales and debt restructuring) are excluded confirms an earlier report demonstrating the reliance on these supplements in several cities that are also the subject of this report (Pennsylvania Economy League, Central PA Division 2009).

"While all departmental categories came in under budget, in some areas significantly so, revenues remain insufficient to support the cost of operations. Tight fiscal controls and exceptional management will not be able to compensate for the fundamental lack of resources necessary to provide current levels of service" (City of Reading 2009, p. MD&A 9).

QUESTION 2: Does the city have an adequate level of "savings" that it can tap into if the need arises?

Figure 6: Ratio of unreserved general fund balance to general fund revenues (%)



Source: Author's calculations using electronic CAFR data provided by Merritt Research Services, LLC, accessed using CreditScope software

Note: Unreserved general fund balance is reported in the Balance Sheet–Governmental Funds. Following the implementation of Governmental Accounting Standards Board (GASB) Statement No. 54, unreserved funds are now classified as assigned or unassigned. General fund revenues are reported in the Statement of Revenues, Expenditures, and Changes in Fund Balances–Governmental Funds.

* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

The resources available in a city's general fund are used to finance the day-to-day operations of the city, and the general fund's balance simply reflects the difference between the assets and liabilities held within the fund. The portion of the fund balance that is unreserved can be used without external limitations, although some portion of the balance may be designated for a particular use by the government itself (Gauthier 2009).[12] A healthy unreserved general fund balance is important because a city's financial health "is partly determined by the level of fund balances available to cushion revenue shortfalls caused by economic downturns, emergencies, or uneven cash flows" (City of Kansas City 2013, p. 17). Additionally, the Government Finance Officers Association (2012) believes reserve levels to be "a good and readily available measure" of structural balance. Rather than reporting the actual dollar values, Figure 6 reports the ratio of each city's unreserved general fund balance to its general fund revenues in order to standardize this metric across cities of different sizes. A negative ratio suggests that the fund's liabilities exceeded its assets.

As Figure 6 illustrates, three cities — Lancaster, Reading, and Bethlehem — ended the study period with a relatively larger unreserved cushion in their general fund than in 2008, with the turnaround exhibited by Bethlehem no doubt related to the annual host fee paid by the Sands Casino Resort following its opening in 2009. Others — Altoona, Allentown, York, and Harrisburg, in particular — had unreserved general fund balances that were on a steady downward trajectory during this period.

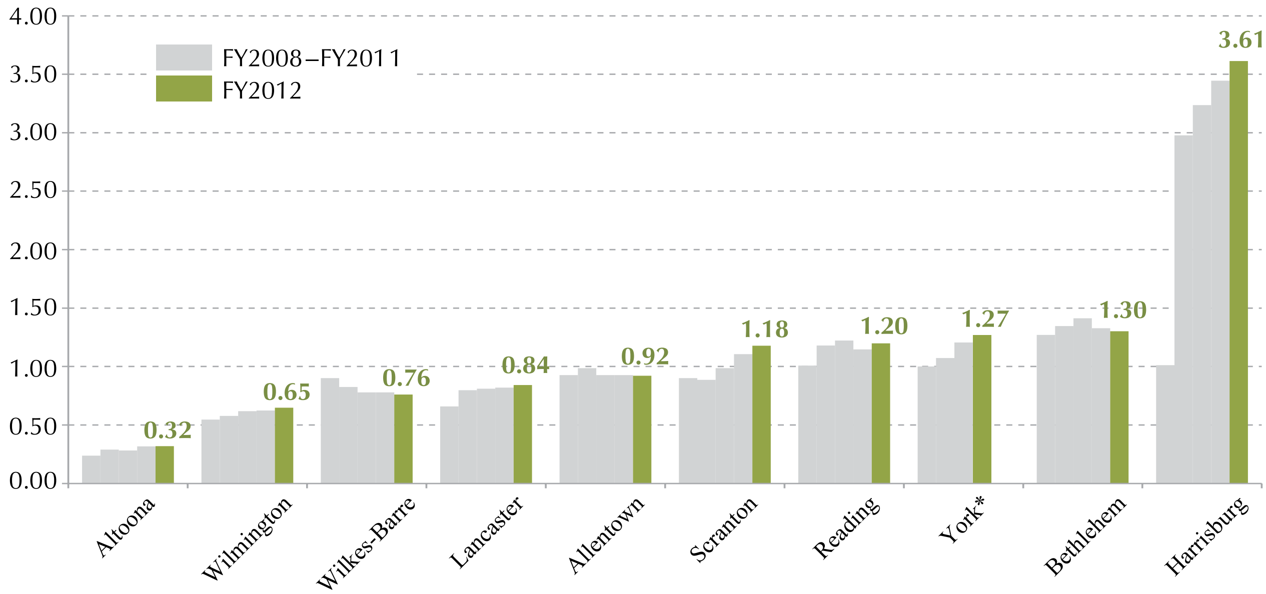
It is unsurprising that many of these cities needed to tap into reserves during and immediately following the Great Recession, and they were hardly alone in doing so. A recent analysis of the 250 largest cities in the U.S. finds that for more than half of them, reserve balances in 2012 remained below 2007 levels (Neumann 2013). And for the central cities in the 30 largest metropolitan areas, average reserve levels fell from 18 percent of general fund revenue to 14 percent from 2007 to 2011 (Pew Charitable Trusts 2013a). As the authors note, however, using reserves in lieu of cutting services is "a short-term solution that can compromise a city's long-term fiscal health" (Pew Charitable Trusts 2013a, p. 16) rather than a sustainable solution for recurring budgetary shortfalls.

Moody's Investors Service reports that nationwide, the ratio of the unreserved general fund balance to total expenditures (rather than revenues) for the typical city was 18 percent in 2010 (cited in City of Kansas City 2013). As the chart indicates, only three cities — Lancaster, Wilkes-Barre, and Reading — exceeded this level in 2012, with Wilmington and Scranton not far behind. At the other end of the spectrum, general fund liabilities exceeded assets, and thus produced a negative ratio, in Allentown, York, and Harrisburg.

[12] After the issuance of new accounting rules in 2009 and their subsequent implementation, funds previously considered unreserved but designated for a specific use by the governing body are now classified as assigned. Funds previously classified as undesignated and unreserved are now recorded as unassigned (Gauthier 2009). Although the overlap between these categories may not be perfect, any discontinuity created by the reclassification of unreserved funds is not believed to substantively affect the trends or levels reported here.

QUESTION 3: Does the city owe more than it owns?

Figure 7: Ratio of total liabilities to total assets for governmental activities



Source: Author's calculations using electronic CAFR data provided by Merritt Research Services, LLC, accessed using CreditScope software

Note: Total assets and total liabilities are reported in the Statement of Net Position, and the figures used here include governmental activities only. This calculation excludes the total unfunded actuarial accrued liabilities associated with pension and other post-employment benefits plans; however, the cumulative differences between annual pension and other post-employment benefits costs and contributions are reported as net assets or net liabilities in the Statement of Net Position (i.e., if contributions to a pension fund in a given year are lower than estimated costs, the city's net pension liability would increase, or its net pension asset would decrease, by an amount equal to the difference).

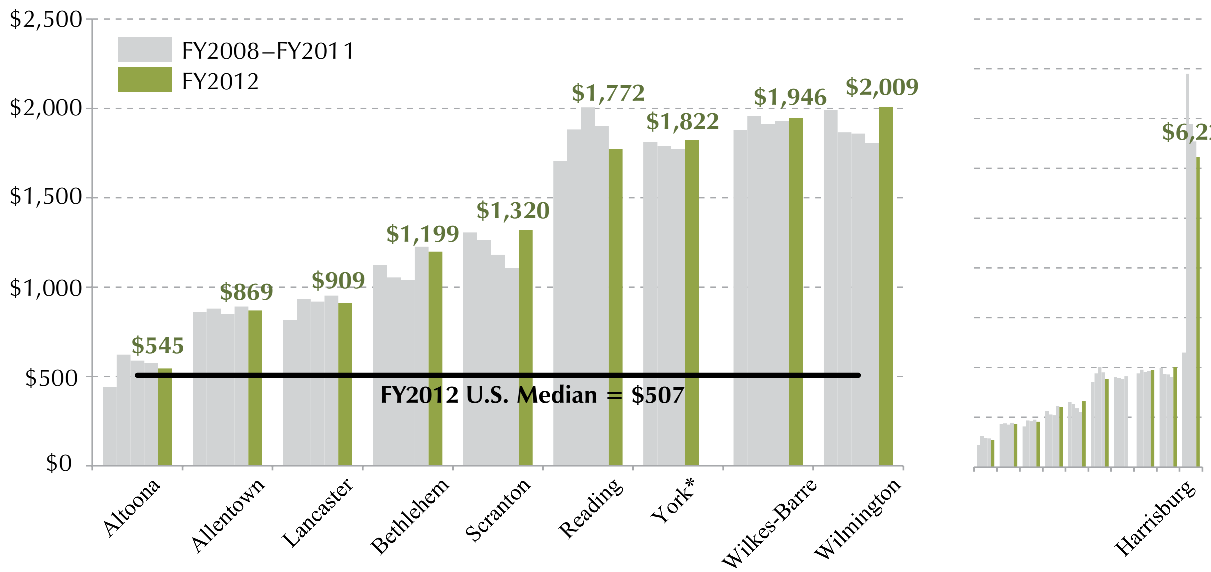
* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

A city's debt-to-assets ratio quantifies the proportion of a government's assets that, if they were to be liquidated, would be required to settle its debts (Mead 2011). A city with low debt relative to its assets will have a ratio well below 1.0, while a ratio over 1.0 indicates greater liabilities than assets. Generally, a city's assets are heavily weighted toward capital assets (e.g., infrastructure, land and buildings, machinery, etc.), and thus not easily liquidated, while the majority of its liabilities often take the form of bonds payable.

As Figure 7 illustrates, the ratio of total liabilities to total assets increased for seven of the nine cities between 2008 and 2012 and was trending upward for York through 2011. Given Harrisburg's assumption of hundreds of millions of dollars of debt associated with its incinerator, it is unsurprising that its ratio would skyrocket, but the ratio also increased considerably in Lancaster, Scranton, Reading, and York. As the chart shows, half of these 10 cities ended the study period owing more than they own, according to this calculation.

QUESTION 4: What is the size of the city's debt relative to its population?

Figure 8: Net direct debt per capita (adjusted for inflation to 2012)



Source: Merritt Research Services, LLC, accessed using CreditScope software

Note: Information to calculate net direct debt can generally be found in the Notes to Financial Statements section of the cities' CAFRs. Net direct debt represents a city's total direct debt less any debt that is self-supporting (i.e., repaid with a dedicated revenue stream) so as to identify debt that must be repaid with general revenues. It includes, for example, general obligation debt for governmental activities, notes and loans payable, certificates of participation, capital leases, and bond anticipation notes. Excluded are general obligation bonds issued to support business-type or component unit activities. Net direct debt is divided by the same-year population as reported in the data set. The median is calculated for all U.S. cities in the database with a population of at least 40,000. All values are adjusted for inflation to 2012 using the GDP price deflator for state and local government consumption expenditures and gross investment, published by the BEA on November 7, 2013.

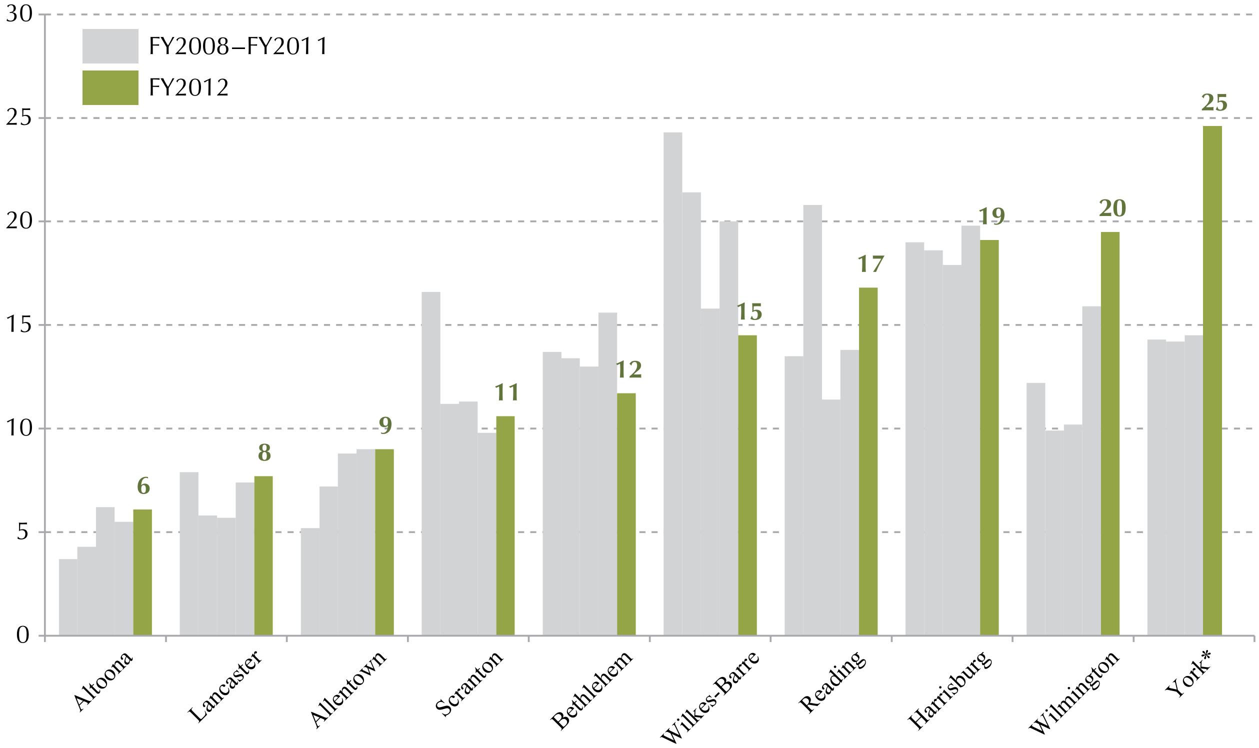
* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

Net direct debt per capita is a good measure of the magnitude of a city's debt relative to its size. The calculation includes debt associated with general government activities paid down with general revenues rather than with a dedicated revenue stream. As Figure 8 illustrates, this indicator increased for each of the 10 cities over the study period even after adjusting for inflation. In some cases — such as Allentown, Scranton, York, and Wilmington — the increase was marginal, while in others (e.g., Harrisburg), the increase was more substantial. Despite a real increase of 23 percent over the period, however, Altoona's net direct debt per capita in 2012 remained near the median and far below the levels reported for the other nine cities.

It is clear that, relative to the median, the population in each of these 10 cities shoulders a larger level of municipal debt than is typical. Only Altoona, Allentown, and Lancaster had less than $1,000 in net direct debt per capita in 2012, or twice the median, while Wilmington exceeded $2,000. As noted before, Harrisburg's debt grew significantly with its assumption of obligations related to its incinerator project, but the city exceeded $2,000 of net direct debt per capita even before that event.

QUESTION 5: To what degree does yesterday's debt consume today's resources?

Figure 9: Ratio of current debt service to total expenses for governmental activities (%)



Source: Electronic CAFR data provided by Merritt Research Services, LLC, accessed using CreditScope software

Note: Current debt service as reported in the data set is the sum of the current portion of long-term debt for the prior year (Balance Sheet–Governmental Funds) and interest for the current year (Statement of Activities). It includes bonds and notes but excludes other types of debt (e.g., uncompensated sick days). Total expenses for governmental activities are reported in the Statement of Activities. This calculation reflects expenses incurred rather than expenditures paid and thus produces a different ratio than would the ratio of debt service to expenditures reported in the Statement of Revenues, Expenditures, and Changes in Fund Balances–Governmental Funds.

* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

The level of debt that a city carries can have a significant impact on its annual expenses. The repayment of principal and interest can account for a substantial share of total expenses for a heavily indebted city, claiming resources that could be allocated to other uses. As Figure 9 indicates, six of the 10 cities ended the period with a higher debt service-to-total expense ratio than in 2008.

On the other hand, four cities reduced their ratios, Scranton and Wilkes-Barre by considerable amounts. For Scranton, this appears to be an artifact of an abnormally high level of debt repayment in 2008 rather than an indication of a sharp long-term downward trend, because, with the exception of that year, data indicate that debt service has been relatively stable since 2006. In Wilkes-Barre, on the other hand, debt service expenses were at a five-year low in 2012.

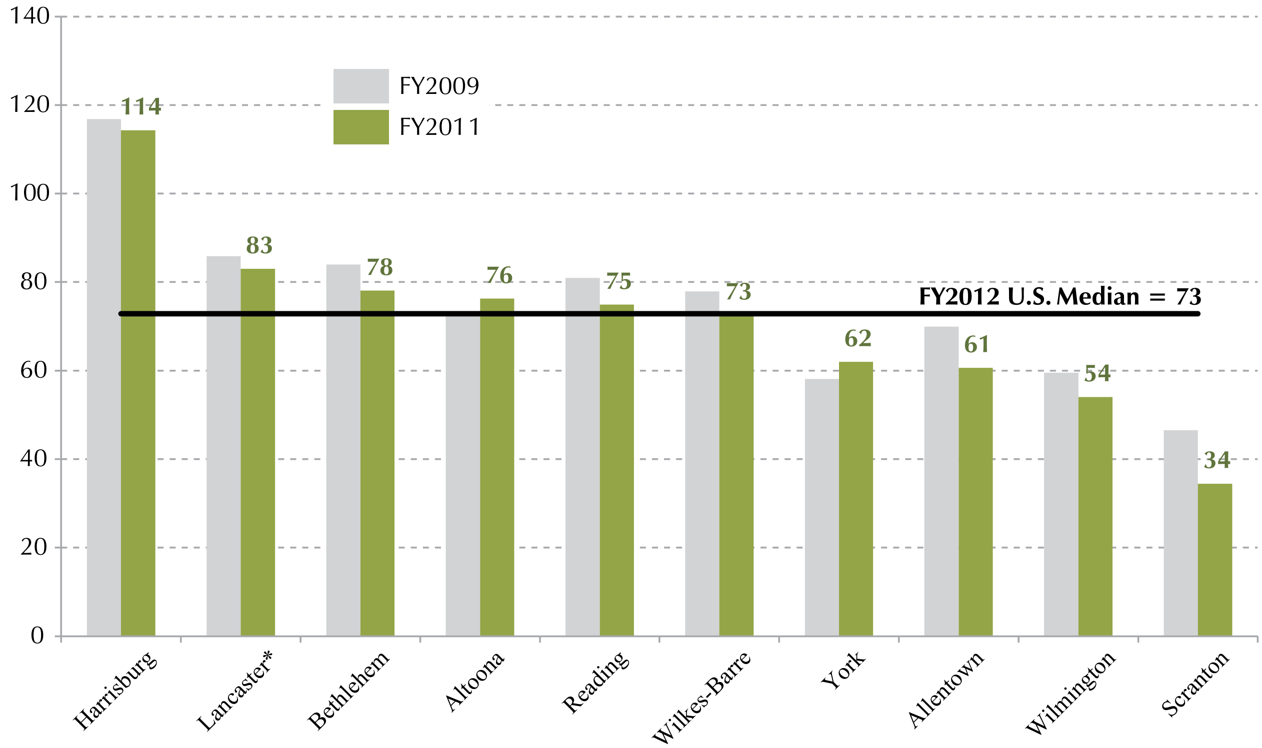
For these 10 cities, the chart shows a fairly wide range for this ratio in the most recent year for which data were available. Debt service claimed less than 10 percent of expenses for Altoona, Lancaster, and Allentown, while in York, it was 25 percent.[13]

[13] Wilmington's ratio was 20 in 2012, the second highest among this cohort. It is worth noting that the state of Delaware provides funds to Wilmington to service the debt on the port that the state purchased from the city in 1996. The budgeted amount of $1.5 million in FY2012 (City of Wilmington 2011) constituted less than 5 percent of the city's actual debt service that year, however.

"The City's substantial reduction in spending has yielded $10 million in expenditure reductions over the last three fiscal years. Unfortunately, these substantial reductions in spending are being negated by unavoidable multi-million dollar annual increases in employee pension and healthcare costs, and new debt service to fund critical infrastructure needs" (City of Wilmington 2012, p. vi).

QUESTION 6: Has the city adequately kept up with its pension obligations?

Figure 10: Pension funded ratio (%)



Source: Merritt Research Services, LLC, accessed using CreditScope software

Note: Information on pension assets and liabilities can generally be found in the Notes to Financial Statements section of the cities' CAFRs. Because the actuarial valuation for pensions is calculated every two years for most of these cities, ratios and unfunded pension liabilities for many were identical in FY2008 and FY2009. The same was true in FY2010 and FY2011. Ratios for the last year in each couplet are provided to indicate direction. Each ratio includes any pension plan with a valuation date that falls between nine months prior to and three months after the end of the fiscal year (e.g., the ratio for a fiscal year that ends on December 31, 2011, includes pension plans with valuation dates between April 1, 2011, and March 31, 2012). For plans that undergo a biennial actuarial valuation, the same information will be used to calculate ratios for consecutive years. The median provided in the chart is calculated for all U.S. cities in the database with a population of at least 40,000.

* FY2010 is shown in green.

As noted previously, costs associated with pensions for current and former public employees can consume a significant share of a city's financial resources. Cities generally operate separate pension funds for police officers, firefighters, and nonuniformed employees, and it is not uncommon for the number of retirees and other beneficiaries to outnumber active employees participating in these plans. In fact, in 2007, there were 1.2 retirees and other beneficiaries for every one active public employee enrolled in a pension plan in Pennsylvania's cities (Institute of Politics Pensions Subcommittee 2009). In the state's townships and boroughs, active members far outnumbered beneficiaries, on average, suggesting that legacy costs associated with retirement benefits are of particular concern to Pennsylvania's cities.

At least every two years, an actuarial analysis of these cities' pension plans estimates the value of current assets in the plans (as determined by both the level of prior contributions and the market performance of the plans' investments), the accrued liability for current and former employees, and the annual required contribution into the plan to cover future liabilities (also known as a mandatory municipal obligation). The ratio of the plans' assets to their accrued liabilities produces the funded ratios depicted in Figure 10. Lower-than-expected returns on investments or a failure to make the annual required contribution into the various pension plans can result in a declining funded ratio. As Figure 10 indicates, Altoona and York made advances in their pension funded ratios between 2009 and 2011, but the other cities saw their funded ratios decline.

While a funded ratio of 100 percent or higher is ideal, actuaries generally consider 80 percent to be "a safe minimum" (Ginsberg 2010, p. 3), and the median shown in the chart is roughly 73 percent.[14] Despite a slight decline from 2009 to 2011, Harrisburg maintained a funded ratio well above 100 percent, Lancaster exceeded 80 percent, and several others outperformed the median.[15] At the other end of the spectrum, Wilmington and Scranton had ratios well below what is both recommended and typical.

It is worth mentioning that the funded ratio for all pension plans is strongly influenced by the interest rate used to estimate the present value of future pension obligations. With the exception of the plan administered by the Commonwealth of Pennsylvania, in which some of these cities participate, these cities' pension plans use a rate of 7.5 to 8 percent — the same rate of return that they assume for their pension assets. This rate is typical in actuarial pension valuations, but at least one ratings agency has decided to begin assessing municipal pension obligations using a more conservative rate tied to the bond market (Moody's Investors Service 2013a). Assuming a lower rate of return would substantially increase the present value of future liabilities and have the effect of lowering a plan's funded ratio. To illustrate, Munnell et al. (2013) calculate that switching from an 8 percent to a 5 percent assumed rate of return lowers the funded ratio from 73 percent to 50 percent for a sample of state and local pensions. In other words, the pension funded ratios provided in this report overestimate the health of these pension plans if the funds do not achieve the 7.5 to 8 percent returns assumed in the ratios' calculation.

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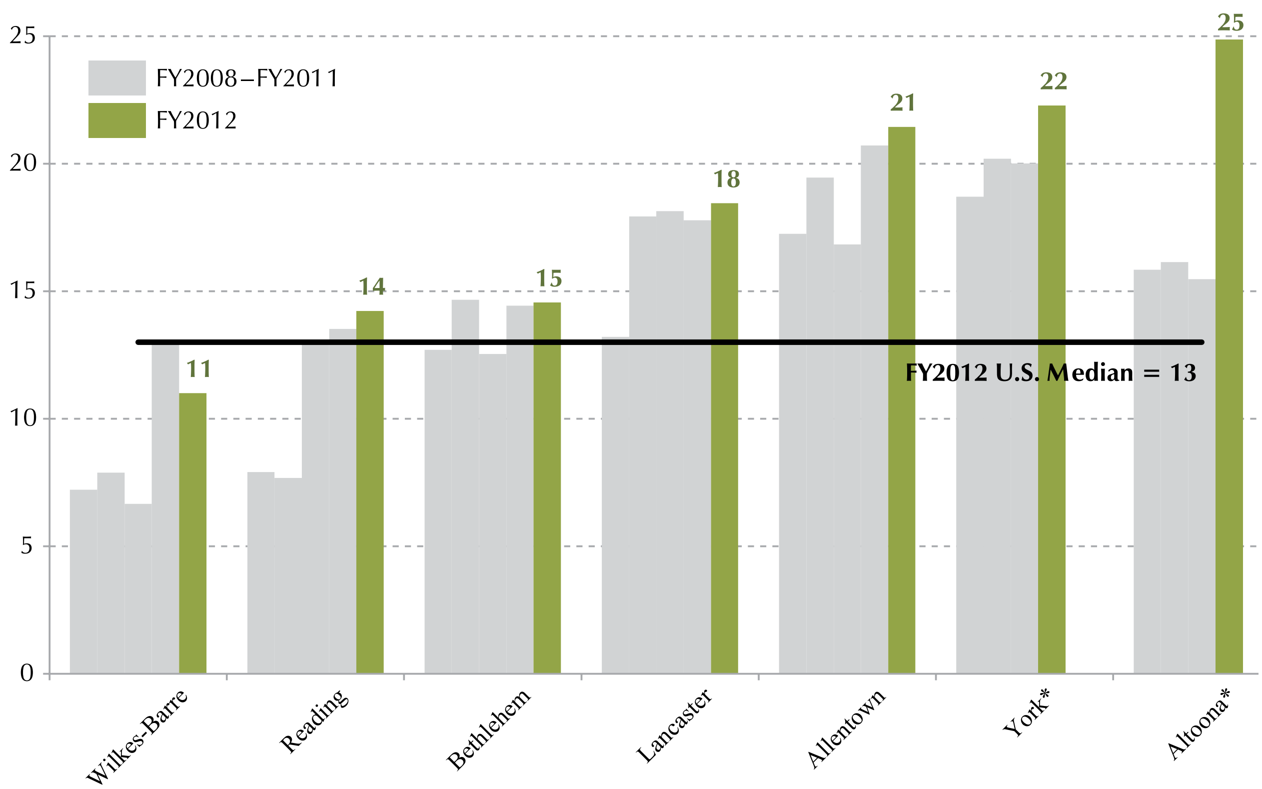
[14] This is in line with the finding by Pew Charitable Trusts (2013b) that the primary cities in the nation's 30 largest metropolitan areas had a combined funded ratio of 74 percent in 2009.

[15] Assets exceeded liabilities in Harrisburg's pension plans for nonuniformed employees and firefighters, while the plan for its police officers was funded at greater than 88 percent. These high funded ratios are at least partly attributable to the city's issuance of bonds in 1995 to cover what was roughly $34 million in unfunded accrued liabilities in these three plans (City of Harrisburg 2009).

"The largest components of the unrestricted deficit [in net assets] are principally the general obligation debt to meet funding requirements to the Pension Fund, borrowings to finance economic development efforts, maintenance, and equipment expenditures on City infrastructure" (City of Reading 2013, p. 29).

QUESTION 7: What share of the city's annual budget is allocated to pension and other retirement costs?

Figure 11: Ratio of pension and other post-employment benefits contributions to general fund expenditures (%)



Source: Author's calculations using data provided by Merritt Research Services, LLC, accessed using CreditScope software

Note: Information on pension and other post-employment benefits (OPEB) contributions can generally be found in the Notes to Financial Statements section of the cities' CAFRs. General fund expenditures are reported in the Statement of Revenues, Expenditures, and Changes in Fund Balances–Governmental Funds. Contributions for governmental and business-type activities are included in this calculation, and it is worth noting that this ratio is not meant to suggest that all contributions are made from a city's general fund. Harrisburg, Scranton, and Wilmington are omitted because data for these cities appear to exclude state pension aid that is included for the other cities. The median provided in the chart is calculated for all U.S. cities in the database with a population of at least 40,000.

* Gray bars reflect data from FY2008–10; FY2011 is shown in green.

Maintaining or increasing the funded ratio for its pension plans can put significant strain on a city's budget. Both the Commonwealth of Pennsylvania and the state of Delaware provide some level of funding support to their cities to assist with annual pension obligations. Through the General Municipal Pension System State Aid Program, Pennsylvania provided roughly $22.6 million in 2012 for the nine Pennsylvania cities discussed in this report, ranging from $1.3 million to $4.2 million for each.[16] Pension aid from Delaware to Wilmington totaled $6.5 million in 2012, accounting for roughly 31 percent of the city's total obligations (City of Wilmington 2012).

In addition to making annual contributions toward their pension obligations, cities must also direct funds toward covering other post-employment benefits (OPEB) for retired workers and, sometimes, their beneficiaries. These benefits generally include health insurance and other health-related services (e.g., dental and vision insurance) but can also include life insurance and legal services (Mead 2011). Unlike with pensions, governments generally do not prefund other post-employment benefits but pay them each year as expenses are incurred (Pew Charitable Trusts 2013b); thus, it is impossible to calculate a funded ratio, as there are no assets in an OPEB account to compare with the city's accrued liabilities.[17] While annual OPEB *payments* can still be significant, it is estimated that actual annual *costs*, when future liabilities are taken into consideration, may be three times higher (Gauthier 2008). Wilmington serves as a good example: The city made OPEB payments totaling roughly $7.2 million from fiscal years 2009 through 2012, but because this represented only about one-third of the actuarially determined OPEB costs during this period, the city's net OPEB obligation rose from $5.0 million in FY2009 to $18.5 million in FY2012 (City of Wilmington 2012).

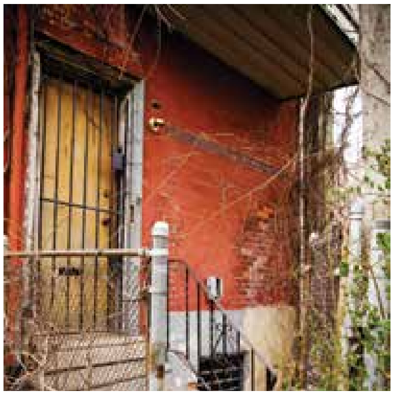
Despite the "pay-as-you-go" practice of funding OPEB expenses, combined pension and OPEB contributions can nonetheless account for a substantial share of a city's general fund expenditures. As Figure 11 illustrates, this ratio rose significantly in Reading and Lancaster between 2008 and 2012 and climbed very quickly for Altoona in 2011. Part of this increase may be attributable to the rising cost of health care, identified by the United States Government Accountability Office (2008) as the primary contributor to state and local fiscal challenges now and in the coming years.

The ratios of pension and OPEB contributions to general fund expenditures for Wilkes-Barre, Reading, and Bethlehem are within two points, plus or minus, of the median for all cities in the database, while the ratios for Allentown, York, and Altoona are considerably higher. Elevated already, these ratios could rise in the future if this prediction by Pennsylvania's Public Employee Retirement Commission (2012) comes to pass: "Municipal [pension] contributions in the aggregate are projected to rise nearly 200 percent in the next six years, assuming the stock market levels return to normal" (p. 16). Such an increase would exacerbate these cities' efforts to simultaneously maintain pension funding levels and balance their budgets in a way that provides their residents with an adequate level of safety and services.

[16] State aid figures are made available by the Pennsylvania Department of the Auditor General, accessed on February 11, 2014, at http://www.auditorgen.state.pa.us/Allocations/.

[17] The Government Finance Officers Association recommends funding OPEB costs as they are earned rather than on the "pay-as-you-go" basis that is typical for these and other cities (Government Finance Officers Association 2008).

"While most City expenses throughout 2012 remained relatively stable due to stringent monitoring and management practices, certain areas continue to increase at rates above the Consumer Price Index. These increases are a result primarily of increasing pension contribution costs. Revenue initiatives and cost control measures continue to be implemented in order to counter this situation. However, throughout [2012], the real problem still remained the City's extraordinarily high unfunded pension liability which in turn fuels the City's continuously growing mandatory minimum municipal obligation (MMO) payment that it must make each year into the pension plan" (City of Allentown 2013, p. 21).



IMPLICATIONS FOR COMMUNITY DEVELOPMENT

As suggested by the broader literature and confirmed by the financial statistics presented in the preceding section, these 10 cities face fiscal challenges that were only exacerbated by the Great Recession. Revenues are insufficient to cover expenditures. Costs associated with debt service, pensions, and other post-employment benefits are consuming a substantial and often increasing share of scarce resources. For many, the unreserved balance in the general fund is lower than four years before and provides little in the way of financial cushion going forward.

In this fiscal environment, many municipal functions can be targeted for cost-cutting initiatives, and public investments in community development are no exception. Using funds from federal, state, and local sources, cities undertake multiple activities that fall under the category of community development or similar terminology in their annual financial reports. These activities vary from city to city and can include planning and zoning, building inspections and code enforcement, housing rehabilitation, affordable housing development, the disposition of vacant properties (sometimes through demolition), investments in commercial corridors, economic development, and financial support for homeless shelters and community centers. Generally speaking, community development activities are intended to make a city more livable by improving the built environment and the quality of life for its residents, often with a focus on low- and moderate-income households and communities. Many of these cities' community development departments likely have a mission similar to Scranton's Office of Economic and Community Development, which strives to "create a local environment that stimulates balanced growth through job creation, business assistance, housing options and neighborhood redevelopment" (City of Scranton 2011, p. 60).

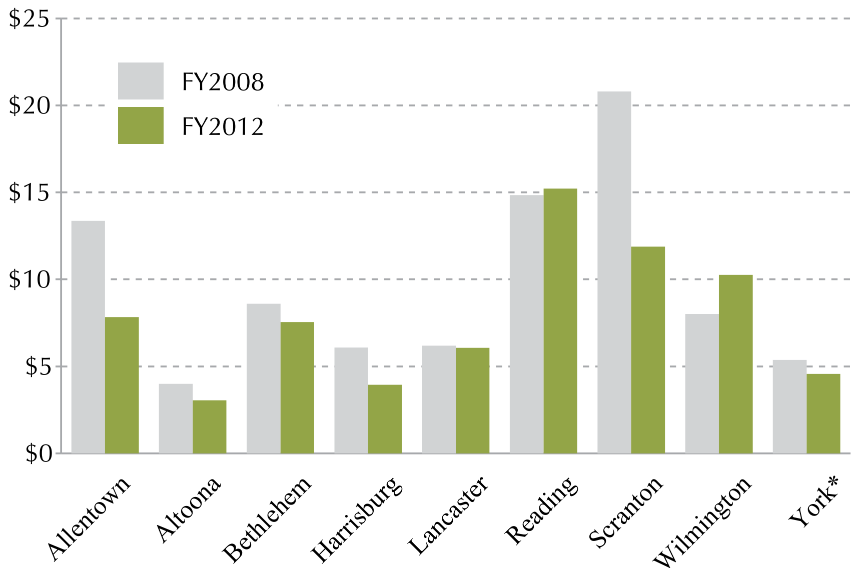
In an effort to understand how expenditures on community development activities have been affected in the span of the last five, particularly difficult, fiscal years, Figure 12 compares expenditures for nine of the 10 cities in 2008 with comparable figures from 2012, with the former adjusted for inflation to 2012 dollars.[18]

Figure 12 indicates that, after adjusting for inflation, community development expenditures were lower in 2012 than in 2008 for seven of the nine cities. The decline was quite dramatic in a few of them (Allentown, Scranton) and minimal in others (Bethlehem, Lancaster). In spite of the economic

[18] Wilkes-Barre is excluded from this chart because different expenditure categories were used in these two years, complicating any trend analysis.

downturn and its effects on available resources, Reading and Wilmington managed to commit a greater level of resources to community development at the end of the period than at the beginning. Across these nine cities, community development expenditures fell in inflation-adjusted terms from $87.2 million to $70.3 million between 2008 and 2012, a decline of $16.9 million or 19 percent.

Figure 12: Community development expenditures
(millions, adjusted for inflation to 2012)



Source: Expenditures are reported in the Statement of Revenues, Expenditures, and Changes in Fund Balances–Governmental Funds, found in these cities' 2008 and 2012 CAFRs.

Note: Values for Bethlehem include program expenditures associated with the Community Development Block Grant Fund. The FY2008 value for Wilmington is from the FY2012 financial report, which reallocates expenditures in a manner that is consistent with 2012; it is slightly higher than the value found in the FY2008 financial report. On this point, it should not be assumed that the expenditures classified as community development in 2008 are necessarily classified in the same manner in 2012 for a given city, nor is it likely that community development is defined consistently across the group of cities. All 2008 values, as well as York's expenditures from 2011, are adjusted for inflation to 2012 using the GDP price deflator for state and local government consumption expenditures and gross investment, published by the BEA on November 7, 2013.

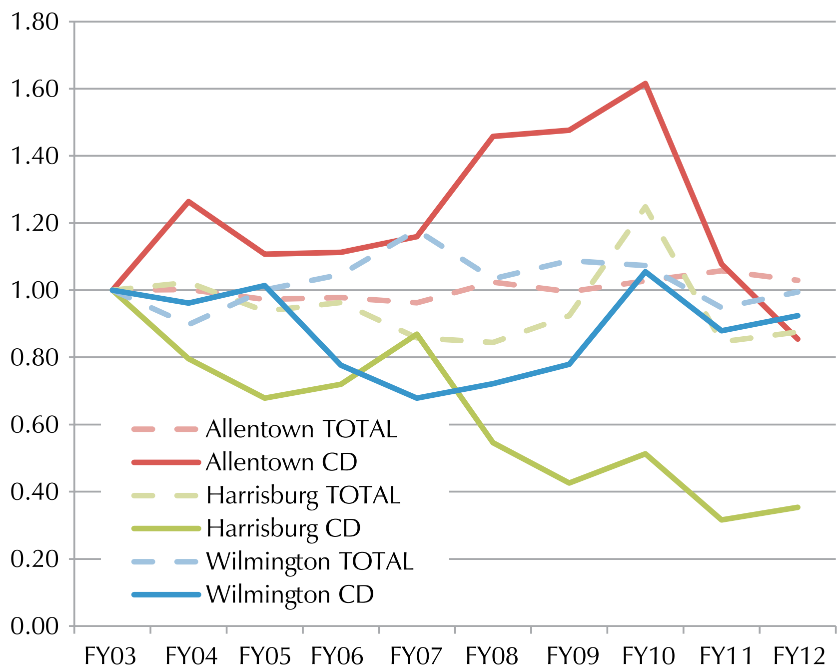
* FY2011 is shown in green.

While Figure 12 illuminates the variance in community development expenditures between 2008 and 2012, it may not accurately convey spending patterns for the in-between years, and it says nothing about spending levels prior to 2008. In truth, a city's revenues and expenditures can be volatile from year to year in ways that can confound efforts to evaluate fiscal trends. If spending in either 2008 or 2012 was out of the ordinary for any reason, the chart could misrepresent the long-run trend.

An obvious way to avoid misinterpretation is to draw a longer trend line. Unfortunately, for most cities, annual expenditure figures are included in separate financial reports, some of which are not easily accessible. However, the most recent financial reports for three cities — Allentown, Harrisburg, and Wilmington — include a statement detailing expenditures for the past 10 fiscal years. For these cities, then, we can analyze annual changes over the decade rather than relying on 2008 and 2012 snapshots.

Figure 13 compares total expenditures for each city and each year from 2003 to 2012, adjusts all values to 2012 dollars, and compares those values with their 2003 levels (2003=1.00). The same is

Figure 13: Ratio of annual total and community development (CD) expenditures to 2003 levels (adjusted for inflation to 2012)



Source: Author's calculations using data from Changes in Fund Balances of Governmental Funds, Last Ten Years in the three cities' 2012 CAFRs

Note: All values are adjusted for inflation to 2012 using the GDP price deflator for state and local government consumption expenditures and gross investment, published by the BEA on November 7, 2013.

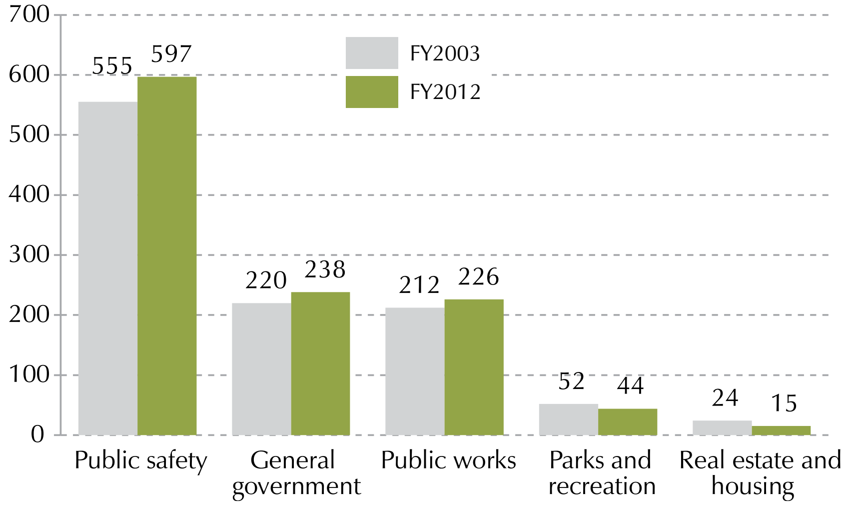
done for community development (CD) expenditures. A value of 1.00 in any given year suggests that, adjusted for inflation, expenditures are comparable with FY2003.

As illustrated by the dashed red and blue lines, overall expenditures in Allentown and Wilmington remained relatively flat after adjusting for inflation, ending the period at 3 percent above and 1 percent below their 2003 levels, respectively. Despite taking different paths and illustrating the volatility of annual expenditures, community development spending in these two cities relative to 2003 fell in real terms by 15 percent in Allentown and 8 percent in Wilmington. In Harrisburg, overall spending fell by 12 percent between 2003 and 2012, but the decline for community development expenditures (65 percent) was significantly steeper.

There could be a number of explanations for why community development expenditures have fallen more sharply than overall spending in these three cities. One possible explanation is that this function is being crowded out by other municipal functions that now require relatively greater resources than before. For example, in a discussion of York's fiscal conditions, O'Rourke (n.d.) asserts that nonpublic safety "expenses are going down to contribute more money to public safety."

One way to lower expenses is to cut payroll, and the most recent financial reports for Allentown, Harrisburg, and Wilmington indicate whether and how these cities have pursued this strategy by providing historic information on the number of public employees responsible for various governmental functions. The reports show that Allentown had 85 fewer employees in 2012 than in 2003, and local government in Harrisburg was smaller by 272 employees. Bucking the trend was Wilmington, which grew the size of government between 2003 and 2012 by 57 full-time equivalents (FTEs). As Figure 14 illustrates, however, job growth in Wilmington did not occur evenly. The number of FTEs committed to public safety, general government, and public works increased between 2003 and 2012, while the

Figure 14: Full-time equivalent public employees by function for Wilmington



Source: Author's calculations using data from Full-Time Equivalent Employees By Function, Last Ten Fiscal Years in Wilmington's 2012 CAFR

already small staffs dedicated to parks and recreation and real estate and housing (i.e., community development) suffered significant reductions.[19]

It is worth noting, however, that whether a city's budget is growing or shrinking, its local revenue-raising capacity is not the only factor that influences its level of community development spending. Waning federal support for community development is also partly responsible. The Department of Housing and Urban Development's (HUD) Office of Community Planning and Development (CPD) operates several programs, such as the Community Development Block Grant (CDBG) and the HOME Investment Partnerships (HOME) programs, that serve as the primary conduits by which community development dollars are directly transferred from the federal government to local governments. As Table 1 and Figure 15 illustrate, federal funding associated with the CPD formula programs fell by 54 percent overall in inflation-adjusted terms between 2003 and 2012 and by anywhere from 47 percent (Harrisburg) to 66 percent (Lancaster) for individual cities.[20]

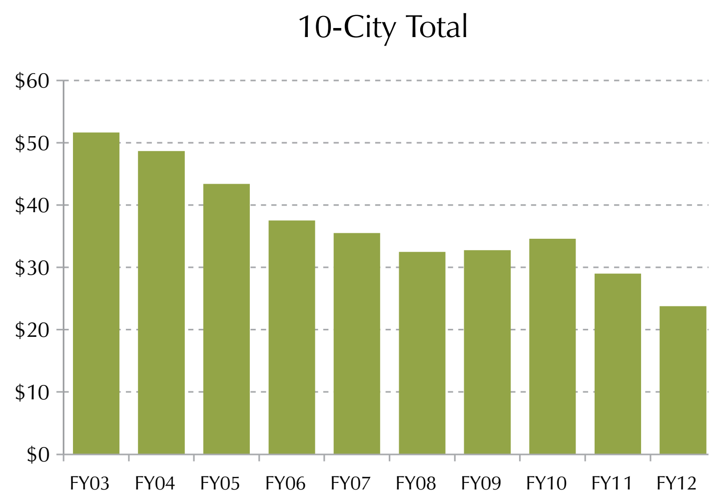
Cuts in federal support have had real on-the-ground impacts in these communities over the past decade. In the latest expenditure reports provided by HUD for the CDBG program, which accounts for the majority of CPD formula grants to local governments, these 10 municipalities disbursed roughly $22.5 million. More than one-quarter of this amount was spent on "housing," a category that includes the rehabilitation of single-family and multifamily homes and code enforcement, among other activities. Another one-quarter of these funds was spent on "public facilities and improvements," which includes investments in streets and sidewalks, parks, and neighborhood centers, for example — precisely the types of investments that improve a city's livability and can help attract and retain households with the means to exercise residential choice. CDBG expenditures

[19] FTEs by function are also available for Allentown and Harrisburg. Given the 36 percent decline in the city's workforce, every function was significantly smaller in Harrisburg in 2012 than in 2003. In Allentown, the number employed in general government was fairly stable, while public safety, public works, parks and recreation, and health and sanitation absorbed the brunt of the downsizing. Allentown's building standards and safety function grew by four FTEs during this period.

[20] An argument could be made for using the Consumer Price Index, rather than the BEA's GDP price deflator for state and local governments, to adjust prior fiscal year appropriations to FY2012 dollars. Using the CPI-U-RS reduces the overall decline in allocations from 54 percent to 49 percent. Nominal CPD allocations to the 10 cities, with no inflation adjustment, fell by 36 percent.

Table 1 and Figure 15: Allocations from HUD's Office of Community Planning and Development formula programs (millions, adjusted for inflation to 2012)

CITY	FY2003	FY2012	% CHANGE
Allentown	$6.3	$3.2	(50)
Altoona	$4.2	$1.9	(55)
Bethlehem	$3.7	$1.5	(60)
Harrisburg	$4.6	$2.5	(47)
Lancaster	$4.1	$1.4	(66)
Reading	$7.0	$3.3	(53)
Scranton	$7.0	$3.2	(55)
Wilkes-Barre	$4.0	$2.0	(50)
Wilmington	$6.9	$3.4	(51)
York	$3.7	$1.6	(58)
Total	$51.6	$23.8	(54)



Source: U.S. Department of Housing and Urban Development, Community Planning and Development Program Funding Allocations; retrieved January 6, 2014, from http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/about/budget.

Note: This includes funds distributed through the Community Development Block Grant (CDBG), HOME Investment Partnerships (HOME), Housing Opportunities for Persons with AIDS (HOPWA), and Emergency Solutions Grants (ESG) programs. All values are adjusted for inflation to 2012 using the GDP price deflator for state and local government consumption expenditures and gross investment, published by the BEA on November 7, 2013. Inflation adjustments are predicated on the federal fiscal year for which funds were appropriated.

in the most recent period were $23.1 million lower than they were nine years prior, after adjusting for inflation.[21]

It may be unsurprising that when a city's fiscal capacity is relatively stagnant and costs associated with certain municipal obligations (e.g., pensions and health care) are on the rise, other parts of the budget suffer. The situation for community development in particular has been made even more tenuous by the retrenchment of federal support.

[21] Author's calculations using data from HUD's CDBG Expenditure Reports, accessed on February 12, 2014, from http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/communitydevelopment/budget/disbursementreports. The reporting periods varied for the cities but generally corresponded to January 2011–December 2011 or July 2011–June 2012 for the most recent reporting period, and January 2002–December 2002 or July 2002–June 2003 for the earlier period. For each city, expenditures for the earlier period were adjusted for inflation to the most recent period and aggregated. The inflation adjustment factor is based on the GDP price deflator for state and local government consumption expenditures and gross investment, published by the BEA on November 7, 2013.

THE ROLE OF THE STATE

Municipal fiscal health is not simply the product of a city's underlying economic strength, the availability of federal aid, and sound local management. Rather, because cities are creatures of the state, a city's fiscal health is also partially determined by the opportunities and challenges that characterize this relationship, and no report on municipal fiscal issues would be complete without at least briefly addressing this point.

Pagano and Hoene (2010) describe the "fiscal policy space" of cities as the room that city officials have to maneuver when developing fiscal policy. The authors note that, alongside the city's economic base, local laws, political culture, and the demands of the electorate, the intergovernmental system in which the city operates plays an important role in defining this space. Aspects of this system that can either expand or shrink a city's fiscal policy space are: the level of state aid, a city's authority to utilize various types of revenue-generating mechanisms, the extent to which a city's revenue sources are diversified, and the presence of tax and expenditure limits (TELs).

State financial aid is probably the most direct and immediate way that states can impact their cities' fiscal health. This form of fiscal support declined nationally following the Great Recession. On the whole, state intergovernmental expenditures, which include financial assistance to local governments and independent school districts, were roughly 8 percent lower in 2012 than in 2008, after adjusting for inflation; declines were comparable in Delaware (-9 percent) and Pennsylvania (-5 percent) during the same period.[22]

State aid for specific cities is difficult to pinpoint in their financial reports, but intergovernmental revenues, which include state aid as well as transfers from the federal government and other local governments, are broken out. In aggregate, intergovernmental revenues reported by the 10 cities featured in this report represented roughly one-quarter of all revenues in both 2008 and 2012, but the total level fell by 2 percent during this period, after adjusting for inflation.[23]

In addition to providing direct financial support, the state can influence its cities' fiscal policy space in less direct ways that are arguably no less important. One critical aspect of the state-city relationship is the taxing authority that the former provides to the latter. Hoene and Pagano (2008)

[22]Author's calculations using data from the U.S. Census Bureau's 2008 and 2012 Annual Survey of State Government Finances, accessed on March 18, 2014, at http://www.census.gov/govs/state/

[23] In order to make the 2008 and 2012 figures as comparable as possible, the portion of the casino host fee that Allentown received from Bethlehem in 2012, totaling around $3.7 million according to its 2012 CAFR, was excluded from this calculation because the casino opened in 2009, during the study period.

find that no state provides all of its cities with the ability to use all three of the primary taxes: property, sales, and income. The authors argue that state restrictions on the types of taxes that cities can impose ignore "the within-state variation of local governments' economic bases and of their diverse spending needs" (p. 3). For example, Pennsylvania's earned income tax generally reverts to a worker's city of residence, and in lieu of a commuter tax on nonresidents' income, a local services tax — capped at $52 — can be withheld in the city of employment. Because many of the cities featured in this report function as regional employment centers, an alternative tax structure that generated incremental tax revenue as compensation for filling this role could strengthen these cities' fiscal positions.[24]

States can also legislatively blunt the impact or effectiveness of revenue-generating tools that they permit cities to use. For example, states frequently impose constraints on local property tax collections by placing limits on tax rates, assessments, or collected revenues (Pew Charitable Trusts 2012). Certain jurisdictions in Pennsylvania are subject to limits on their property tax rates and year-over-year increases in revenues, while cities in Delaware must publicly advertise, in the newspaper, any proposed postassessment tax rate that generates revenue in excess of the prior year's collections and hold a public meeting to discuss the proposal.[25]

While this section focuses primarily on state actions that shrink the fiscal policy space of their cities, the concluding section discusses strategies proposed by others to create more financial breathing room for their municipalities. Cities, however, must operate under conditions on the ground today and have a limited number of fiscal coping strategies at their disposal.

[24] For more information on local government taxing authority in Pennsylvania, see http://www.newpa.com/local-government/tax-information.

[25] Information on property tax limits was gathered from the Lincoln Institute of Land Policy and the George Washington Institute of Public Policy's Significant Features of the Property Tax database accessed on March 19, 2014, at http://www.lincolninst.edu/subcenters/significant-features-property-tax/Report_Tax_Limits.aspx.

MUNICIPAL RESPONSES TO FISCAL STRESS: GENERAL AND SPECIFIC

Cities that suffer from a structural imbalance between their revenues and expenditures are faced with few palatable options for restoring that balance on paper, if not in fact. The following are a few of the most common methods that cities use to cope with an ongoing structural deficit.[26]

Reducing the Size and Cost of Government

As previously illustrated in the cases of Allentown and Harrisburg, some cities attempt to balance their budgets by reducing the number of people they employ. Whether achieved through layoffs or attrition, nationwide, cities trimmed their workforces by roughly 3.4 percent between 2008 and 2011 (Pew Charitable Trusts 2012), while the primary cities in the 30 largest metropolitan areas shrank their payrolls by 40,000 positions during roughly the same period (Pew Charitable Trusts 2013a). Pagano and McFarland (2013) find that approximately 32 percent of city finance officers surveyed reported municipal workforce reductions in 2013. Additionally, nearly two-fifths of the cities represented in the survey reduced costs through the implementation of a hiring freeze, while almost one-quarter reduced health care and pension benefits.

Trimming public payrolls can have a cost of its own. The recovery plan for the City of Altoona, written to assess the city's fiscal challenges and to outline strategies for its emergence from its "financially distressed" designation, notes the following with respect to its Department of Planning and Community Development: "Due to federal funding reductions, several positions have been eliminated or merged with other positions, and several vacant positions are not being filled (City of Altoona 2012, p. 159). This has left Altoona "badly equipped to fulfill its responsibilities for city government operations" (p. 168), such as inspections, code enforcement, contractor licensing, zoning, and so on.

A city can also achieve savings by providing fewer or less frequent services to its residents. A report by Pew Charitable Trusts (2012) documents examples of cities and counties reducing services related to welfare and social services, education, public safety, trash pickup, park maintenance, and library systems. Drawing on observations from Oakland, CA, Liu (2013) notes that the increasing costs of "protective" services have resulted in cuts to "proactive" services such as education, human services, and community economic development that could increase a city's appeal to prospective residents and ultimately put it on sounder financial footing.

In an effort to reduce municipal costs, the City of Harrisburg eliminated its Park Ranger Corps (City of Harrisburg 2013). Before the program was discontinued, rangers were tasked with acting "as

[26] Many of the responses covered in this section are discussed by Mallach and Scorsone (2011) and in a report issued by Pew Charitable Trusts (2013c).

ambassadors to the public" and protecting the city's park system, in addition to promoting public safety in cooperation with the police department (City of Harrisburg 2011, p. 290). Once staffed by 40 people, the program was slashed to three employees, which surely contributed to the determination in the city's financial recovery plan that this now "ineffective and inefficient program … should be discontinued" (p. 280).

Deferring Employment Costs and Underfunding Future Benefits Accounts

As previously shown, some cities have accumulated significant and unfunded pension and healthcare obligations for former and current employees. Glaeser (2012) notes that generous post-employment benefits not only lower current costs for public employees (by postponing some compensation until retirement) but also present an opportunity for cities to defer costs further by underfunding the accounts. As the data previously presented indicate, a few of these 10 cities use this coping mechanism to respond to their fiscal challenges.

Since 2008, the City of York has delayed its minimum municipal obligation (MMO) to its pension fund to the following year:

> However, as the shortfall approaches the full amount of the MMO, the ability of the City to continue unreduced operations becomes more tenuous. Eventually resources will be exhausted before we reach the end of the year and services will be drastically reduced. Delaying the MMO payment also ends up costing the City in interest payments. Although the delayed payment of the 2011 MMO reduced stress on cash flow, that stress reduction came at a cost of almost $500,000 in interest. Additionally, the 2011 MMO was not fully paid until the beginning of 2013. Although this is the only method of assuring adequate cash flow available to the City, short of a calamitous increase in taxes, it is not sustainable over the long term (City of York 2013, p. xvi).

Deferring Infrastructure Investment

Setting aside the notion of investing in new public facilities for a moment, the costs associated with simply maintaining existing public buildings, streets, and utilities in older cities can be substantial. Lacking funds to proactively maintain its infrastructure, a city can defer these costs until it reaches crisis levels or can resort to covering the costs with debt.

Harrisburg's recovery plan notes that capital improvement funding has been lacking for the past 15 years. Given the city's resource constraints, a "comprehensive preventative maintenance plan does not exist," so maintenance is conducted only "in response to system failures" (City of Harrisburg 2011, p. 262). In spite of these recognized needs, the city's response to its budget challenges requires a "deferral of capital expenditures" (City of Harrisburg 2013, p. ix).

Increasing Taxes and Fees

Based on its analysis of five fiscally distressed cities, including four cities featured in this report, the Pennsylvania Economy League, Central PA Division (2009) concludes that because certain services are expected of cities by their populations and regional leaders, "The cities' dilemma is fundamentally a revenue problem" (p. 9-4). Thus, instead of, or more likely in combination with, exploring ways to reduce costs, many cities attempt to increase revenue through higher taxes and fees in order to provide these services. The general anti-tax sentiment that pervades public discourse (Brunori et al. 2005) and the degree to which higher taxes reduce competitiveness with surrounding locales for prospective businesses and residents tend to make this an unpopular, albeit sometimes necessary, response to fiscal stress.

Intended to help Scranton emerge from its status as "financially distressed," first assigned in 1992, the city's recovery plan calls for "an aggressive approach to current revenues" (City of Scranton 2013, p. 15), including a property tax increase of roughly 70 percent to be phased in between 2013 and 2015, a nearly 50 percent increase on real estate taxes, and higher refuse and rental registration fees that are expected to raise an additional $2.5 million.

Relying on Reserves or Debt

When belts have been tightened and revenue limits — whether state-imposed or naturally occurring — have been reached, some cities have the option of spending down reserves or turning to the municipal bond market. The data presented in this report suggest that many of the District's postindustrial cities have pursued both options to fill their structural budget deficits, and an independent survey of city finance officers shows that, in aggregate, responding cities saw their general fund balances as a share of expenditures decline precipitously from 2007 through 2010 before rebounding (Pagano and McFarland 2013). Both strategies can be acceptable short-term solutions during fiscal emergencies, but neither is sustainable over the long term.

The City of Reading notes that its positive general fund balance in 2008 was the product of deficit elimination in prior years "through the issuance and forwarding swapping of debt" and should not be misinterpreted as "an indication of fiscal health." Rather, in 2008, Reading continued "to operate naturally at a deficit," and although yearly shortfalls can be papered over, "addressing the structural flaws has proved to be a challenge that has not been met" (City of Reading 2009, p. MD&A 3).

CONCLUSION

This report was written to draw attention to the fiscal difficulties faced by many of the postindustrial cities in the Third Federal Reserve District and elsewhere. Where possible, the report places these cities' challenges into context with other cities and sheds light on the historical and contemporary causes of their fiscal conditions. While the objective of this report is not to put forward policy solutions to these fiscal challenges, it is my sincere hope that this work informs future policy discussions around this issue.

Were this report to delve into policy solutions aimed at alleviating municipal fiscal distress, there would be no shortage of proposals to discuss. Without providing an exhaustive list, it is worth mentioning a few that explicitly recognize the role states could play in ameliorating their cities' fiscal challenges, since, "In as much as municipal government is a creation of the state, leaders … bear responsibility to create structures that allow municipalities to become and remain strong, vibrant entities" (Pennsylvania Economy League 2007, p. 4). A few state-based strategies that have been discussed come with potentially large price tags, including:

- providing additional financial assistance in dealing with the burden of municipalities' legacy pension and health-care costs (Mallach and Scorsone 2011). The Institute of Politics Pensions Subcommittee (2009) discusses the possibility of a change to the funding formula in Pennsylvania that would provide more aid to older cities with higher legacy costs.
- recognizing the challenges that shrinking cities face in generating revenue and addressing the subsequent funding inequities by providing "an equalization grant to local governments to compensate for differences in local tax capacities" (Wolman et al. 2007, p. 2; Hoene and Pagano (2008) also see a role for the state in reducing fiscal inequities). Along these lines, the state of Delaware began providing Wilmington with significant revenue in 2004, recognizing that "the City's long-term financial stability required a stronger and more diversified revenue stream" (City of Wilmington 2011, p. iv).[27]
- providing financial support to cities with concentrations of tax-exempt properties, an option raised by Pennsylvania legislators (Pew Charitable Trusts 2013c) and already enacted in Delaware with regard to the presence of state property (State of Delaware n.d.).[28] The

[27] Classified as "task force revenue" and a "county seat relief package" in the FY2012 budget, revenue provided by the state and enabled through additional local taxes and fees were budgeted to total $11.3 million in FY2012. It is beyond the scope of this report to assess whether, controlling for the differences in services provided by the state versus the city, these programs represent greater or lesser overall state support for Wilmington than for cities in Pennsylvania.

[28] Payments in lieu of taxes (PILOTs) from the state to Wilmington for state tax-exempt properties were expected to total $2.4 million in FY2012 and are included in the "county seat relief package" (City of Wilmington 2011).

implementation of user or service fees for all landowners, regardless of tax-exempt status, would also generate needed revenue for cities dominated by tax-exempt property (Kenyon and Langley 2011) and could serve as an alternative or complement to state financial support.
- funding state agencies to promote regional cooperation and shared services in an effort to create better governmental efficiency (Pennsylvania League of Cities and Municipalities 2010). Along these lines, Pennsylvania has a 15-year history of providing grants to local governments to support regional planning and shared services. Annual appropriations for these activities totaled several million dollars at their peak but have fallen to just over $600,000 in recent years.[29]

Less costly strategies proposed by others would focus on ways that the state could empower, rather than directly fund, local governments. They include:

- providing a "form of proactive state fiscal oversight" (Wolman et al. 2007, p. 2) of fiscal health so that problems can be identified and addressed before they rise to crisis levels and state intervention — a strategy that has yielded good results in North Carolina, for example.
- removing limits on local revenue-raising tools as a partial strategy for remediating fiscal distress (Wolman et al. 2007), thereby increasing local flexibility, ideally in the context of appropriate state controls and incentives (Hoene and Pagano 2008).

[29] Conversation with staff from Pennsylvania's Department of Community and Economic Development. For more about Pennsylvania's Municipal Assistance Program, see http://www.newpa.com/.

It is clear that while many of these strategies have been pursued to one degree or another in Pennsylvania and Delaware, their combined impact has fallen short of restoring the cities featured in this report to fiscal health. Whatever strategies states employ to improve their cities' fiscal conditions going forward, the problems they are intended to solve are well beyond the reach of the short-term fix. As Mallach and Scorsone (2011) note, state intervention efforts often implicitly assume that improvements in governmental efficiency and sound fiscal management are sufficient to address the issue; the authors counter that rather than nibbling around the edges, "long-term change in these cities' fiscal reality" (p. 2) is required to shore up their fiscal footing.

In all likelihood, it will take multiple efforts over many years to change the fiscal reality of the small postindustrial cities in the Third Federal Reserve District and elsewhere. The following observation by Wolman et al. (2007) is a fitting way to conclude and should provide all of the necessary impetus for working to address the fiscal challenges discussed in this report:

> Cities whose economies are stagnant, whose residents suffer from poverty and unemployment, whose budgets are in chronic fiscal stress, and who require state aid to sustain basic services are a drag on the entire state economy. Cities whose economies are vibrant, whose residents are productive, whose budgets are fiscally stable, and who do not require massive infusions of state aid are assets to the entire state (p. 1).

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