League of Minnesota Cities

State of the Cities Report 2009

City Fiscal Conditions & Economic Trends

League of Minnesota Cities

State of the Cities REPORT 2009

State of the Cities Report 2009

Acknowledgements

Researched and written by
Lena Gould, Policy Analyst
Rachel Walker, Manager of Policy Analysis

Edited by:
Claudia Hoffacker, Web Content and Publications Manager

Designed by:
Stephanie Thoe, Graphic Designer

The authors would like to thank the following people who contributed to this report:
George Marretta, Louisiana Municipal Association
Arnold Weinfeld and Mary Charles, Michigan Municipal League
Stuart Haynes, Missouri Municipal League
Sarah Werner, North Dakota League of Cities
Kim Bently, League of Oregon Cities
Mary Beth Lake, Pennsylvania League of Cities and Municipalities
Melissa Carter, Municipal Association of South Carolina
Debbie Price, West Virginia Municipal League

Chris Hoene, Director of Policy and Research, National League of Cities
Christiana McFarland, Manager of Policy and Research, National League of Cities

League of Minnesota Cities
145 University Avenue West
St. Paul, MN 55103-2044
(651) 281-1200   (800) 925-1122
TDD (651) 281-1290 Fax (651) 281-1299
www.lmc.org

Table of Contents

Continued ▶

Report Highlights

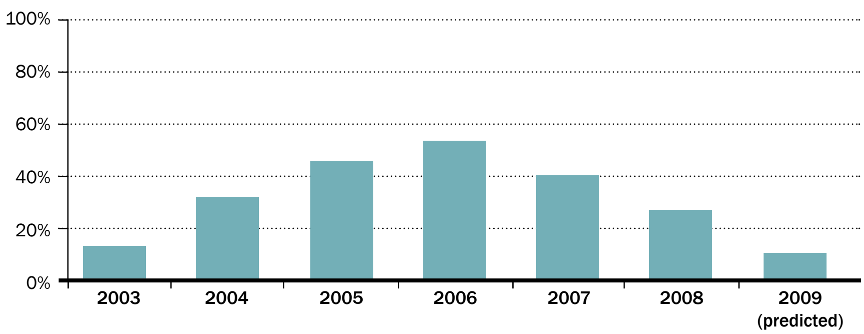
This is the seventh annual *State of the Cities Report*. It describes the findings of the annual fiscal conditions survey and explores several issues affecting the financial circumstances of cities across Minnesota: the economic downturn, the foreclosure crisis, and the costs to operate and maintain streets. Highlights from each section of the report are listed below.

Chapter 1: City Fiscal Conditions

The League of Minnesota Cities asked city officials to describe the fiscal challenges their cities face and the strategies used to address those challenges. Cities are feeling the effects of several challenges, including an economy that is in a recession, increasing health care costs, the continued foreclosure crisis, and the state budget deficit. Highlights of Chapter 1 include:

- The share of Minnesota cities reporting improved fiscal conditions in 2008 dropped sharply from 40 percent in 2008 to just over one-quarter in 2009 (see Chart RH-A). The share of cities looking to 2009 with optimism falls even more severely, to just 9 percent. This share is even smaller than those reporting an improved ability to meet needs in 2003 and 2004, following the last major cuts to state aid.

Chart RH-A: Percentage of Minnesota cities better able to meet financial needs



- The incidence of shortfalls increased or stayed the same across most categories of revenue; the greatest increase was in the property tax category (see Table RH-A on page 2). Many cities reported delinquent property taxes due to foreclosures. Others indicated an increase in delinquent property tax payments associated with the decline in the overall economy.

Table RH-A: Percent of Minnesota cities reporting revenue shortfalls*

	Property taxes	Fees and charges	Sales tax	Local income tax	Lodging and restaurant taxes	State revenues	Federal revenues
2003	28%	17%	3%	n/a	5%	82%	12%
2004	27%	24%	1%	0%	3%	55%	8%
2005	40%	25%	3%	2%	4%	39%	12%
2006	40%	33%	4%	2%	4%	31%	13%
2007	43%	36%	6%	3%	5%	35%	15%
2008	54%	41%	7%	3%	8%	41%	14%

**combines shortfalls of greater than and less than 10 percent of expected revenues*

- Budget pressures that increased for most cities in 2008 include prices, cost of living, and inflation; employee wages and salaries; and infrastructure needs. Cities that reported being less able to meet needs in 2008 were more likely to report increases in these budget factors.
- The most common budget-balancing actions taken by Minnesota cities in 2008 in preparation for fiscal year 2009 included revenue increases, spending decreases, and increases in efficiencies. The share of cities reporting revenue increases and increases in efficiencies are the lowest ever reported. The percentage reporting service cuts, workforce cuts, and increased use of reserve funds all increased over 2007.

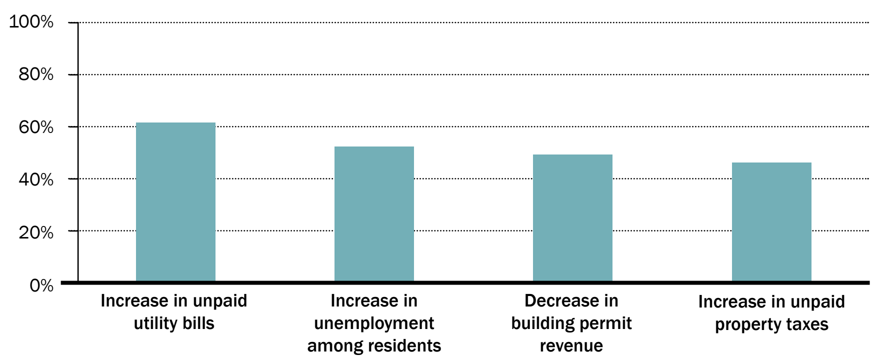
Chapter 2: Economic Trends and the Effect on Cities

The economic recession, the decline in the housing market, and the recent crisis in the financial market have affected cities in many ways. Some of the effects are the result of economic troubles at the state level trickling down to local governments. Other effects are more direct and include foreclosures and local business closures. Cities are also seeing their own local revenues decline as a result of delinquent fees and taxes. All of these trends have hampered cities' ability to provide services to residents and businesses. Highlights of Chapter 2 include:

Financial storm overview

- The most frequently identified problems in cities as a result of the economic downturn are an increase in unpaid utility bills, an increase in unemployment among residents, a decrease in building permit revenues, and an increase in unpaid property taxes (see Chart RH-B).

Chart RH-B: Most frequently cited impacts of economic downturn by Minnesota cities

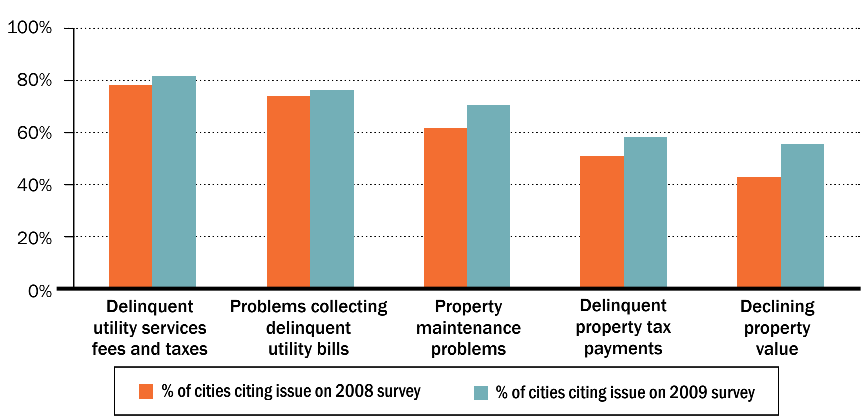


- The struggles of individuals, families, and businesses are translating into financial challenges for city governments. Thirty-four percent of cities reported an increase in requests for deferred payment of taxes and/or bills over the last year.
- More than 80 percent of cities anticipate having trouble meeting debt service payments; late payment or non-payment of taxes and/or utility bills are common reasons for this trend.
- The nationwide economic downturn is being reflected in local economies and communities around Minnesota. More than 26 percent of cities reported an increase in business closures in their communities.
- Forty-one percent of cities indicated that they have seen development projects delayed or canceled. Often, cities are left struggling to pay for new infrastructure in which they invested in anticipation of development that never came or was not completed.
- Almost two-thirds of cities are seeing their fund balances shrink over the long term. Cities have had to turn to their fund balances more and more to make up for aid and credit cuts, and shortfalls in revenue streams like the property tax and utility charges.

Foreclosures

- In Minnesota, there were 26,265 foreclosures in 2008, according to Housing Link.[1] That is a 29 percent increase in foreclosures over 2007 levels. Since 2007, foreclosures for the metro area overall have increased 33 percent while the increase for greater Minnesota overall has been 21 percent.
- National data show that delinquency and foreclosure rates are high for risky mortgages. Almost three-quarters of subprime loans in Minnesota are adjustable rate mortgages (ARMs); more than 14 percent of subprime ARMs in Minnesota will reset during the next 12 months.[2]
- Cities continue to see declines in building permit revenues and other revenue streams associated with new development. In Minnesota, the number of single-family building permits issued fell 58 percent between January 2008 and January 2009.[3]
- The most frequently identified problems caused by foreclosures in Minnesota cities are delinquent utility services fees and taxes, problems collecting delinquent utility bills, property maintenance issues, delinquent property tax payments, and declining property values. As Chart RH-C shows, the proportion of cities reporting the top foreclosure-related problems increased in 2009, compared to 2008.

Chart RH-C: Top foreclosure-related issues in Minnesota cities

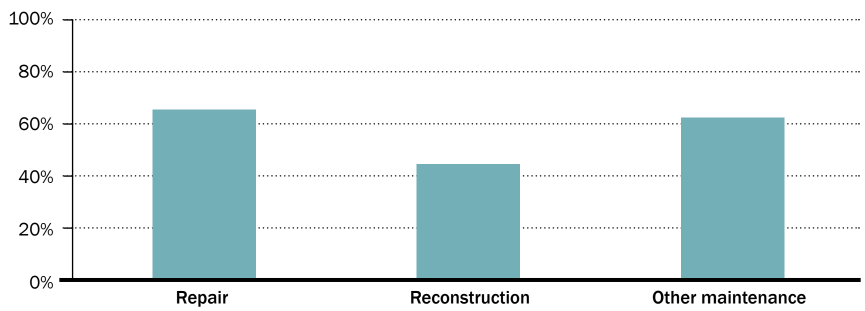


- Problems created by foreclosures strain city budgets as demand grows for a higher level of existing services, such as maintenance and public safety. Cities are also being asked to provide new services, including making counseling services available to residents facing foreclosure.
- The foreclosure trend is hurting the vitality of communities across the state. The character of individual neighborhoods or sections of cities has changed in many ways, including an increase in conversion of owner-occupied housing units to rental units.

Delivering city services during the financial storm—city streets

- The operation and maintenance of city streets is one of many services cities provide. This year's survey asked city officials several questions regarding the funding and improvement needs of their city streets.
- The majority of cities identified repair, reconstruction, or other maintenance needs for their streets over the next year (see Chart RH-D).

Chart RH-D: Percent of cities with street improvement needs over the next year



- Local funding sources—the property tax and special assessments—have over time become a larger share of the dollars used for street projects for most cities. LGA and other state assistance have declined.
- Cuts to streets and public works budgets were among the actions cities took in preparation for 2009. These cuts included the elimination of personnel and the cancellation or deferral of planned maintenance and improvement projects.

[1] Foreclosures in Minnesota: A Report Based on County Sheriff's Sale Data. February 26, 2009 Supplement. HousingLink. February 2009.

[2] Dynamic Maps, FirstAmerican CoreLogic, LoanPerformance Data. New York Federal Reserve. January 2009.

[3] Building Permits by States and Metro Areas. U.S. Census Bureau. January 2009.

Chapter 1
City Fiscal Conditions

Introduction

For the sixth consecutive year the League of Minnesota Cities (LMC) asked city officials to report on the fiscal challenges their cities face and the strategies used to address those challenges. The complete 2009 survey tool can be found in the appendix. For the fifth consecutive year several other state leagues around the country sent the same fiscal conditions survey to their member municipalities.[1] In Minnesota, the response rate was 54 percent, with 445 cities returning the survey. The appendix includes a list of participating states and response rates. This chapter will discuss the survey results from Minnesota cities, comparing them with data from previous years.

Results from the 2008 survey began to show how the faltering economy and the collapse of the housing market are affecting cities. The most recent results confirm that conditions are now dire. This year's survey came at a critical time for cities across Minnesota—the economy has entered a severe downturn, the state now faces a massive deficit, foreclosures continue to devastate families and neighborhoods, and property tax bases have shrunk considerably in many parts of the state.

The National Bureau of Economic Research declared that the country entered a recession in December 2007. Most tax revenues are affected by changes in the economy. Retail sales tend to slow during a recession, thereby decreasing sales tax revenues. The national unemployment rate rose to 8.1 percent in February 2009. Minnesota's unemployment rate in February, 8.1 percent, was the state's highest since 1983. As the jobless rate increases, revenues from the income tax decline. Foreclosures and vacant homes have led to an increase in property tax delinquencies. A recent study by the Rockefeller Institute shows that, for the first time since 2002, all three tax types were down nationwide in the fourth quarter 2008.[2] A National League of Cities (NLC) survey from the spring of 2008 shows a projected decline of 4 percent in sales tax revenues, a 3 percent decline in income tax revenues, and a 4 percent decline in property tax revenues in cities nationwide by the end of 2008.[3] The latest economic update for Minnesota shows that the state collected less revenue from all tax types than was expected for November and December 2008. Challenges related to falling tax revenues will likely continue for two or more years following the end of the recession.[4] The second chapter of this report describes some of the direct effects that the economic downturn has had on cities in Minnesota, including declines in investment revenue, difficulty making debt payments, and closures of local businesses. Many problems at the state level lead to challenges for cities.

At the end of 2008, the state was facing a $426 million deficit for the remainder of the 2008-2009 biennium. As part of the solution for that short-term deficit, the governor reduced the December payment of local government aid (LGA) and market value homestead credit (MVHC) payments to cities with populations over 1,000. The reductions came right at the end of the city budget year, giving cities virtually no time to adjust their own budgets. Several cities depleted or severely reduced their

budget reserve. The February 2009 forecast for the 2010-2011 biennium predicted a state budget shortfall of $4.6 billion. As suggested by the governor's budget proposal, aid and credit cuts will likely be part of the long-term budget solution as well. The cuts that the governor has recommended are similar in structure and magnitude to those enacted during 2003.

In 2003, facing a deficit of $4.5 billion, the Legislature cut LGA and MVHC by 25 percent. Funding has been partially restored, but is still below the original 2003 funding level. Although the 2008 Legislature passed LGA increases for 2009, 2010, and 2011, the current budget forecast raises concern that the increases will not be realized and, instead, cities will receive cuts over the next several years. Survey responses indicate that reductions in aid and credit will add significantly to many cities' fiscal challenges. While a larger percentage of cities reported being better able to meet needs in 2008 (26 percent) than in 2003 (12 percent), the share with a positive outlook for 2009 is much smaller (9 percent).

Residential foreclosures continue to plague cities, creating both cost and revenue problems. The general slowdown in the real estate market has led to a decline in property values and has slowed some foreclosure recovery efforts. Minnesota cities have also been challenged by increases in unpaid utility bills, decreases in building permit revenues, and increases in unpaid property taxes as the number of foreclosed or abandoned homes grows. At the same time that cities face all of these budget challenges, they must continue to deliver services and respond to the effects of these challenges on their communities. Chapter 2 provides more details on problems stemming from foreclosure for cities across the state.

Although cities are facing aid and credit cuts similar to 2003, the economic context is very different now than it was the last time the state faced a deficit. The property tax base was much stronger in 2003 than it is today. Over half of cities identifying problems caused by foreclosure on the recent survey have experienced a decline in property values over the last year. Cities in Minnesota rely heavily on the property tax to fund local services. Most cities do not have access to a local sales tax, and no cities in Minnesota have authority for a local income tax.

The end of 2008 and the early part of 2009 were very uncertain times for cities. While aid cuts were speculated upon for much of December, cities did not learn of the official amounts until the very end of the month. Talk of additional aid cuts for 2009 and 2010 further propelled this cloud of uncertainty in city finances. The 2009 fiscal conditions survey was first sent to cities in mid-December with a response deadline of late-January. A city official's response may be quite different depending on when in that time frame he or she completed the survey. Several cities included notes on their surveys that their responses may change once the magnitude of aid cuts is known. It is important to remember that survey research must be considered as a snapshot of conditions at a particular point in time.

The share of Minnesota cities reporting an increased ability to meet their financial needs drops severely

The percentage of cities across Minnesota that reported being better able to meet their financial needs plummeted from 40 percent in 2007 to just 26 percent in 2008, lower than predicted by responses to last year's survey. One-third of cities had predicted being better able to meet needs in 2008. The outlook for the year ahead is extremely dire with just 9 percent of cities expecting that they will be better able to meet needs in 2009. Worries about aid cuts, declines in property tax revenues, and the overall economic recession are driving down the proportion of cities with a positive outlook. The share of Minnesota cities predicting improved financial circumstances in 2009 is the lowest ever, reflecting a difference in today's overall economic context from that in 2003, when aid was last cut.

An NLC survey conducted in December 2008 and January 2009 shows that 84 percent of city officials nationwide are pessimistic about their city's current fiscal condition when compared to one year prior. The survey also found that 92 percent of city officials across the country predict worsening financial conditions in 2009.[5] The trend for Minnesota cities revealed by LMC's survey largely echoes the one found by NLC. However, when compared against cities in the other states participating in this year's LMC survey, a smaller percentage of Minnesota cities reported being better able to meet needs in 2008 (34 percent vs. 26 percent). Similarly, the share of all other cities predicting improved circumstances in 2009 is larger than the share of Minnesota cities with a positive outlook (23 percent vs. 9 percent). The portion reporting improved conditions in 2008 ranges from just 12 percent of Michigan cities to 57 percent of West Virginia cities.

The measure of "better able" or "less able" is a relative comparison between a city's fiscal condition in the current year and in the previous year. In other words, a response of "better able" does not imply that a city's financial circumstances are good, only that they improved over the previous year. Cities are not asked how well they are able to meet needs in any given year.

Chart 1A: Ability of Minnesota cities to meet financial needs.[6]

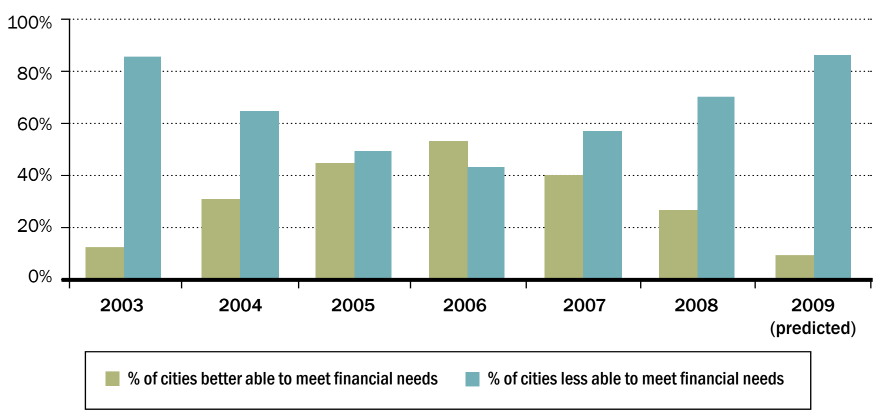


Chart 1A shows the share of Minnesota cities reporting "better able" and "less able" to meet their financial needs since 2003. The share of cities reporting an increased ability to meet needs grew steadily through 2006, with the greatest increase occurring between 2003 and 2004. In 2005 and 2006 roughly half of cities saw improvements in their financial circumstances while half faced additional challenges. After 2006 the trend started going in the opposite direction. In 2007 and 2008 more than half of cities experienced difficulty meeting the needs of their community. On last year's survey, 35 percent of cities predicted better times in 2008. However just over one-quarter actually reported improved financial conditions in 2008.

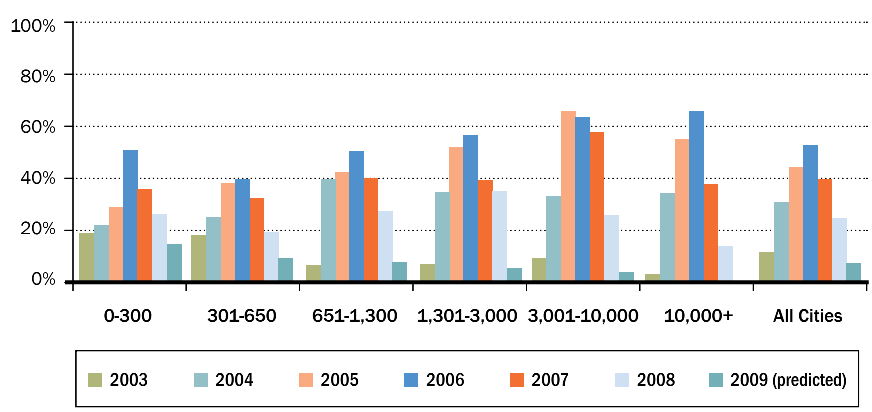
Less than one in 10 cities now predicts improving fiscal health in 2009. This is a smaller share than the 12 percent that reported favorable conditions following the last state deficit in 2003. While cities lost state aid in 2003, the overall economic context was much different. This year, property tax collections are down and foreclosures are up. Several cities have lost large employers, and other cities have struggled with incomplete or failing developments. Cities throughout Minnesota may also still be feeling the effects of the 2003 cuts in addition to these latest challenges. Use of one-time funds and transfers were a large part of the state's budget solution in 2003. These temporary fixes did not solve many of the underlying structural problems adding to challenges cities face today. Failure to restore aid funding to certified 2003 levels, as well as additional aid cuts, has weakened the state-local relationship.

Because the mix of cities responding to the survey varies from year to year, it is helpful to compare overall results with just those for Minnesota cities that have returned a survey each year (94 cities). The trend among these repeat cities is similar to the overall trend. Just under one-quarter reported improved conditions in 2008. This is a smaller share than that which predicted an easier time for 2008 (28 percent). The percentage of cities predicting positive fiscal conditions for 2009 drops to just 7 percent.

Fiscal conditions continue to worsen for cities of all sizes

As shown in Chart 1B, the portion of cities reporting better fiscal conditions decreased in all size categories for the second year in a row. Further, in each size category, the share reporting better actual financial conditions for 2008 is smaller than the share that had predicted improved conditions for 2008. The grim outlook continues for 2009, with declines across all size categories in the percentage predicting an easier time meeting needs in 2009. Almost all cities predicting improved conditions in 2009 are under 2,500 in population; these cities are not subject to levy limits. Additionally, four out of five cities looking to 2009 with optimism are under 1,000 in population and so did not lose aid or credit as part of the governor's December 2008 unallotment. Of the cities with a positive outlook for 2009, most (79 percent) are located outside the seven-county metro area.

Chart 1B: Percentage of Minnesota cities better able to meet financial needs (by population size and year)



Greater shares of medium sized cities (between 651 and 3,000 in population) reported improved conditions in 2008 than did cities in other size categories. Larger percentages of the smallest cities predict improving circumstances in 2009. All of the largest cities (over 10,000 in population) predict a decreased ability to meet needs in 2009. With the aid cuts in late 2008, the pending aid cuts for 2009, and the inability to levy again until 2010, cities may feel that they face limited options in 2009. Cities with populations over 2,500 may look to the future with additional concern due to levy limits placed on their 2009, 2010, and 2011 levies. Just over 10 percent of small cities (under 2,500 in population) are optimistic about 2009 while fewer than 5 percent of cities with populations over 2,500 see conditions improving for 2009.

Regional differences in fiscal health

A smaller share (19 percent) of cities in the seven-county metro area than in greater Minnesota (27 percent) reported being better able to meet financial needs in 2008. However, the reverse is true for 2009, with 10 percent of metro cities and only 8 percent of non-metro cities predicting an improvement in circumstances for the coming year.

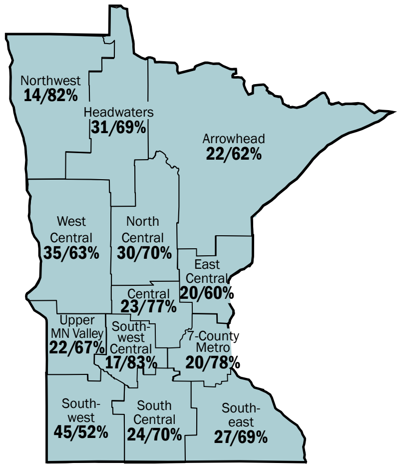
Typically a larger portion of cities classified as metropolitan statistical area[7] (MSA) cities than non-MSA cities has reported improving conditions (see Table 1A). The reverse is true for 2008, with a slightly larger share of non-MSA cities reporting improved conditions. The share of cities with a positive outlook for 2009 is the same for both classifications of cities. The lack of difference suggests that the poor economy and financial worries are affecting cities in urban areas and non-urban areas similarly.

Table 1A: Percentage of Minnesota cities better able to meet financial needs (by MSA status)

	2004	2005	2006	2007	2008	2009 (predicted)
MSA cities	35%	48%	57%	46%	24%	9%
All cities	31%	45%	53%	40%	26%	9%
Non-MSA cities	29%	43%	50%	34%	27%	9%

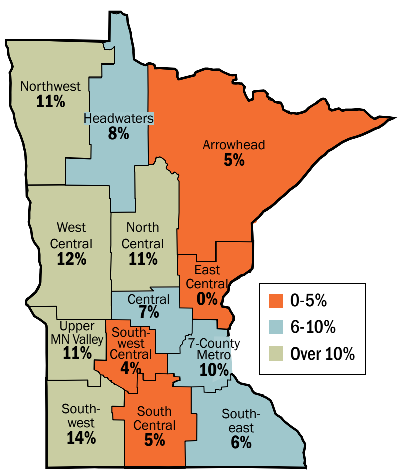
While 26 percent of Minnesota cities overall reported better fiscal conditions in 2008, differences in fiscal outlook exist within the state's geographic regions (see Map 1A on page 10). In all regions, the share reporting a decline in fiscal conditions was greater than the share reporting an improved ability to meet needs. More than three-quarters of cities in the Southwest Central, Northwest, Twin Cities, and Central regions reported facing more difficult conditions in 2008. The percentage of cities reporting improved conditions in 2008 was smaller than the percentage predicting improvements for 2008 in most regions. However, larger shares reported improvements in 2008 in the West Central, East Central, and Southwest regions.

Map 1A: Ability of cities to meet financial needs in 2008 (percent "better able"/percent "less able")



Regardless of location, city officials in Minnesota are pessimistic about their ability to fund the services their communities need in 2009. Few cities in all regions foresee an improvement in circumstances. In all regions, the percentage of cities with an optimistic view for 2009 is less than the percentage reporting a positive outlook in 2008. Less than 10 percent of cities in the East Central, Southwest Central, Arrowhead, South Central, Southeast, Central, and Headwaters regions predict fewer challenges in 2009 (see Map 1B). No cities in the East Central region predict an improvement for 2009. Cities in regions along the western border of Minnesota were slightly more likely to look to 2009 with optimism. The share predicting improved conditions in these regions ranges from 11 percent in the Northwest and Upper Minnesota Valley regions to 14 percent in the Southwest region.

Map 1B: Percentage of cities by region predicting improved conditions for 2009

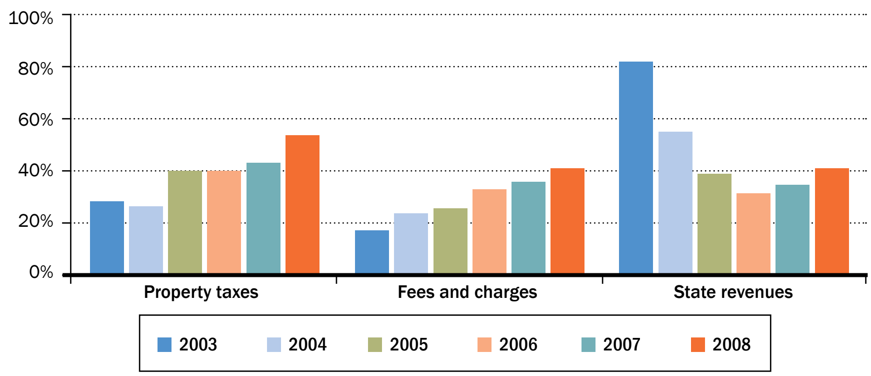


In general, the share of Minnesota cities predicting that conditions will worsen in 2009 is larger than the share that predicted worsening conditions for 2004—the year after the state's last substantial deficit. Seven regions show a larger share of cities predicting greater difficulty in 2009 than the share reporting a decline in conditions in 2003. Only the Arrowhead, Upper Minnesota Valley, East Central, and Southwest regions show a smaller percentage looking to 2009 with pessimism than the percentage reporting worsening conditions in 2003. There was no change for the Northwest and Southwest Central regions between these two years.

Reports of revenue shortfalls more frequent

The share of Minnesota cities reporting shortfalls increased substantially for some revenue sources. As in the past five years, cities in Minnesota most often identified shortfalls in property taxes, fees and charges, and state revenues (see Chart 1C). While the portion of cities reporting a shortfall in state revenues increased for the second year in a row, it is not as high as it was in 2003 and 2004, when city revenues were affected by cuts to state aid. This may be because the large cuts likely for 2009 and 2010 have not yet happened.

Chart 1C: Percentage of cities reporting revenue shortfalls (2003-2008)*



**combines shortfalls of greater than and less than 10 percent of expected revenues*

The share of Minnesota cities reporting shortfalls in property taxes jumped 10 percentage points over 2007 to the highest reported share ever. The portion reporting shortfalls in fees and charges also grew at a faster rate from 2007 to 2008 than in recent years to 41 percent, the largest portion ever. The increases in these two categories are likely due in part to the continued collapse of the housing market. Several cities commented on the impacts of unpaid utility bills, property taxes, and special assessments on their ability to meet debt service requirements. Many cities reporting at least one problem associated with foreclosures identified delinquent utility fees. Many also reported delinquent property taxes. Other cities mentioned problems stemming from incomplete or stalled development projects. Almost half of all responding cities reported delayed or canceled development projects. Half of cities reported a decline in building permit revenues. These issues are discussed in greater detail in Chapter 2.

The portion of cities reporting property tax shortfalls in 2008 of greater than 10 percent increased slightly over 2007 (13 percent vs. 10 percent). The share of cities reporting shortfalls of greater than 10 percent in revenue from fees and charges jumped from 12 percent in 2007 to 20 percent in 2008. For some cities, reports of shortfalls in property taxes may also be due to cuts in their MVHC reimbursement. More than 100 cities lost all or part of this payment when the governor unallotted city aid and credit payments in December 2008.

The share of cities in Minnesota reporting shortfalls in state revenues increased at a greater rate from 2007 to 2008 than it did from 2006 to 2007. Cities with populations over 1,000 experienced reductions in LGA and/or MVHC in December 2008. Although the survey asks cities about shortfalls in fiscal year 2007, comments written near this question suggest that some cities answered with regard to fiscal year 2008. Several cities, responding before aids were unallotted, commented that their response would likely change once cut amounts were known.

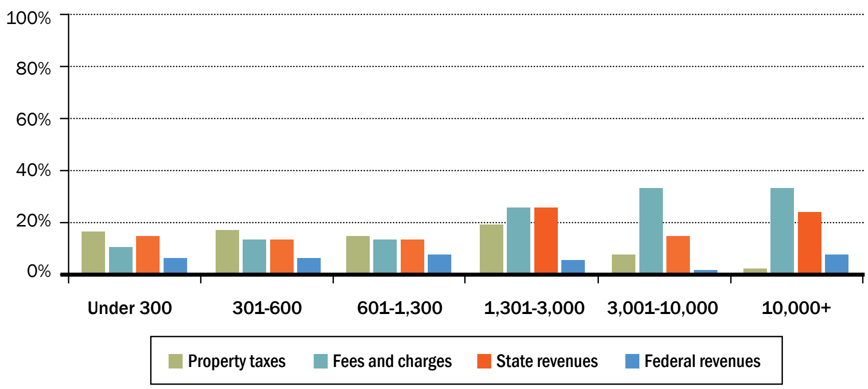
Table 1B: Percentage of Minnesota cities reporting shortfalls in various revenue sources (2003-2008)

	Property taxes	Fees and charges	Sales tax	Local income tax	Lodging and restaurant taxes	State revenues	Federal revenues
2003	28%	17%	3%	n/a	5%	82%	12%
2004	27%	24%	1%	0%	3%	55%	8%
2005	40%	25%	3%	2%	4%	39%	12%
2006	40%	33%	4%	2%	4%	31%	13%
2007	43%	36%	6%	3%	5%	35%	15%
2008	54%	41%	7%	3%	8%	41%	14%

The percentage of cities reporting a shortfall also increased in most other categories of revenue (see Table 1B). Federal revenues was the only category to show a decline in the share of cities reporting shortfalls.

The largest cities—those with populations over 3,000—were least likely to report large shortfalls in property tax revenues (see Chart 1D). Conversely, reports of significant shortfalls in revenue from fees and charges were most frequent among these cities. (Larger cities are likely to rely more heavily on fees and charges. They also have more options for implementing them.) Just 3 percent of metro cities reported property tax shortfalls greater than 10 percent while 15 percent of cities in greater Minnesota did so. The opposite is true for cities reporting large shortfalls in revenue from fees and charges; 33 percent of metro cities and 17 percent of non-metro cities experienced them.

Chart 1D: Percentage of Minnesota cities reporting revenue shortfalls greater than 10 percent of expected revenue (by population size and revenue type)

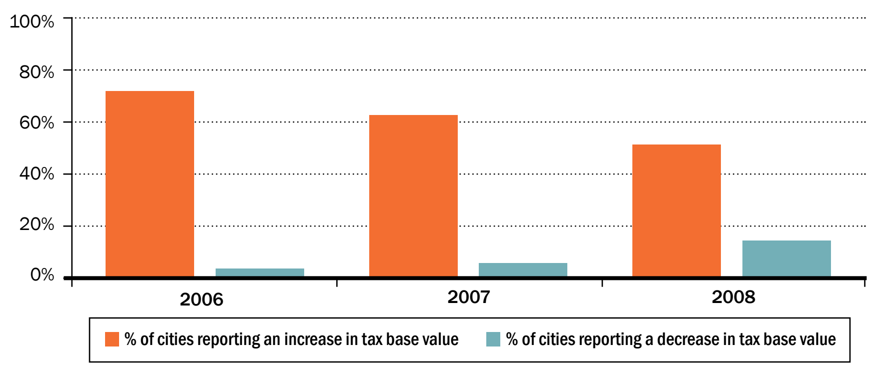


Reported changes in budget factors are similar to past years

Cities were asked to identify whether a wide variety of budget factors increased, decreased, or remained the same from fiscal year 2007 to fiscal year 2008. Most findings are similar to those reported in past years. Again, most of the budget factor changes, such as increasing costs of employee health benefits, add to the challenges facing cities. On a slightly positive note, the share of Minnesota cities reporting an increase in the value of the tax base was again larger than the share reporting a decrease (52 percent vs.16 percent). However, the portion reporting an increase in value is smaller than in past years while the portion reporting a decrease is growing (see Chart 1E). This trend is likely to strengthen in future years. This likely reflects foreclosures and problems in the housing market. When evaluating changes in the value of the tax base, it is important to remember that property values are determined almost one year before a city sets the tax levy. A city's property tax base may have increased or decreased since then.

The value of the tax base was one of the five factors most often identified by cities as increasing in 2005, 2006, and 2007. However, for 2008, employee pensions replaced it in the top five, joining prices, cost of living, and inflation; employee wages and salaries; cost of employee health benefits; and infrastructure needs. Increasing costs associated with employee pensions likely stem from problems in the stock market. Cities may have seen investment losses in their pension funds.

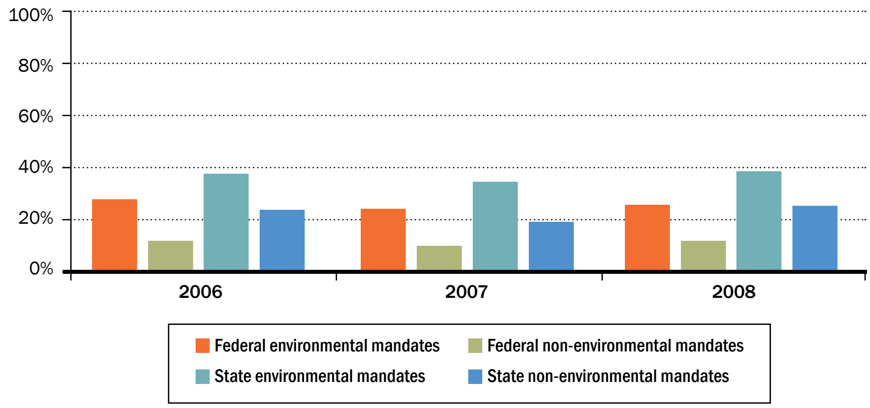
Chart 1E: Changes in the value of the city tax base (2006-2008)



The percentage of cities reporting increases in prices, cost of living, and inflation (83 percent) and in employee wages and salaries (80 percent) for 2008 remain unchanged from 2007. A slightly smaller percentage of cities reported increases in infrastructure needs in 2008 than in 2007 (69 percent vs. 72 percent). A large portion of cities reported an increase in the cost of employee health benefits (69 percent). This is a slight increase over the percentage reported in 2007 (63 percent).

The survey asked whether cities saw an increase or decrease in four types of mandates: (1) federal environmental mandates, (2) federal non-environmental mandates, (3) state environmental mandates, and (4) state non-environmental mandates. Compared to 2007 responses, a higher percentage of cities in 2008 reported increases in all four categories of mandates. Compared to 2006 responses, a lower percentage of cities in 2007 reported increases in all four categories (see Chart 1F).

Chart 1F: Percentage of cities reporting increases in mandates (2006-2008)



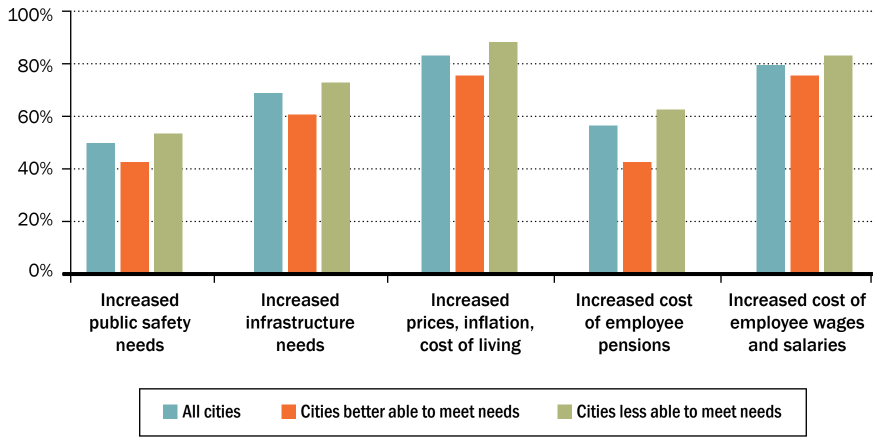
The percentage of cities in Minnesota reporting an increase in restrictiveness of tax and expenditure limits jumped significantly in 2008 to 22 percent from just 7 percent in 2007. This increase is likely due to the imposition of levy limits on cities with populations over 2,500 during the 2008 session. The limits are currently in place for taxes levied in 2009, 2010, and 2011. A city's levy can increase by either 3.9 percent *or* the amount of change in the implicit price deflator (IPD) for local governments, whichever is less. It is speculated that the changes in IPD will be quite low, severely limiting increases in 2010 and 2011 levies. More than half of cities with populations over 2,500 reported an increase in this factor while just 8 percent of cities not subject to levy limits did so.

Only one in 10 Minnesota cities reported an improvement in local economic health in 2008. The share of cities reporting an increase in local economic health declined for the second year in a row, although not as severely as from 2006 to 2007, when the share fell from 22 percent to just 13 percent. However, more than half of cities reported a decline in local economic health in 2008, a much larger share than in past years. This is reflective of the effects of the broader economic problems on cities.

Business closures, slow home sales, foreclosures, and stalled development projects continue to create fiscal stress for cities across the state. The percentage of cities reporting an increase in service needs for new developments fell slightly from 34 percent in 2007 to 30 percent in 2008. However, an analysis by city size shows that, in general, the share of cities reporting increasing service needs grows with city size. Just over half of the largest cities reported an increase in service needs while 18 percent of the smallest cities did so. Interestingly, this trend holds true when comparing the portion of cities reporting a decrease in this budget factor, suggesting that little development is occurring in the smallest Minnesota cities.

Changes in all of these factors influence a city's ability to meet its financial needs in a given year. For example, cities reporting an increase in the amount of federal aid were more likely to report an improvement in fiscal conditions in 2008. Conversely, cities reporting increases in several other budget factors, such as public safety needs, were more likely to report a decline in financial conditions in 2008 (see Chart 1G). For most budget factors, cities reporting increases were more likely to report being less able to meet needs.

Chart 1G: Cities reporting larger increases in many budget factors were less able to meet financial needs



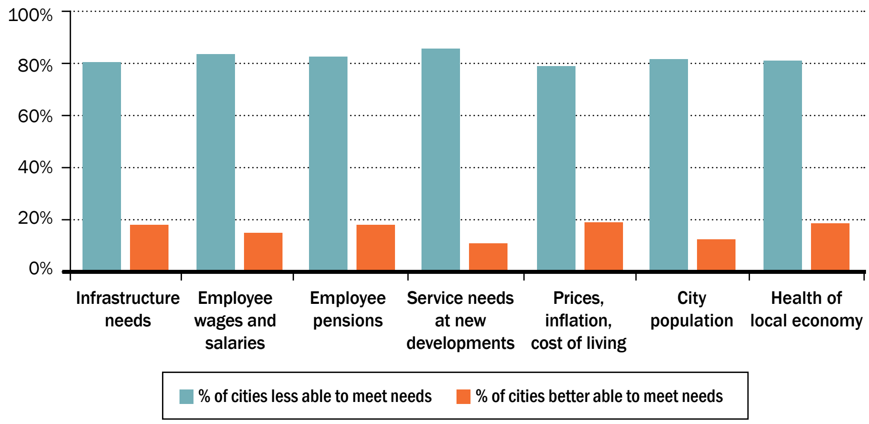
Impact of changes in budget factors

Changes in budget factors have different effects on cities, depending on their specific circumstances and the particular combination of cost pressures. Slightly larger shares of cities in 2008 than in 2007 reported at least moderate impacts on their budgets due to changes in service needs of new developments; all types of mandates; education needs; employee health benefits; human service needs; employee pensions; cost of employee wages and salaries; and prices, inflation, and cost of living. The greatest change from 2007 to 2008 was in the percentage reporting at least a moderate budget impact from changes in restrictiveness of tax and expenditure limits (16 percent in 2007 vs. 32 percent in 2008). This is likely due to the imposition of levy limits.

The top factors identified as having at least a moderate impact on Minnesota cities' budgets in 2008 are changes in prices, inflation, and cost of living (81 percent); changes in the cost of employee wages and salaries (75 percent); changes in the cost of employee health benefits (70 percent); changes in infrastructure needs (70 percent); and changes in local economic health (64 percent). Except for local economic health, which replaced tax base changes, these same factors were identified by most cities in 2007. The share reporting at least a moderate impact due to changes in local economic health is almost 10 percentage points larger than the share reported in 2007. Problems stemming from the economic recession likely contributed to this increase. More than half of cities across the state reported an increase in unemployment among residents and more than a quarter of cities reported an increase in business closures.

A city's overall fiscal condition is greatly influenced by impacts from those various budget factors. The majority of cities reporting at least a moderate impact from any of the budget factors included on the survey reported being less able to meet needs in 2008. Cities citing at least a moderate impact were even more likely to predict a decreased ability to meet needs in 2009. This is also true for cities citing a major impact (see Chart 1H on page 16).

Chart 1H: Cities identifying major impacts from various budget factors were less able to meet financial needs in 2008



Cities respond to challenges

Cities have responded to their numerous fiscal challenges in many ways, including cutting services, reducing or delaying infrastructure projects and major capital purchases, spending down reserves, and increasing revenues, such as property taxes and user fees. A city's response to fiscal challenges is determined by its unique circumstances and the range of budget-balancing options available.

Cities may use a number of budget-balancing strategies. Cities were asked which strategies they used in fiscal year 2008 in preparation for 2009. Many of these strategies can be grouped into broad categories. The trends in these categories over the last six years are shown in Table 1C. The revenue increases category includes property tax increases and increases in fees, charges, and license fees. Spending decreases include cuts in infrastructure, public safety, and other spending, as well as reductions in the overall growth rate of spending. Increasing productivity levels, contracting out or privatizing, and increasing inter-local agreements are included in the increasing efficiencies category.

Table 1C: Budget-balancing actions taken by Minnesota cities (2003-2008)

	Revenue increases	Spending decreases	Increasing efficiencies	Workforce cuts	Service cuts	Draw down reserves
FY2003	85%	55%	33%	26%	20%	60%
FY2004	84%	47%	34%	22%	15%	46%
FY2005	83%	12%	32%	5%	9%	33%
FY2006	83%	11%	31%	5%	3%	31%
FY2007	85%	12%	32%	6%	6%	32%
FY2008	76%	32%	26%	15%	13%	47%

Despite remaining steady for the past several years, the share of cities reporting revenue increases fell sharply this year from 85 percent in 2007 to just 76 percent in 2008. This drop likely reflects the new economic context cities must operate in. The property tax system is the primary discretionary tool through which to raise revenue for Minnesota cities. Levy limits on cities with populations over 2,500, shrinking tax bases due to foreclosure and housing market declines, and concerns over residents' abilities to pay all weaken the revenue raising capacity of this tool. Resistance to property tax increases has also grown. Taxpayers are often reluctant to accept tax increases when they perceive property values to be falling. The lag between when property is assessed and when property tax bills are received fuels taxpayers' frustration.

The share of cities in Minnesota increasing efficiencies also fell from relatively steady levels to the lowest share ever reported, 26 percent. Cities may have exhausted possibilities for new efficiencies or may forgo new arrangements because of cost barriers. Larger percentages reported dipping into reserves, implementing service cuts, and reducing the workforce than in recent years. And 2008 marks the first year that the portion of cities taking action in the different categories has shown any real growth. While the share of cities taking action in each of these categories increased, cities are not yet using these strategies at the level they did in 2003.

More than half of cities cut spending in 2003, following the last major cuts to state aid. Since then, the share of cities spending less has trended down until 2008, when 32 percent of cities implemented spending decreases. This is a significant jump over 2007, when just 12 percent of cities reported cuts to spending. Minnesota cities were more likely to report decreases in all categories of spending in fiscal year 2008 than in the previous year. This includes infrastructure spending and public safety spending. Cuts to infrastructure spending likely means that planned projects will be delayed, scaled back, or canceled. Cuts in public safety can mean forgoing equipment upgrades, fewer training opportunities, or fewer officers on the street. Looking at revenue increases, the share of cities increasing fees and charges remained the same while the share implementing tax increases fell from 79 percent in 2007 to 67 percent in 2008. Levy limits, declines in the value of the tax base, and resistance to property tax increases are among the reasons fewer cities chose to increase taxes. Table 1D shows specific budget-balancing actions taken by cities in 2007 and 2008.

Table 1D: Specific budget-balancing actions taken by Minnesota cities (2007-2008)

	Increase in taxes	Increase in reliance on reserves	Increase in fees/ charges	Decrease in infrastructure spending	Decrease in other spending	Decrease in growth rate of spending	Decrease in public safety spending
FY2007	79%	32%	36%	6%	4%	5%	3%
FY2008	67%	47%	36%	20%	18%	14%	11%

Cities were asked to provide details on the actions they've taken in preparation for fiscal year 2009. Cities across the state described reductions to the workforce through layoffs, attrition, and changes in seasonal staffing levels. Park and recreation programs were cut in several cities or assessed higher fees. Several cities have frozen or delayed major purchases and projects. Other cities increased cooperative agreements or contracting. Others looked for new revenues in grant monies. One city, with a population of fewer than 50 residents, made the decision to dissolve in 2009. Several cities cautioned that their actions may change once the magnitude of the 2009 aid cuts are known.

Data from the most recent NLC survey shows that cities across the country have used similar strategies.[8] The most commonly reported strategies include enacting a hiring freeze and/or layoffs (69 percent), increasing the level of fees and charges (49 percent), delaying or canceling capital infrastructure projects (42 percent), and instituting new fees and charges (28 percent).

Conclusion

Continuing the reversal of the 2003-2006 trend, fewer Minnesota cities reported improvement in their financial circumstances. Looking to 2009, cities of all sizes predict a decline in conditions. Metro cities were less likely than greater Minnesota cities to report improved conditions for 2008. The reverse is true when looking to 2009. Similarly, cities outside of the largest urban areas were slightly more likely than other cities to report improved conditions in 2008.

City budgets across the state are affected by many factors, some new and others old. Some of these are local while others, such as state budget worries and the economic downturn, are statewide or national in scale. Factors that had at least a moderate impact on city budgets include increasing prices, cost of living, and inflation; infrastructure needs; employee wages and salaries; and the cost of employee health benefits. Problems associated with foreclosure continue to plague cities. Cities have also faced problems associated with the tightening of the credit markets. Service delivery may be affected by a city's financial challenges. These topics are discussed further in Chapter 2.

[1] Comparisons to other north central states are not included in this year's report due to a lack of participation from these states.

[2] Dadayan, Lucy and Donald J. Boyd. "State Revenue Flash Report: State Tax Revenue Declined Sharply in Fourth Quarter." Nelson A. Rockefeller Institute of Government. March 12, 2009.

[3] Pagano, Michael A. and Christopher W. Hoene. "Research Brief on America's Cities: City Fiscal Conditions in 2008." National League of Cities. September 2008.

[4] Boyd, Donald J. "What Will Happen to State Budgets When the Money Runs Out?" Nelson A. Rockefeller Institute of Government. February 19, 2009.

[5] Hoene, Chris. "Research Brief on America's Cities: Fiscal Outlook for Cities Worsens in 2009." National League of Cities. February 2009.

[6] The share of cities reporting an increased ability to meet needs and the share reporting a decreased ability may not sum to 100 percent. Cities are not required to answer all questions on the survey. Cities may leave no response if they are unsure how to answer or if the question does not apply to their city. Many cities that leave the question regarding ability to meet needs blank do so because they feel that that there is no change between years.

[7] A metropolitan statistical area (MSA) is defined by the U.S. Census Bureau as a geographical area containing at least one urbanized area of at least 50,000 inhabitants with a total area population of at least 100,000. The area consists of one or more counties. The seven MSAs that include at least one Minnesota county are: Duluth-Superior, Fargo-Moorhead, Grand Forks, La Crosse, Minneapolis-St. Paul, Rochester, and St. Cloud.

[8] Hoene, Chris. "Research Brief on America's Cities: Fiscal Outlook for Cities Worsens in 2009." National League of Cities. February 2009.

Chapter 2

Economic Trends and Their Effect on Cities

Introduction

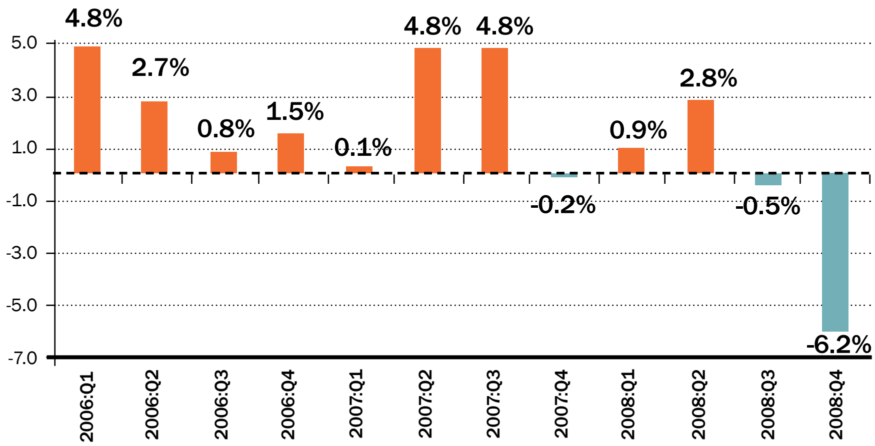
The economic recession, the decline in the housing market, and the recent crisis in the financial market have affected cities in many ways. Some of the effects are the result of economic troubles at the state level trickling down to local governments. The best example of this is how the state reduced aid to cities because it is experiencing significant declines in major revenue streams such as income and sales taxes. Other effects are more direct and include foreclosures, local business closures, and increasing demand for services from residents struggling to make ends meet. Across the state, cities are also seeing their own local revenues decline as a result of delinquent fees and taxes. The crisis in the financial market has had negative consequences for city investments and for the ability of cities to obtain loans for projects. All of these trends have hampered cities' ability to provide services to residents and businesses.

This chapter explores the various effects that broad economic trends are having on cities in Minnesota. The first section focuses on the challenges cities face as a result of problems in the financial market and the overall economic slowdown. The second section describes survey research on the effects of foreclosures in cities. This serves as a follow-up to research done on foreclosure trends in cities in the *State of the Cities Report 2008*. Finally, the third section of this chapter will highlight the difficulties cities encounter in trying to deliver one of the main services on which residents and businesses rely—city streets—in the midst of the financial storm.

SECTION 1: FINANCIAL STORM: CONSEQUENCES FOR MINNESOTA CITIES

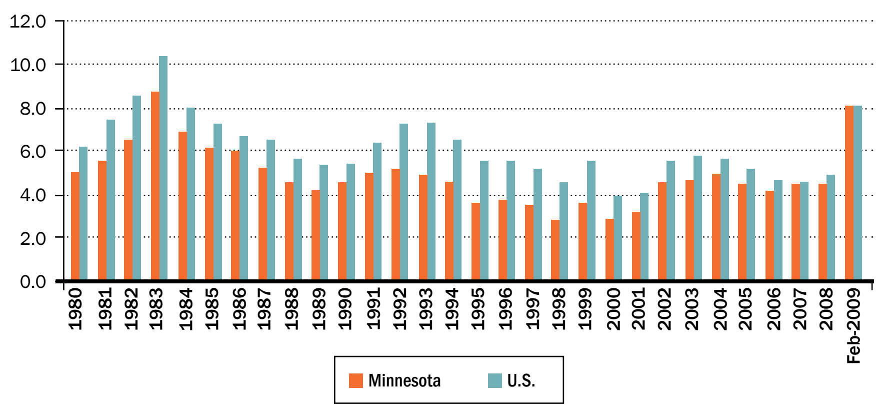
The United States economy is in what economists have said will be the longest and deepest recession since the 1980s. The bursting of the housing bubble sparked a major decline in home construction, which in turn, hurt consumer spending, a primary driver of the U.S. economy. The foreclosure crisis further aggravated this trend as people struggled to pay bills and eliminated non-essential spending. Large financial institutions holding significant amounts of risky loan products felt the pinch and tightened credit standards. These factors and more resulted in a dramatic slowdown in the country's economic growth as measured by gross domestic product (GDP). The most recent data shows actual declines in the GDP, as Chart 2.1A illustrates. GDP fell by more than 6 percent in the last quarter of 2008.[1]

Chart 2.1A: Change in U.S. gross domestic product (2006-2008)



The slowdown in the economy has meant the loss of millions of jobs. Financial institutions and large corporations have had significant layoffs. The stagnant home construction industry has left many without work. These high levels of unemployment led to additional layoffs as consumer demand for services and products fell, causing businesses to experience losses. The rise in unemployment has exacerbated the slowdown in economic growth because it means less consumer spending. Chart 2.1B below shows the unemployment rate for the nation and for the state of Minnesota since 1980. From 1980 to 2008, Minnesota outperformed the nation as a whole with a lower unemployment rate. The latest data shown in the chart marks the end of this trend. Minnesota's unemployment picture at the start of 2009 was just as bad as that of the nation's overall. The national and Minnesota unemployment rates were both 8.1 percent in February of 2009.[2] This is the state's highest rate since 1983.

Chart 2.1B: Unemployment rate, Minnesota and U.S. (1980-February 2009)



State budget woes mean city budget woes

Actions that the state has taken and may take in the future as a result of its own budget woes, namely a large deficit for fiscal years 2010-2011, will significantly impact cities. The latest forecast shows the state facing a $4.6 billion budget gap for the 2010-11 biennium. The deficit would have been $6.4 billion had it not been for the infusion of federal dollars via the American Recovery and Reinvestment Act (the federal stimulus package). Minnesota is not alone; states across the country are facing significant deficits as a result of the economic downturn. According to a survey of state budget officers, 31 states reported deficits totaling almost $30 billion for fiscal year 2009.[3] Most states rely heavily on income and sales taxes—two revenue streams devastated by high unemployment and declines in consumer spending. State revenue growth slowed significantly in 2008 compared to 2007, with overall corporate income tax collections dropping 4.5 percent.[4] The survey results show overall increases in state sales and income tax revenues, but when adjustments are made for inflation, those revenues have actually declined since 2007.

State governments, therefore, have taken a range of budget actions to address their deficits in the face of the ongoing recession. In Minnesota, the governor reduced the December 2008 aid and credit payments to cities as part of the solution to a then-forecasted $426 million shortfall for the remainder of fiscal year 2009. The governor's proposal for the 2010-2011 budget includes larger cuts in state aids and credits for 2009 and 2010.

Effects of the economic downturn on cities

There are many other ways that the nationwide recession is hurting cities, including declines in revenues like building permit fees and a weakening of local economies. In order to get a better understanding of how the financial and economic problems at the state and national levels have affected cities, this year's fiscal conditions survey included several new questions on this topic.

City officials identified the problems they have seen in their communities over the past year as a result of the economic downturn. The most frequently cited problems are an increase in unpaid utility bills, an increase in unemployment among residents, a decrease in building permit revenues, and an increase in unpaid property taxes. Three of these problems center on revenue decreases. Table 2.1A shows the portion of cities reporting each of these four problems.

Table 2.1A: Top impacts of the economic downturn in Minnesota cities

	Percentage of cities that experienced problem over past year
Increase in unpaid utility bills	62%
Increase in unemployment among residents	52%
Decrease in building permit revenues	50%
Increase in unpaid property taxes	45%

As described earlier in this section, the unemployment rate in Minnesota was 8.1 percent in February. Cities of different sizes reported increasing unemployment at fairly similar rates. As more and more people lose their jobs, it is obviously more difficult for them to pay bills, including utility charges and property taxes.

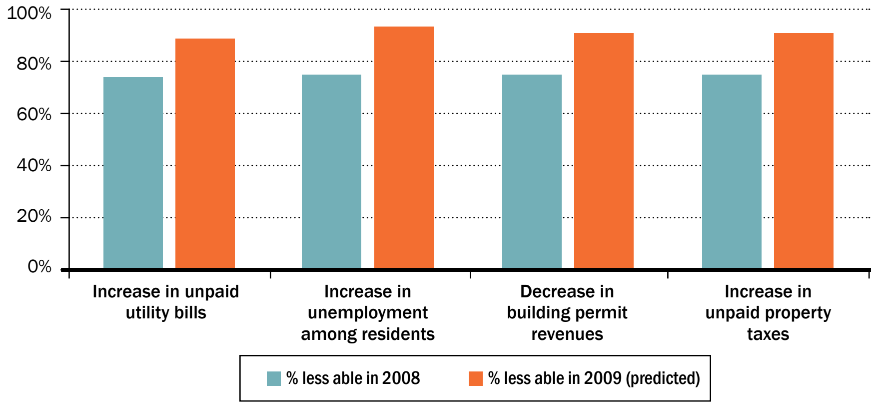
For cities, unpaid utility bills means less revenue coming in than was budgeted to cover the fixed costs of infrastructure improvements and maintenance for water, sewer, or other systems. If revenues fall below budgeted amounts, city officials are faced with difficult decisions about how to cover fixed costs. They may be forced to raise fees and/or utility rates in order to make up the difference in revenues. This means that those still paying the fees will be faced with growing costs for the activities and services that the fees cover. Cities may have to increase their reliance on the property tax to pay for certain services. Roughly 15 percent of cities in most size categories reported an increase in unpaid utility bills. The one exception is the smallest cities. Among cities with fewer than 300 people, more than 20 percent have experienced an increase in unpaid utility bills.

Almost half of cities reported an increase in unpaid property taxes. Clearly unpaid taxes create extraordinary difficulty for Minnesota cities since the property tax is their major revenue source. Cities cannot make adjustments to their levy amounts during the budget year so there is no chance to make up for property tax shortfalls until the next year. Even then, some cities (those with populations over 2,500) currently face levy limits for 2010 and 2011 that will restrict how much the levy can grow from year to year. The tax burden may be shifted to those homeowners and business owners that remain in the community as the city needs to continue delivering services, covering fixed costs like infrastructure, and meeting debt obligations. Delinquent property taxes are eventually collected when a house (or other property) is sold. With low demand in the housing market, however, this may take a long time. About 15 percent of cities in every size category report an increase in unpaid property taxes, except for the smallest cities.More than 21 percent of cities with populations under 300 have experienced this problem over the last year.

The bursting of the housing bubble and subsequent sharp decline in housing construction has had serious consequences for state and local governments alike. As mentioned earlier, the housing slowdown means less income and sales tax revenue for states. With diminished demand for new homes, suppliers and construction workers are adversely affected. When home sales go down, so does demand for large consumer goods like appliances and furniture. Some states also realize revenue from taxes and fees placed on real estate transactions. For cities, the stagnation in the home-building industry has significantly decreased the revenue coming from building-related fees and charges, like building permit fees. Half of all cities have experienced declining building permit revenues.

For each of the four economic problems most often cited by Minnesota city officials, the vast majority of cities experiencing them reported difficulty meeting their financial needs in 2008. As Chart 2.1C illustrates, even larger majorities of cities seeing these four trends predict fiscal challenges in 2009.

Chart 2.1C: Majority of cities with top economic problems are less able to meet needs in 2008 and 2009



More revenue strains

It is clear that the struggles of individuals, families, and businesses are translating into financial challenges for city governments. Thirty-four percent of all cities reported an increase in requests for deferred payment of taxes and/or bills over 2008. Residents are also going to their city halls asking for help with their own financial struggles. Typically, cities in Minnesota do not provide most health and human service type programs. Fifteen percent of cities, however, reported an increase in requests for financial assistance. Cities have also seen a rise in the number of bad checks they receive as payment for various fees and taxes. More than a quarter of cities have experienced an increase in the number of bad checks paid to city hall. This is much less common in cities with populations over 10,000.

Making debt payments

More than 10 percent of cities anticipate having trouble meeting debt service payments over the next year. Many cities mentioned possible cuts to local government aid (LGA) as the reason for their concern about meeting debt obligations. Another common reason was late payment or non-payment of taxes, including special assessments and/or utility bills. Special assessments are used to cover the cost of various infrastructure projects for which the city has already bonded. Unpaid utility bills are giving city officials cause for concern as well.

Investment problems

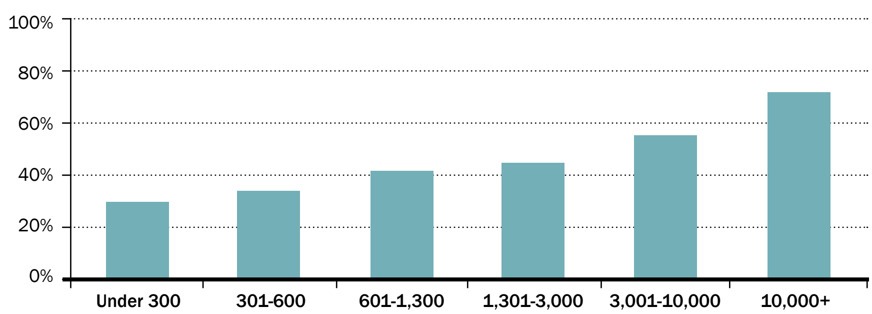
As the economy spiraled downward, nervous investors started selling their stocks in record amounts, leading to a significant loss of value in the stock market. In turn, the Federal Reserve drastically reduced interest rates on multiple occasions to try to attract investors. Those interest rate changes have hurt city investments. Forty-three percent of cities reported a decrease in their investment income. Among those cities that specified what the percentage decline has been, the average was a 20 percent loss of investment income. More than 100 cities, however, reported a loss of greater than 20 percent. The survey asked city officials to describe the impact of declining investment income. Many cities explained that they have opted to delay capital purchases and/or projects as a result of investment income declines. Other cities are using their reserves to make up for the losses. Some cities are cutting back on services. Several cities described the additional pressure that such investment income declines have put on the property tax.

Local economy

The nationwide economic downturn is, of course, reflected in local economies and communities around Minnesota. More than 26 percent of cities reported an increase in business closures in their communities. Larger cities are more likely to have experienced this outcome of the bad economy—while 15 percent of cities under 300 in population have seen rising business closures, 23 percent of cities with populations over 10,000 have done so. A recent National League of Cities (NLC) survey of local retail closures revealed that 57 percent of cities nationwide experienced a higher rate of retail store closings than during the previous year.[5] Further, more than 60 percent of cities across the nation indicated that locally owned retailers on Main Street were most affected by the economic downturn.

Another way that the economic slowdown is affecting cities in Minnesota is the stalling of development projects. Forty-one percent of cities indicated that they have seen development projects delayed or canceled. In many cases, cities invest in infrastructure like streets or water systems in anticipation of development projects and use special assessments to recover those costs. When the development does not occur or is delayed, cities are left struggling to pay for that new infrastructure because the special assessments are not being paid. As Chart 2.1D shows, the share of cities reporting delayed or canceled projects increases with population size. This may be due in part because larger cities are likely to have more development projects planned.

Chart 2.1D: Percentage of cities with delayed or canceled projects



Fund balance trends

Cities use their fund balances to set aside money for capital projects and for cash flow in between payments of property taxes and any state aids or credits. Those payments only come twice a year, but cities need to pay bills and meet payroll year-round. After the unallotment of LGA and market value homestead credit (MVHC) reimbursement in December 2008, many cities turned to their fund balances to deal with the sudden shortfall of revenues. Cities are also using their fund balances to cover shortfalls in utility bills and property tax bills that are paid late or not at all.

Table 2.1B shows the long-term trend in city fund balances. Almost two-thirds of cities are experiencing the long-term trend of a shrinking fund balance. As cities turn to their fund balances more and more to make up for aid and credit cuts, and shortfalls in revenue streams like the property tax and utility charges, they are exposed to several risks. First, they will have less to rely on for cash flow purposes in between payments of property taxes and state aids. Second, they will have less of a safety net in future times of extreme fiscal stress or during emergencies. Third, the major bond rating agencies, such as Moody's, take into account the size of a city's fund balance when determining its rating. A lower bond rating makes borrowing money more expensive for a city. Finally, it is more difficult if not impossible to put money aside for major capital projects like street reconstruction or water treatment center replacement. Often, the costs of these kinds of infrastructure projects grow over time, so having to delay them because no funds have been put into reserve can be problematic.

Table 2.1B: Long-term city fund balance trend

	Percentage of cities
Increasing fund balance	11%
Stable fund balance	31%
Decreasing fund balance	58%

Conclusion

The ongoing economic downturn is not just hurting Wall Street and state budgets. Its effects have been broad and wide-reaching among Minnesota's cities as well. Across the state, cities have experienced declines in important revenue streams like utility fees, building permits, and property taxes. Much of the decline in these sources can be attributed to rising unemployment among city taxpayers. The high level of unemployment in the state is creating new pressures for cities as residents increasingly look to city hall to help them through their financial crises with things like delayed payment schedules for utility charges. Cities are turning to their reserve funds, intended largely for meeting cash flow needs, as a way to make up for their revenue shortfalls. This option is likely not sustainable in the long term for most cities in Minnesota. Finally, city budgets face additional threat as the state moves to solve its own budget deficit in part through cuts in state aids and credit payments to cities.

[1] U.S. Bureau of Economic Analysis. February 2009 GDP release.
[2] Minnesota Department of Employment and Economic Development.
[3] *The Fiscal Survey of States: December 2008.* The National Association of State Budget Officers.
[4] *The Fiscal Survey of States: December 2008.* The National Association of State Budget Officers.
[5] *State of America's Cities Survey: Local Retail Slowdown.* National League of Cities. March 2009.

SECTION 2: FORECLOSURE CRISIS CONTINUES TO CHALLENGE CITIES

As the previous section mentioned, the bursting of the housing bubble and the foreclosure crisis are closely connected with the overall economic downturn. The survey results reported in the first section of this chapter make clear that local economies have not escaped unscathed. This section details the ongoing impacts of foreclosures on Minnesota cities. As the foreclosure problem grows in magnitude and spreads to more communities across the state, cities are facing myriad challenges on both the revenue and expenditure side.

Introduction

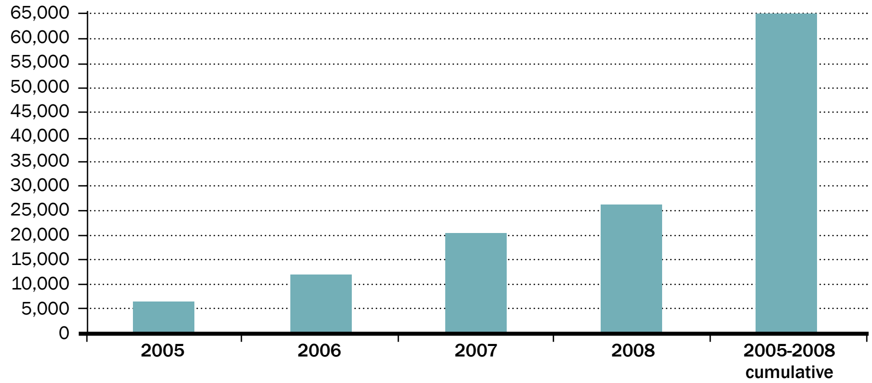
Last year's *State of the Cities Report* dedicated a chapter to the ways in which the foreclosure crisis was affecting cities across Minnesota. The bursting of the housing bubble had caused a flood of homes onto the market as more and more owners were overwhelmed by their mortgages. Homeowners in this situation tried to sell or were foreclosed upon. The number of vacant, abandoned homes grew. In some cases, owners simply walked away before filing for foreclosure rather than try to pay utility, mortgage, and tax bills for a house they would not keep. In cases where banks became the owners after foreclosure, they were unable to sell the homes due to the oversupply problem.

More than 80 percent of the cities responding to the 2008 fiscal conditions survey identified at least one negative consequence of foreclosures in their community. Among the most frequently reported issues were delinquent utility fees, property maintenance problems, and delinquent property taxes. The findings of this year's survey make it clear that the foreclosure problem has not gone away and in some communities the challenges created by vacant and abandoned homes continue to grow.

Trends

Nationwide, the mortgage delinquency rate was 7 percent in the third quarter of 2008, the latest time period for which data is available.[1] Failing to meet payments on time usually precedes foreclosure filing. According to RealtyTrac, an organization that monitors state and national foreclosure trends, there were 2.3 million foreclosures in 2008. That is an increase of 81 percent over 2007 levels and of 225 percent over 2006.[2] In Minnesota, there were 26,265 foreclosures in 2008, according to HousingLink.[3] Data compiled by HousingLink is based on sheriff's sales—that is, only the homes that are actually sold at a sheriff's auction are counted (the last step in the foreclosure process), not those that have simply filed for foreclosure. That figure is a 29 percent increase in foreclosures over 2007 levels (see Chart 2.2A). Sixteen counties experienced more than a 50 percent increase in the number of foreclosures from 2007 to 2008. All but one of these—Scott County—are in greater Minnesota. The 2008 statewide total, however, is slightly less than HousingLink's projection of 29,843 for the year.

Chart 2.2A: Number of foreclosures in Minnesota (2005-2008)



The chart also shows the cumulative total of foreclosures in Minnesota since 2005. The figure is staggering at almost 65,000. Table 2A shows how foreclosures break down between the metro area and greater Minnesota. For the four years shown in the table, foreclosures in the Twin Cities metro area have consistently been roughly two-thirds of the state total. Since 2007, foreclosures for the metro area overall have increased 33 percent while the increase for greater Minnesota overall has been 21 percent.

Table 2.2A: Number of foreclosures in the Twin Cities and greater Minnesota

	2005	2006	2007	2008
Twin Cities	3,759	7,039	12,974	17,268
Greater MN	2,707	4,777	7,430	8,997
State total	6,466	11,816	20,404	26,265

Source: HousingLink, February 2009 Supplement

Besides looking at raw numbers of foreclosures, it can be useful to think about the foreclosure rate—the number of foreclosures as a percent of total households. In 2008, the foreclosure rate for the entire state was 1.26 percent.[4] The metro rate was 1.54 percent in contrast to the greater Minnesota rate of 0.94 percent. The metro area foreclosure rate is five times higher than it was in 2005. In greater Minnesota, it has more than doubled in that time period. In six counties (Chisago, Isanti, Mille Lacs, Sherburne, Scott, and Wright), the foreclosure rate exceeds 2 percent, meaning that more than two out of every 100 households has gone through foreclosure.

Foreclosure problem continues

Several factors explain why the foreclosure problem continues. First, the overall economy is struggling with significant job losses and declines in the stock market. As people lose their jobs, it clearly becomes more difficult to meet mortgage payments and other financial obligations. A recent report from the Mortgage Bankers Association revealed that the rise in joblessness is causing mortgage defaults to spread to even those borrowers with prime fixed-rate loans.[5] Previously, the mortgage foreclosure crisis had primarily affected subprime borrowers.

Financial institutions are still recovering from the financial market crisis. Many of these organizations took huge losses as a result of holding mortgage-backed securities. As a result, banks have tightened their criteria for issuing loans, making it harder for would-be buyers of homes to get mortgages. This is one reason an oversupply of homes still plagues the market, making it very difficult for homeowners at risk of foreclosure to sell their homes. Another reason is that most people who have lost or fear losing their jobs are not looking to purchase a home, further shrinking the pool of potential buyers.

Additionally, housing prices have continued to fall. Over the 12-month period ending in November 2008, U.S. home prices fell 8.7 percent.[6] Recent data available on national home price trends shows a 3.5 percent decline in the third quarter of 2008.[7] State level data shows that from the fourth quarter of 2007 through the fourth quarter of 2008, housing prices in Minnesota fell 4.3 percent.[8] Falling home values make it more difficult for homeowners having trouble making payments to refinance their loans. If a homeowner owes more than the house is currently worth, banks are extremely wary of negotiating a refinance deal.

Risky loans

Finally, there are still significant numbers of risky loans in the marketplace. The housing market boom led to a huge increase in the number of creative, sometimes risky mortgage products (e.g., adjustable rate mortgages [ARMs] and negative amortizing loans—those that result in the borrower owing more over time instead of less) as the demand for homes and mortgages grew dramatically. It also led to banks issuing credit for the first time to those with bad or even no credit (i.e., subprime lending). One of the main reasons for the foreclosure problem has been the resetting of mortgages that were at very low interest rate for the first few years (i.e., ARMs). When those interest rates reset, many homeowners became unable to meet their mortgage payments.

National data show that delinquency and foreclosure rates are high for risky mortgages. In the third quarter of 2008, the delinquency rate for subprime loans was nearly five times higher than that for prime loans.[9] Table 2.2B shows a similar pattern in the foreclosure rates for prime loans (less than 1 percent) and subprime loans (4 percent). According to loan data on the Federal Reserve web site, almost three-quarters of subprime loans in Minnesota are ARMs.[10] More than 14 percent of subprime ARMs in Minnesota will reset during the next 12 months.

Table 2.2B: U.S. delinquency and foreclosure rates: prime vs. subprime loans

	Delinquency rate	Foreclosure rate
Prime loans	4.3%	.06%
Subprime loans	20%	4.1%

For third quarter of 2008, Standard and Poor's data, January 2009

Housing starts

The bursting of the housing bubble and the subsequent foreclosure crisis have affected cities in another way—through the downturn in home construction. As the demand for new homes dried up, construction obviously slowed down. Many state and local governments rely on revenues from building-related fees and taxes, including building permit fees. Cities continue to see declines in building permit revenues and other revenue streams associated with new development. Nationally, housing starts for private residences were 56 percent lower in January 2009 than a year prior.[11] In Minnesota, the number of single-family building permits issued fell 58 percent between January 2008 and January 2009.[12] The City of Hastings reported only four permits for single-family homes and zero for townhomes in the first half of 2008 compared to 150 and 200, respectively, in 2003.[13]

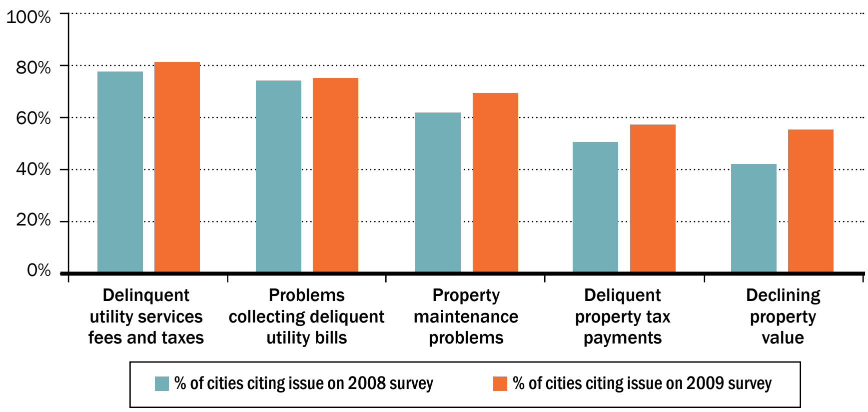
Foreclosures causing range of issues for cities

The foreclosure problem continues to create challenges for cities. The NLC found in its most recent opinion survey of city officials around the country that cities of all sizes—core cities, suburbs, and small rural cities—reported a worsening of the foreclosure problem.[14] In an earlier NLC survey focused on housing issues, 14 percent of city officials identified increasing foreclosures as one of three conditions that have had the most severe impact on their communities.[15]

The 2008 LMC fiscal conditions survey asked Minnesota city officials to identify what issues and problems foreclosures had caused in their communities. The 2009 survey asked a very similar question, but instructed respondents to refer to only the most recent 12-month period. Further, the latest survey included a few new foreclosure issues for city officials to select. Having two years' worth of data allows for analysis of how foreclosure issues have changed over time for cities across the state. The results clearly show that the foreclosure problem continues to create revenue and cost challenges for Minnesota cities.

The problems reported most frequently on the current survey are the same ones reported most often on last year's survey: delinquent utility services fees and taxes, problems collecting delinquent utility bills, property maintenance problems, delinquent property tax payments, and declining property value. All but one of these (property maintenance) can be described as a revenue problem. In Breezy Point, for example, city officials are weighing which projects to cancel or delay because of money issues caused in part by unpaid taxes on the roughly $6 million of private property in foreclosure.[16] As Chart 2.2B shows on page 30, in each case, the proportion of cities reporting these problems increased over last year.

Chart 2.2B: Top foreclosure-related issues in Minnesota cities



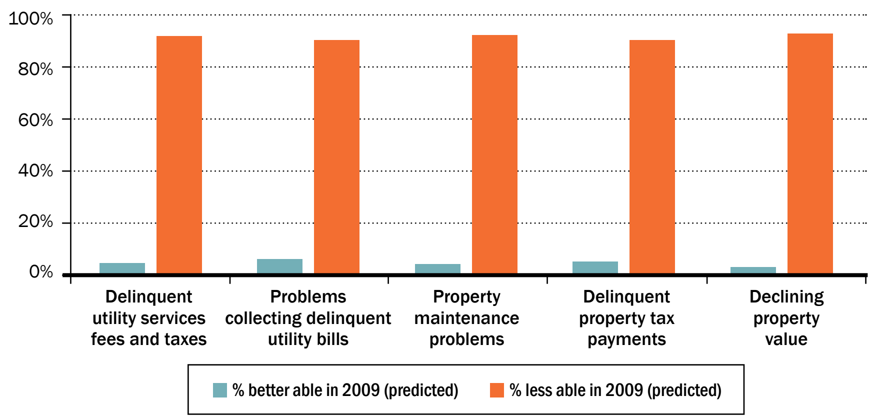
In percentage terms, the increase from 2008 to 2009 in the share of cities seeing a decline in their property values as a result of foreclosures is most dramatic. The portion of cities reporting this problem grew by more than 30 percent. As cities grapple with the reduction or, in some cases, elimination of their December 2008 aid and credit payments and potentially large aid and credit cuts in 2009, a tax base that is decreasing in value makes the situation much more complex. It forces local officials to make hard decisions about what services to provide and how much of the cuts to try to make up with the property tax that must be levied on a declining tax base.

As the tax base shrinks because of declining home values, the tax rate will rise in a city that chooses to maintain its levy. This could mean larger tax bills for those property owners who remain. In order to avoid this outcome, city officials have to cut or reduce services. In some cases, in order to make debt payments for capital projects, cities must actually increase the levy. Growth in the levy is also sometimes needed when cities need to pay for investments in infrastructure, like streets and water systems, for anticipated development that was never completed and, therefore, did not bring homeowners to cover those costs.

An additional complication for city officials in these decisions is the confusion among taxpayers who perceive that their homes have devalued but continue to see valuation increases and/or tax increases. Much of this confusion stems from the fact that taxes are levied on property values determined more than a year before a city sets the property tax levy. So a given home may have declined in value since the official valuation, but that won't have an impact on taxes owed until the following year. Ramsey County (counties administer the property tax system) reported significant increases in the number of homeowners challenging their valuations.[17] Further, the amount of taxes owed on a specific property depends on more than just property value. It is also affected by whether the levy goes up or down and how other properties in the city have increased or decreased in value compared to the specific property.

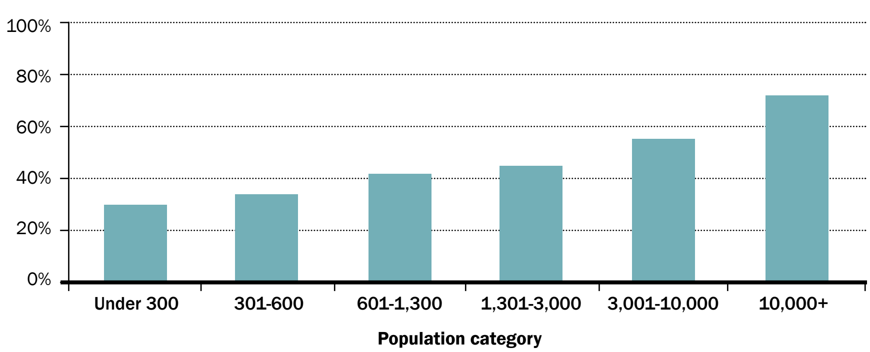
Looking at cities' overall fiscal condition and the kinds of foreclosure problems they are experiencing reveals that cities that report the top five foreclosure problems are significantly more likely to be among those cities with a negative outlook on their future financial circumstances. For example, 92 percent of cities that have experienced delinquencies in the payment of utility fees and taxes indicated they would be less able to meet their financial needs in 2009. Only 5 percent of these cities were optimistic about 2009. Chart 2.2C shows this comparison for all five of the most frequently reported foreclosure impacts.

Chart 2.2C: Cities reporting foreclosure problems are less able to meet financial needs



There are also some interesting patterns when comparing cities by population size. At least half of cities in each population category reported a problem with delinquent utility fees and taxes. For all but the smallest cities (under 300 in population), the share of cities reporting property maintenance problems was at least 55 percent. The portion of cities seeing delinquent property taxes rises with population size. As Chart 2.2D shows, the share of cities seeing property values fall as a result of foreclosures also rises steadily as population increases. While slightly less than a third of cities with populations under 300 reported declining property values, almost three-quarters of cities with populations over 10,000 did so.

Chart 2.2D: Percentage of cities with declining property values (by population size)



Exploring the impacts of foreclosure

As described above, four of the five top-reported problems have to deal with cities not realizing expected revenues and/or receiving revenues late. While the foreclosure problems described above were the ones reported most often by cities, many other effects of foreclosures have been felt in cities across the state. The rest of the city problems caused by foreclosure fall into two broad categories—cost pressures and overall city vitality.

Cost pressures caused by foreclosures

Some of the foreclosure problems create cost pressures on city budgets. Table 2.2C summarizes the problems cited this year and last year that strain city finances.

Table 2.2C: Percentage of cities with cost-related foreclosure problems (2007-2008)

	Cities identifying issue in 2007 (from 2008 survey)	Cities identifying issue in 2008 (from 2009 survey)
Property maintenance problems	62%	69%
Budgetary burdens/staff time to identify vacant properties	n/a	38%
Increase in dangerous property conditions	29%	31%
Costs to reconnect homes to utilities	26%	26%
Increased demand for public safety services	16%	25%
Increase in criminal activity at vacant property	n/a	20%
Budgetary burdens/staff time for counseling	n/a	6%

Cities have experienced increasing pressure to provide a higher level of existing services, such as maintenance services and public safety. As described above, one of the most frequently mentioned foreclosure problems is property maintenance. Nearly 70 percent of cities have experienced this issue. As the number of foreclosed and vacant homes grows, so do the problems with sidewalks not being cleared of snow and grass not being mowed. In order to keep communities safe and pleasant for remaining residents, cities are struggling to take care of these maintenance problems.

One specific maintenance concern stems from frozen pipes in abandoned homes that burst, resulting in hundreds if not thousands of gallons of water flooding the home. In many cases, such homes are beyond repair and must be demolished. The City of Elk River estimates that it lost 20 million gallons of water due to frozen pipes in vacant homes over the winter.[18] The problem is leading the city to develop a tracking system to identify vacant homes. Almost 40 percent of cities with foreclosure problems reported that they are being forced to dedicate staff time and resources to identifying vacant properties.

Demand for public safety has grown as well since vacant homes can be targets for criminal activity like painting graffiti, breaking windows, and stealing copper pipes. One out of five cities reported increased criminal activity at vacant homes over the last 12 months. Twenty-five percent of cities reported an increase in public safety needs as a result of foreclosures, compared to 16 percent last year. Cities are also being asked to provide new services. For example, 6 percent of cities indicated that they have had to devote staff time to make counseling services available to residents facing foreclosure. St. Paul is leveraging city funds through its Housing and Redevelopment Authority to access millions of dollars in funding to help homeowners refinance their mortgages and to help potential owners qualify for loans.[19] Several of the problems listed in Table 2.2C were new to the 2009 survey, so comparisons over time are not possible. It is clear, however, that both the pressure to devote staff time to determining whether a property is actually vacant, and an increase in criminal activity like arson or drug activity are serious problems.

City vitality harmed by foreclosures

In addition to revenue problems and cost pressures, foreclosures are also hurting the vitality of communities across the state. In many cases, foreclosures have changed the character of individual neighborhoods or sections of a city. Table 2.2D summarizes some of the problems caused by foreclosure related to city vitality.

Table 2.2D: Percentage of cities with vitality-related foreclosure problems (2007-2008)

	Cities identifying issue in 2007 (from 2008 survey)	Cities identifying issue in 2008 (from 2009 survey)
Declining property value	42%	55%
Difficulty in attracting new residents and/or businesses	39%	45%
Conversion of owner-occupied units to rental units	24%	23%
Foreclosure of rental properties	15%	18%

Boarded up windows, yards filled with trash, and the loss of neighbors can have significant negative impacts on quality of life and the vitality of a city. As described above, the most dramatic change from last year's survey in terms of the incidence of foreclosure problems occurred with the share of cities seeing a decline in property value in their community. This problem was cited 31 percent more frequently by cities on the 2009 survey. Foreclosures can negatively affect home values in entire neighborhoods. This is obviously a decline in the quality of life for remaining homeowners as they see their major investment lose value.

It is also hard to bring in new families or new industry to communities where foreclosures have occurred. People are attracted to neighborhoods that feel vibrant and healthy, not ones that feel abandoned or dangerous. The foreclosure crisis is also changing the characteristics of neighborhoods by bringing about an increase in conversion of owner-occupied housing units to rental units. A higher concentration of rental housing often means more turnover in residents and reduces the sense of stability in a neighborhood. About a quarter of cities with foreclosure problems cite this issue. Cities have concerns about the conversion of owner-occupied to rental. In New Prague, where there have been a large number of these conversions, the city established a new registration system to keep track of rental properties.[20] Minneapolis implemented a new fee for homes converting to rental.[21] That fee covers costs like inspections that help ensure the quality and safety of the city's housing stock.

Legislative action

During the 2008 session, the Minnesota Legislature passed several pieces of legislation focused on the foreclosure crisis. The foreclosure of rental properties often means that renters are out of luck after their landlords fall behind on their mortgages.

The legislation clarified tenants' rights during the foreclosure process, modified lending regulations, and created a statewide foreclosure data working group. The Minnesota Foreclosure Partners Council, comprised of representatives of local governments, nonprofit organizations, banks, and federal agencies, established a plan to address foreclosures across the state.[22] That plan includes data collection activities, homeowner counseling, neighborhood recovery programs, and legislative strategies. On the national level, Congress passed the American Housing Rescue and Foreclosure Prevention Act of 2008. Major goals of that legislation included strengthening hard-hit neighborhoods, providing tax incentives to purchase homes, and boosting the stock of affordable rental housing. Early in the 2009 session, Minnesota legislators proposed bills to expand cities' flexibility in using tax increment financing. Specifically, the changes would allow cities to pool their increment to acquire foreclosed properties in order to maintain them as market rate housing. Another bill would temporarily suspend payments due on foreclosed homes.

Conclusion

For cities, the ongoing foreclosure problem is creating a host of challenges, ranging from shortfalls in revenues like utility fees to cost pressures for additional public safety services. The foreclosure trend has altered the dynamics of many neighborhoods and communities across the state through an increase in the number of vacant homes and the conversion of owner-occupied housing units to rental properties. The foreclosure crisis has also hurt the property tax base on which cities rely heavily to provide the local services that residents and businesses demand.

---

1 Residential Real Estate Indicators. Standard and Poor's. January 2009.
2 *ForeclosurePulse*. Realty Trac. January 14, 2009.
3 Foreclosures in Minnesota: A Report Based on County Sheriff's Sale Data. February 26, 2009 Supplement. HousingLink. February 2009.
4 Foreclosures in Minnesota: A Report Based on County Sheriff's Sale Data. February 26, 2009 Supplement. HousingLink. February 2009.
5 "One in 8 U.S. Homeowners Late Paying or in Foreclosure." *News Daily.* March 5, 2009.
6 Federal Housing Finance Agency News Release. January 22, 2009.
7 Residential Real Estate Indicators. Standard and Poor's/Case-Shiller Home Price Indices. January 2009.
8 Four-Quarter Percent Change in Office of Federal Housing Enterprise Oversight State-Level House Price Indices. Office of Federal Housing Enterprise Oversight. January 2009.
9 Residential Real Estate Indicators. Standard and Poor's. January 2009.
10 Dynamic Maps, FirstAmerican CoreLogic, LoanPerformance Data. New York Federal Reserve. January 2009.
11 New Residential Construction in January 2009. U.S. Census Bureau News Joint Release-U.S. Department of Housing and Urban Development. February 18, 2009.
12 Building Permits by States and Metro Areas. U.S. Census Bureau. January 2009.
13 "Slumping housing market takings its toll on city budget." *Hastings Star-Gazette*. August 8, 2008.
14 *2008 State of America's Cities: Annual Opinion Survey of Municipal Officials*. National League of Cities. December 2008.
15 *Housing Finance and Foreclosures Crisis: Local Impacts and Responses*. National League of Cities. April 2008.
16 "Breezy Point: Projects tabled, rejected or delayed because of money, citizen objections." *Pine and Lakes*. March 5, 2009.
17 "Housing market: prices down, taxes up." *Pioneer Press*. April 4, 2008.
18 "Pipes are freezing in foreclosed homes." *Star News*. March 5, 2009.
19 "St. Paul takes a swipe at the subprime mortgage fiasco." *Star Tribune*. July 8, 2008.
20 "As rentals boom, cities strive to protect home values." *Star Tribune*. April 8, 2008.
21 "As rentals boom, cities strive to protect home values." *Star Tribune*. April 8, 2008.
22 The Coordinated Plan to Address Foreclosures: Strategies to address foreclosures and help families and communities succeed in the Twin Cities and the State of Minnesota. Minnesota Foreclosure Partners Council. March 2008.

SECTION 3: DELIVERING CITY SERVICES DURING THE STORM—CITY STREETS

Introduction

Minnesota cities are weathering many challenges brought about by the economic slump. The majority of cities are pessimistic about their ability to meet the fiscal needs of their communities over the next year. One of the most common service needs in cities is the provision of safe, reliable streets. This section highlights city efforts to provide that service in the midst of a serious economic recession that is affecting government at all levels.

Financing for street maintenance and operation

Minnesota has 289,522 lane miles of highways, roads, and streets. Approximately 16 percent of those streets are owned and maintained by cities. Collectively, city streets saw an average 11,862,931 vehicle miles traveled daily in 2007 (see Table 2.3A).

Table 2.3A: Comparison of lane miles (2008) and vehicle miles traveled (2007)

	Lane miles		2007 Vehicle miles traveled		
	Number	Percent of total	Daily (average)	Annual (total)	Percent of total
City streets	37,644	13.0%	11,862,931	4,329,969,815	8%
Municipal state aid streets	7,212	2.5%	12,424,246	4,534,849,790	8%
Township streets	116,312	40.2%	3,251,995	1,186,978,175	2%
County state aid highways	62,251	21.5%	35,265,238	12,871,811,870	22%
County roads	28,821	10.0%	2,838,832	1,036,173,680	2%
Interstates & trunk highways	20,641	7.1%	66,267,941	24,187,798,465	42%
Federal agency streets	8,587	3.0%	25,277,936	9,226,446,640	16%
Other	8,053	2.8%	98,507	35,955,055	0%
Total	289,522	100%	157,287,626	57,409,983,490	

Source: Minnesota Department of Transportation[1]

Some streets that run within a city's boundaries are the responsibility of another governmental entity such as the state or county or may be maintained jointly with a neighboring township. Highways and streets that function as an integrated network, provide more than local access, and are located within cities over 5,000 in population may be designated as municipal state aid (MSA) roadways. MSA roadways are subject to rules established by the Minnesota Department of Transportation (MnDOT).

Only cities over 5,000 in population receive an annual allocation from the state for the maintenance of MSA streets. Funds are distributed based on a formula that considers a city's population and estimated relative costs to build and maintain MSA streets. Funding comes from the state Highway Users Tax Distribution Fund, which is comprised of motor fuel taxes, tab fees, and transfers from the motor vehicle sales tax general fund. The MSA system receives 9 percent of the fund's revenues. Total MSA mileage has increased 182 percent since the start of the program in 1960. However, the share of revenues the MSA system receives from the Highway User Tax Distribution Fund has not increased. Available MSA aid has not kept pace with cities' construction and maintenance costs.[2]

The costs to operate and maintain these streets are much greater than the available funds. A 2003 study revealed that while the MSA funding formula is based on a 25-year construction needs lifecycle, the system is funded at a level resulting in a 53-year lifecycle.[3] Any costs in excess of a city's MSA allocation are the city's responsibility. Cities may borrow against future MSA allocations or combine MSA dollars with special assessments. In specific circumstances cities may be eligible for funds from the state's "turnback" account. This occurs when MnDOT "turns back" a trunk highway to a local unit of government.

Cities that are not eligible for MSA funding must rely on local sources of revenue to operate and maintain streets. The same is true of MSA cities when aid is not enough to fund needs. The property tax and special assessments are the two most used sources of revenue for streets. As discussed in Chapter 1, the property tax may be constrained by levy limits, a shrinking tax base, concerns over residents' ability to pay, and resistance to property tax increases. Other street financing tools available to cities include tax increment financing, property tax abatements, special enterprise funds, general obligation bonds, and the state Transportation Revolving Loan Fund. Each of these tools has its own constraints and limitations. For example, special assessments are a major source of revenue for initial improvements and have typically been used by cities experiencing growth. Assessed charges cannot exceed the benefit brought to an individual property by the improvement. Assessments may also be used in reconstruction projects, although the individual benefit can be difficult to calculate. Further, cities are frequently challenged by public opposition to special assessments. Special assessments typically do not cover the total cost of a street project.

In addition to MSA funding, the state can provide support for street projects through general fund appropriations and bonding. The issuance of general fund appropriations is limited and considered one-time money. The Legislature has the authority to include state bonds for local road and bridge projects in the capital bonding bill typically passed in even-year sessions. Cities may also utilize federal funds provided to the state through the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), legislation that is set to expire in 2009. SAFETEA-LU is funded by the federal gas tax. Congress is currently discussing the Act's reauthorization. The American Recovery and Reinvestment Act of 2009 (the federal stimulus package) included funds for various transportation improvement projects. Because of federal guidelines, these funds are largely limited to MSA projects.

Bills have surfaced at the state Legislature that would enable cities to establish a municipal street improvement district. A street improvement district allows cities more flexibility in funding street maintenance. Despite a myriad of existing funding sources, the total dollars available for street construction, reconstruction, and ongoing maintenance fall far short of the needs.

Majority of cities have street improvement needs

The need for street repairs, reconstruction, and maintenance is ongoing even while cities are experiencing new fiscal challenges. The fiscal conditions survey asked cities to estimate the percentage of their roadways needing repair, reconstruction, and other maintenance, such as seal coating, over the next year. Eighty percent of cities identified needs in at least one area. Of these cities, more than 80 percent identified repair needs, and over half had streets needing reconstruction. Just over three-quarters had other maintenance needs. Table 2.3B shows the average percentage of streets within a city needing each type of improvement.

Table 2.3B: Percentage of cities with street improvement needs in the next year

	% of cities with need	Average % of streets in need
Repair	66%	23%
Reconstruction	44%	21%
Other maintenance	63%	29%

Cities were also asked to estimate their costs for each type of improvement over the next year. Several cities wrote that they have no funds for improvements in the next year. Others wrote that while they have needs, they cannot afford to take action on them. Table 2.3C shows the estimated improvement cost for streets.

Table 2.3C: Estimated improvement cost for streets

	% of cities estimating cost	Average estimated cost per city
Repair	57%	$372,799
Reconstruction	29%	$1,665,752
Other maintenance	54%	$364,786

Repair needs and costs

Overall, more than half of all cities identified street repair needs. When broken out by population size, the portion of cities identifying needs increases with city size (see Table 2.3D). However, the average percentage of city streets in need of repair was smaller for larger communities. On average, 11 percent of streets in cities with populations over 10,000 need repair while cities with populations under 300 identified one-third of city streets in need of repair on average. Larger cities may have more resources, including MSA funding, available for street projects. The average cost of repairs increases with city size although estimated costs vary widely within each size category.

Table 2.3D: Percentage of cities with street repair needs in the next year and estimated costs

City population	% of cities identifying repair needs	Average % of streets in need	Average estimated cost per city
0-300	54%	34%	$52,852
301-650	61%	29%	$25,672
651-1,300	64%	21%	$113,729
1,301-3,000	73%	24%	$239,554
3,001-10,000	76%	18%	$354,531
10,000+	79%	11%	$1,246,128

Reconstruction needs and costs

Fewer cities in all size categories identified reconstruction needs (see Table 2.3E on page 38). Almost three-quarters of the largest cities identified streets in need of reconstruction. For these cities, on average, just 8 percent of streets need reconstruction. In contrast, while just 18 percent of the smallest cities identified reconstruction needs, the average share of streets needing reconstruction was 37 percent.

Table 2.3E: Percentage of cities with street reconstruction needs in the next year and estimated costs

City population	% of cities identifying reconstruction needs	Average % of streets in need	Average estimated cost per city
0-300	18%	37%	$130,769
301-650	32%	37%	$151,490
651-1,300	43%	21%	$418,050
1,301-3,000	64%	20%	$941,591
3,001-10,000	63%	17%	$1,324,554
10,000+	72%	8%	$3,608,170

Other maintenance needs and costs

An analysis by population size of cities identifying other street maintenance needs reveals the same trends (see Table 2.3F). A greater share of larger cities identified needs while the average percentage of streets with maintenance needs was greater among smaller cities. Estimated maintenance costs vary widely within each size category.

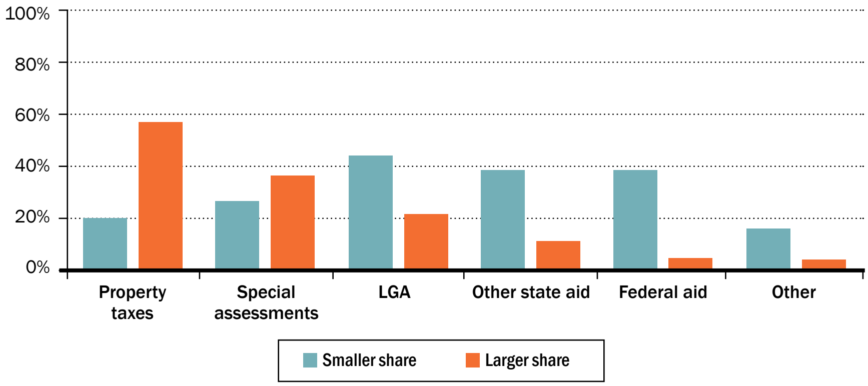
Table 2.3F: Percentage of cities with other street maintenance needs in the next year and estimated costs

City population	% of cities identifying other maintenance needs	Average % of streets in need	Average estimated cost per city
0-300	45%	37%	$7,665
301-650	67%	42%	$24,294
651-1,300	69%	32%	$79,437
1,301-3,000	61%	24%	$47,879
3,001-10,000	73%	26%	$1,388,951
10,000+	77%	13%	$475,854

Local sources of revenue now a larger share of total funding for most cities

This year's fiscal conditions survey asked cities about the change in funding sources for street projects over time. Cities were presented with a list of funding sources and asked to indicate if each was a smaller or larger share of overall funding for streets in 2008 when compared to 2000. Local sources of revenue—property taxes and special assessments—have clearly become a larger part of the funding mix for cities overall. As illustrated in Chart 2.3A, 57 percent of cities reported that property taxes made up a larger share of the funding mix in 2008 than in 2000. Property taxes comprised a smaller portion of funding for just 19 percent of cities. More cities (36 percent) also reported that special assessments have become a larger portion of the mix in 2008. LGA has become a smaller share for 44 percent of cities. Very few cities (3 percent) reported a larger share of funding from other funding sources.

Chart 2.3A Percentage of cities reporting that various funding sources made up a larger or smaller share of street project funding in 2008 vs. 2000



Budget-balancing strategies impact city streets

Most Minnesotans use city streets every day. Drivers probably don't consider who is responsible for the roadway until they are faced with a maintenance or safety issue such as unplowed snow or potholes. When cities face budget shortfalls, street maintenance and construction budgets are often reduced and projects delayed in efforts to balance the budget. As mentioned above, several cities indicated that despite the need for improvements, there are no funds in the budget for significant street projects.

Cities were asked to describe the budget strategies they took in 2008 in preparation for 2009. Several cities mentioned leaving positions open or eliminating positions in the streets or public works departments. Others mentioned adjusting maintenance schedules for seal coating and other repairs. Deferring street projects, planned improvements, and major purchases to future years was another strategy described by several cities. Others have eliminated future improvements indefinitely.

Conclusion

As cities face current and future budget challenges, tough decisions will be made about how to fund city services and at what level. Street maintenance and operation is one area where cities are already making adjustments. While cities have repair, reconstruction, and other maintenance needs, they are frequently unable to fund these projects immediately. Several cities have delayed planned projects or made cuts to streets and public works departments. Sufficient funding is required to maintain Minnesota's most critical infrastructure system.

[1] Minnesota Department of Transportation, Transportation Information System, current as of March 12, 2009.

[2] Transportation Policy Institute. "Funding Street Construction and Maintenance in Minnesota's Cities: Providing the tools to help cities preserve their road and bridge capital assets." Sponsored by City Engineers Association of Minnesota, The Minnesota Chapter of the American Public Works Association, and League of Minnesota Cities. January 2003.

[3] Transportation Policy Institute, 2003.

Appendix
Fiscal Conditions Survey

Fiscal Conditions Survey methodology

The 2008 fiscal conditions survey was sent to all League of Minnesota Cities (LMC) member cities. When the survey was distributed, 831 of Minnesota's 855 cities were members. As in each of the previous surveys, the first four questions were modeled after questions on the National League of Cities annual survey. State leagues in Louisiana, Michigan, Missouri, North Dakota, Oregon, Pennsylvania, South Carolina, and West Virginia also sent the survey to their members. States had the option of adding several additional state-specific questions to the survey. All cities were given the option of taking the survey online.

Of the 3,242 cities surveyed overall, 1,243 responded for a response rate of 38 percent. Response rates for each state are listed in Table APP-A.

Table APP-A: Survey response rates for all participating states

	Completed surveys	Total members	Response rate
Louisiana	16	34	47%
Michigan	140	538	26%
Minnesota	445	831	54%
Missouri	254	658	39%
North Dakota	95	357	27%
Oregon	98	242	40%
Pennsylvania	21	80	26%
South Carolina	120	270	44%
West Virginia	54	232	23%
Total	1,243	3,242	38%

The number of Minnesota cities that have responded to all six of the annual LMC fiscal conditions surveys is 94. The year-to-year trends in the responses are in part influenced by the fact that the group of cities responding to the survey changes each year.

2009 Multistate Fiscal Conditions Survey—All States

1. Overall, would you say that your city is better or less able to…

a. Meet financial needs in fiscal year 2008 than last year? (*check one*) ☐ Better able ☐ Less able

b. Address its financial needs in the next fiscal year (2009) compared to this fiscal year? (*check one*) ☐ Better able ☐ Less able

2. Please indicate whether FY2007 revenue shortfalls in the following areas were less than 10% or greater than 10% as a percentage of funding expected from each revenue source:
Check one box for each item on the list below. Shortfall = actual receipts fell below predicted or budgeted receipts. Not all revenue sources are available to cities in all states—in this case, please mark "not authorized."

	No shortfall	Shortfall <10% of expected	Shortfall >10% of expected	Not authorized in my city
a. Property tax revenues	☐	☐	☐	☐
b. Fees, charges, license revenues	☐	☐	☐	☐
c. Sales tax revenues	☐	☐	☐	☐
d. Local income/commuter tax revenues	☐	☐	☐	☐
e. Lodging, restaurant, amusement, other tourist-related taxes	☐	☐	☐	☐
f. State revenues	☐	☐	☐	☐
g. Federal revenues	☐	☐	☐	☐

3. Please indicate in Part A whether there has been an increase, a decrease, or no change in an item between FY2007 and FY2008 for your city.
Check one box in Part A for each item.

Please indicate in Part B whether it had no impact, a moderate impact or a major impact on your city's overall FY2008 budget.
Check one box in Part B for each item.

	PART A: CHANGE				PART B: IMPACT		
	Increase	No change	Decrease		No impact	Moderate impact	Major impact
a. Value of city tax base	☐	☐	☐	Go to Part B ⟹	☐	☐	☐
b. Service needs of new development	☐	☐	☐	⟹	☐	☐	☐
c. Amount of federal aid to city	☐	☐	☐	⟹	☐	☐	☐
d. Federal environmental mandates	☐	☐	☐	⟹	☐	☐	☐
e. Federal non-environ. mandates	☐	☐	☐	⟹	☐	☐	☐
f. State environmental mandates	☐	☐	☐	⟹	☐	☐	☐
g. State non-environ. mandates	☐	☐	☐	⟹	☐	☐	☐

1

	PART A: CHANGE				PART B: IMPACT		
	Increase	No change	Decrease		No impact	Moderate impact	Major impact
h. Restrictiveness of state tax & expenditure limits on cities..........................	☐	☐	☐	**Go to Part B** ⇒	☐	☐	☐
i. Public safety needs...........	☐	☐	☐	⇒	☐	☐	☐
j. Infrastructure needs..........	☐	☐	☐	⇒	☐	☐	☐
k. Human services needs......	☐	☐	☐	⇒	☐	☐	☐
l. Education needs................	☐	☐	☐	⇒	☐	☐	☐
m. Cost of employee pensions...........................	☐	☐	☐	⇒	☐	☐	☐
n. Cost of employee health benefits........................	☐	☐	☐	⇒	☐	☐	☐
o. Employees wages and salaries........................	☐	☐	☐	⇒	☐	☐	☐
p. Prices, inflation, cost of living..........................	☐	☐	☐	⇒	☐	☐	☐
q. Population (# of people in city)...........................	☐	☐	☐	⇒	☐	☐	☐
r. Health of local economy ...	☐	☐	☐	⇒	☐	☐	☐

4. Please indicate which actions your city has taken in FY2008 for the 2009 fiscal year:
Check one box for each item on the list; if your city does not have authority to take action regarding an item, please check the "not authorized" box.

		Significant increase in 2009	Slight increase in 2009	Maintain	Slight decrease in 2009	Significant decrease in 2009	Not auth.
a.	Taxes..	☐	☐	☐	☐	☐	☐
b.	Reliance on ending balances/reserves....	☐	☐	☐	☐	☐	☐
c.	Fees/charges/licenses increases............	☐	☐	☐	☐	☐	☐
d.	Growth rate of operating spending........	☐	☐	☐	☐	☐	☐
e.	Actual infrastructure spending............	☐	☐	☐	☐	☐	☐
f.	Actual public safety spending.............	☐	☐	☐	☐	☐	☐
g.	Other spending...............................	☐	☐	☐	☐	☐	☐
h.	Service cutbacks/elimination..............	☐	☐	☐	☐	☐	☐
i.	Privatizing or contracting out.............	☐	☐	☐	☐	☐	☐
j.	Productivity levels..........................	☐	☐	☐	☐	☐	☐
k.	Number and/or scope of interlocal agreements or other cost-sharing plans..	☐	☐	☐	☐	☐	☐
l.	Size of city government workforce.......	☐	☐	☐	☐	☐	☐
MN only:							
m.	Other	☐	☐	☐	☐	☐	☐

Please give details on the strategies your city has taken (*e.g., cut 2 police officers; increased park & rec. fees*).

____

____

____

2

2009 Multistate Fiscal Conditions Survey—Minnesota Add-On Questions

5. Please indicate which of the following issues your city has experienced <u>over the last 12 months</u> as a result of residential foreclosures:
Check all that apply.

a. ___Increased demand for public safety services
b. ___Increased budgetary burdens/staff time for foreclosure prevention counseling
c. ___Increased budgetary burdens/staff time for identifying vacant abandoned properties
d. ___Property maintenance problems
e. ___Increase in dangerous property conditions
f. ___Declining property value
g. ___Difficulty in attracting new residents and/or businesses
h. ___Foreclosure of rental properties
i. ___Conversion of owner-occupied units to rental
j. ___Delinquent utilities service fees and/or taxes
k. ___Problems collecting delinquent utility bills
l. ___Costs to reconnect homes to utilities
m. ___Delinquent property tax payments
n. ___Delinquent nuisance abatement charges
o. ___Increase in criminal activity at vacant properties including vandalism, theft (copper stripping, appliances, etc.), and arson
p. ___Other (*please specify*): ____________________

6. Please indicate which of the following your city has experienced over the past year:
Check all that apply.

a. ___Increase in unemployment among residents
b. ___Increase in requests for deferred payment of taxes and/or utility bills
c. ___Increase in requests for financial assistance
d. ___Increase in business closures
e. ___Increase in the number of residents and businesses with unpaid utility bills
f. ___Increase in the number of bad checks paid to the city
g. ___Increase in unpaid property taxes
h. ___Development projects delayed or canceled
i. ___Decrease in building permit revenues
j. ___Problems issuing debt—*Please explain these problems briefly below:*

____

____

7. Does your city anticipate problems meeting its debt service payments in the next year?
_____ No
_____ Yes – *Please explain briefly below:*

____

____

8. A. Many cities have seen lower earnings from investments as a result of the economic downturn. Please estimate the percentage decline in your city's investment income over the last year:
_____ No decline
_____ Don't know
_____ No investments
__________% decline (**go to part B**)

3

B. If you have had lower earnings on investments in the last year, what impact has that had on city services?

____

____

____

9. Which of the following best describes the long-term trend for your city's fund balance (unreserved fund balance for accrual-reporting cities; overall reserve for cash basis cities)?

_____ Increasing over time
_____ Decreasing over time
_____ Stable over time

10. Estimate the portion of your city-owned streets that need the following in the next year:

Repair ____________%
Reconstruction ____________%
Other maintenance (e.g., seal coating) ____________%

11. What are your city's estimated costs for each of the following over the next year:

Street repair $____________
Complete street reconstruction $____________
Other street maintenance $____________

12. Please estimate your city's spending for county and state road projects in 2008:

County $____________
State $____________

13. Please estimate how the mix of funding sources for your city's street projects has changed over time. Indicate whether each revenue source below was a smaller or larger share of total street funding in 2008 than it was in 2000.

	Smaller share	Larger share
City property taxes	☐	☐
Special assessments	☐	☐
Local government aid	☐	☐
Other state aid	☐	☐
Federal aid	☐	☐
Other	☐	☐

4

Index of Tables, Charts, and Maps

Report Highlights

Chapter 1: City Fiscal Conditions

Chapter 2: Economic Trends and Their Effect on Cities

Continued ▶

Appendix: Fiscal Conditions Survey

LEAGUE OF
MINNESOTA
CITIES

145 University Avenue West
St. Paul, MN 55103-2044
(651) 281-1200 • (800) 925-1122
TDD: (651) 281-1290
Fax: (651) 281-1299
www.lmc.org