FISCAL RECOVERY AFTER THE GREAT RECESSION: REVIEWING THE PERFORMANCES OF METROPOLITAN CHICAGO COMMUNITIES

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This study evaluates the comprehensive financial statements of 109 municipalities in the Chicago region to explore trends in revenues, employment, and other metrics. The results show that both employment and the total equalized assessed value of property remain significantly below the levels before the Great Recession. Municipal fund balances, property tax revenues, and retail sales, however, have recovered and in many cases are far higher than they were a few years ago. While local government revenues are gradually bouncing back, emerging constraints will require municipalities to expand their "financial toolbox" to capture sufficient revenues to sustain infrastructure reinvestment.

INTRODUCTION

The Great Recession, while officially lasting only from December 2007 to June 2009, put enormous stress on municipal governments. The downturn's effects, together with worsening fiscal problems faced by the State of Illinois government, have had far-reaching consequences that add complexity to the work of municipal officials. In many locales, it is difficult to separate *local* economic issues from the statewide issues stemming from Springfield's fiscal woes.

This study seeks to provide new insights into the financial health of Illinois communities by reviewing audited data from 110 towns, villages, and cities in the Chicago region. (The analysis excludes Chicago for reasons noted below). The analysis includes a review of: i) data on municipal revenues, expenses, and other variables reported in the comprehensive annual financial reports (CAFR) for these 110 communities and, ii) trends in retail sales in these communities, as reported by the state. Together, these data offer a rich perspective on the evolving fiscal position of a wide spectrum of municipalities.

BACKGROUND

The impetus for this research effort began with a collaboration launched in 2009 between AECOM and the Chaddick Institute at DePaul University, to study the policy implications of the Cook County sales-tax increase enacted the previous year.[1] For suburban municipalities in this action, the increase created sizeable sales-tax differentials across county boundaries, which gave consumers a greater incentive to alter their buying habits to reduce the sales-tax burden. The AECOM/Chaddick analysis showed that communities in suburban Cook County were experiencing a proportionately greater decrease in sales compared to other jurisdictions in the metro area as a result of the sales-tax increase (Schwieterman, et. al, 2009).

These initial study results laid the groundwork for more detailed analysis of municipal finances for 107 municipalities in Cook, DuPage, Lake, McHenry, Will, Kane, and Kendall counties in 2012, which resulted in the creation of a large dataset of information from comprehensive annual financial statements. This included assembling a dataset of government revenues and expenditures, capital spending, general fund balance, sales-tax collections, equalized assessed value (EAV), and municipal employment. This study drew attention to weakness in traditional public-sector revenue streams—a topic that remains timely today.

For the present study, the analysis is expanded to 109 municipalities in these same counties, with the final sample most heavily represented by Cook (36 municipalities) and DuPage (30), and the remainder in Kane (10), Lake (14), McHenry (7), and Will (12). The sample includes some of the region's most prominent commercial centers, such as Downers Grove, Evanston, Naperville, Tinley Park, and Vernon Hills. To account for the fact that some municipalities straddle two or more counties, the analysis tabulates sales-tax collections across jurisdictional boundaries. The sample is heavily weighted toward suburban municipalities that have published CAFR on a recurring basis going back to 2001. Furthermore, the analysis also considers data on retail sales obtained from the Illinois Department of Revenue's Standard Industrial Classification Code Reporting sales tax receipt database, with the municipal-tax (MT) data field evaluated from 2002 to 2014.

While the analysis intentionally excludes the City of Chicago, which is worthy of its own study due to its enormous size and severe budgetary issues (see Hendrick, Luby, and Mason, 2010), it also does not include a significant number of smaller "non-home rule" municipalities, including many with populations

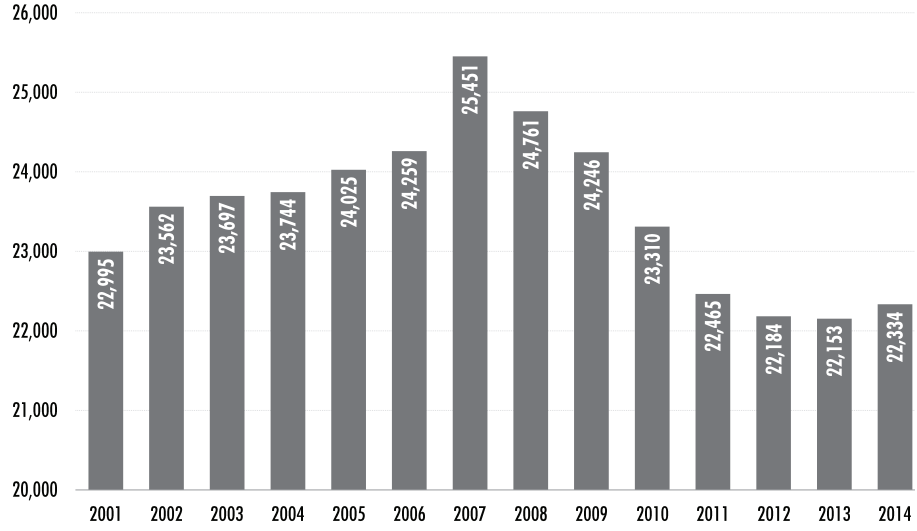
less than 15,000. Notable past research on the financial condition of Illinois communities includes works by Hendrick (2004) and a research team led by Sohl (2009), both of whom have articles on related topics for this issue.

PUBLIC-SECTOR EMPLOYMENT

Estimates of municipal employment include jobs in all classifications typically associated with municipal government, such as general administration, fire and police, planning, and utilities. The results show that this public-sector employment rose between 2001 and 2007 at a robust 1.7% annualized rate (Figure 1). The Great Recession then created enormous budget pressure, which, together with retirements, led to a sharp reversal. Employment fell at a 2.3% annualized rate between 2008 and 2013.

The cumulative effect of this has been enormous. Municipal employment in 2014 stood at 22,334 positions, which is more than 3,000 below the peak of 25,451 in 2007. The average municipality in the sample lost about 30 workers. Employment in 2014 was even lower than that in 2001 (22,995 positions), despite population gains and general economic growth. Between 2013 and 2014, municipal employment increased only 0.8%. On a more positive note, as shown in Figure 1 below, rising general fund balances suggest that the modest addition of jobs in recent years is financially sustainable.

FIGURE 1
Trends in Total Public Sector Employment



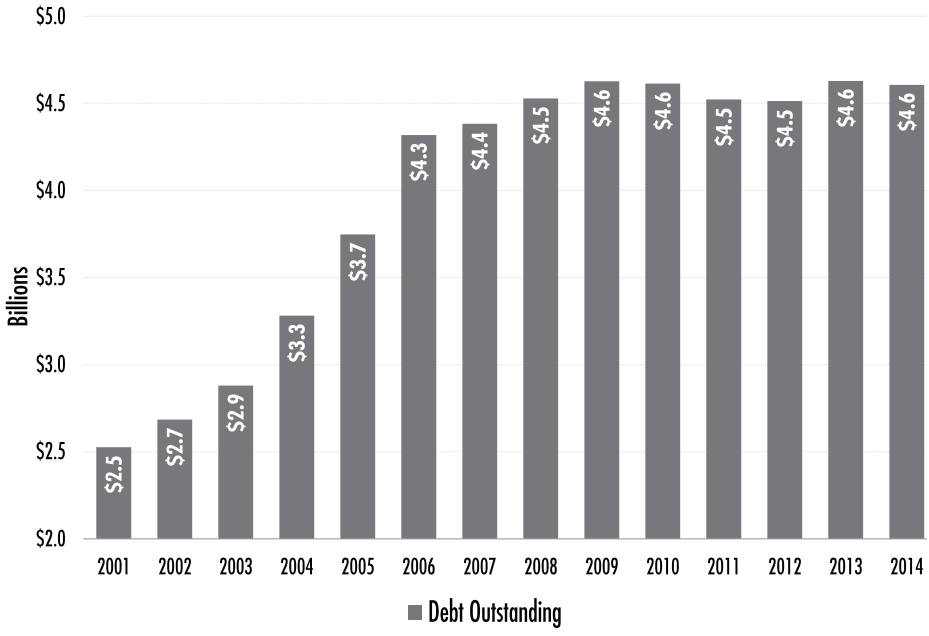
Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

Perhaps the simplest conclusion that can be drawn from these data is that municipal employment will likely remain well below pre-Recession levels for many years. As populations rise, these results also suggest that the productivity of municipal workers is rising accordingly.

MUNICIPAL DEBT

Measurements of primary government debt include financial obligations linked to each municipality, as well as any component unit for which the elected officials of the primary government are responsible, such as the public library in many communities. The results show that primary government debt has increased substantially at the municipal level throughout the region. Between 2001 and 2014, this debt increased at an annual rate of 4.7%, with more volatility than any of the other metrics evaluated in this report (Figure 2). A considerable portion of this increase, particularly between 2001 and 2006, is attributable to tax increment financing (TIF), a tool that typically involves the issuance of bonds.

FIGURE 2
Trends in Total Outstanding Debt in Observed Communities



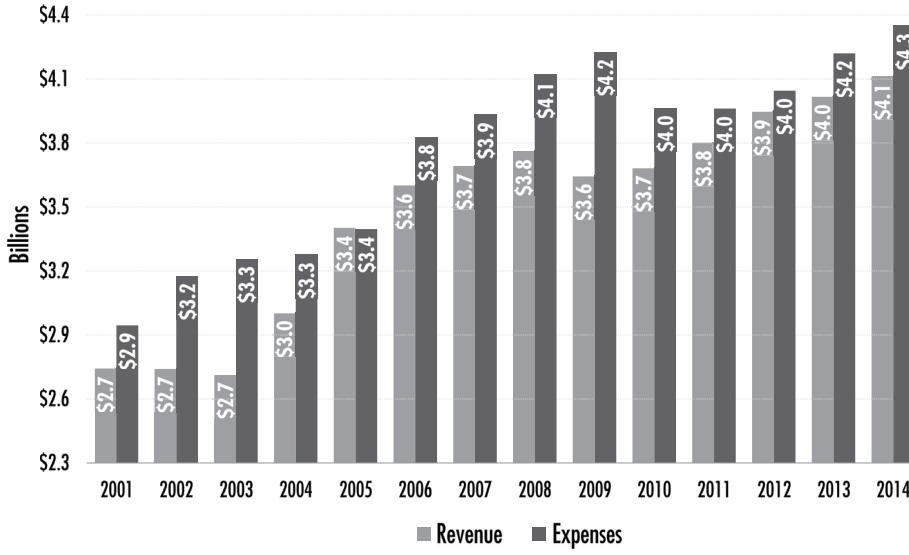
Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

After years of uninterrupted growth, there was a modest decline between 2010 and 2011 and then a leveling off. On a per capita basis, the amount of debt residents now are obligated to pay (before adjustments for inflation) has increased, growing from $795 to $1,305 between 2001 and 2014. Nevertheless, although such a rise may be disturbing, the vast majority of it occurred in the years prior to 2008. Since then, the overall annual rate of growth has been just 0.3%. Although TIF was the primary tool to finance new infrastructure before the Recession, that has changed. Declines in construction, combined with concurrent falls in real estate values, have created a difficult environment for municipal finance.

MUNICIPAL REVENUE, EXPENDITURES, AND CAPITAL IMPROVEMENTS

Municipal revenues have fully recovered from the Great Recession, reaching levels previously unseen during the observed period (Figure 3). This suggests that communities, on the whole, have found ways to offset the declines in real estate values with new forms of revenues. As might be expected, expenses also reached a peak in 2014.

FIGURE 3
Trends in Municipal Revenue and Expenditures



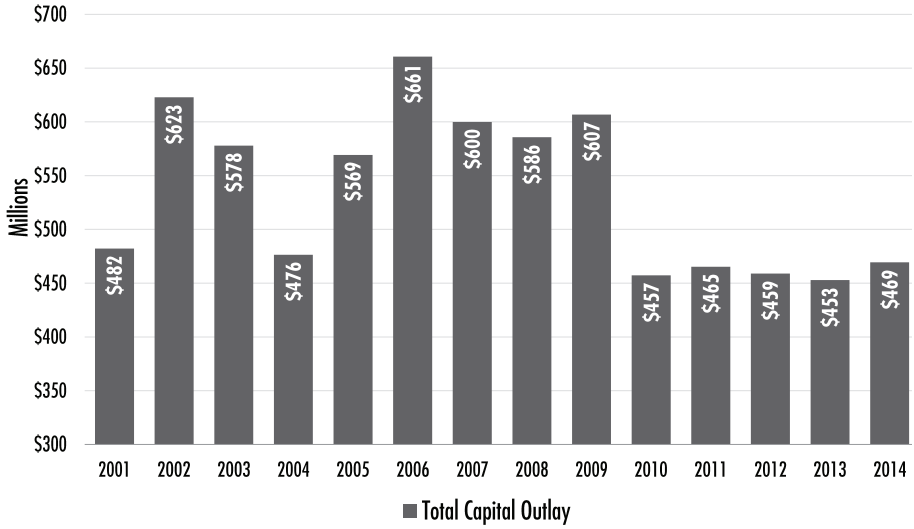
Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

The revenue/expenditure gap during the downturn between 2008 and 2011 brought enormous stress to local governments. Overall, however, there has been a clear *positive* trend in recent years, with deficits gradually falling. Still, it should be acknowledged that expenditures have generally exceeded revenues, even in non-recession years, with the proportional gap reaching its peak in 2003, when expenses outpaced revenues by 22.2%. By comparison, the gap in 2014 was below 5%.

Capital spending has followed a different path (Figure 4), seeing gradual growth between 2003 and 2007 averaging 0.9% annually. Between 2009 and 2014 the trend reversed, with capital spending declining at a 5% annual rate. Investment levels have now stabilized at about two-thirds of what they were during the peak year, 2006.

FIGURE 4

Trends in Total Capital Improvements Funding



Source: *Comprehensive Annual Financial Report-Unaudited Statistical Section*

In addition to the absolute decline in capital-improvement spending evident on this figure, capital-improvement spending has also declined markedly as a share of municipal spending (Figure 4). As a percentage of the overall budget, capital-improvement spending represented 17.4% of total municipal spending in 2006. By comparison, the 2014 share was just 10.8%. In both absolute and relative terms, therefore, funding for capital improvements has been on

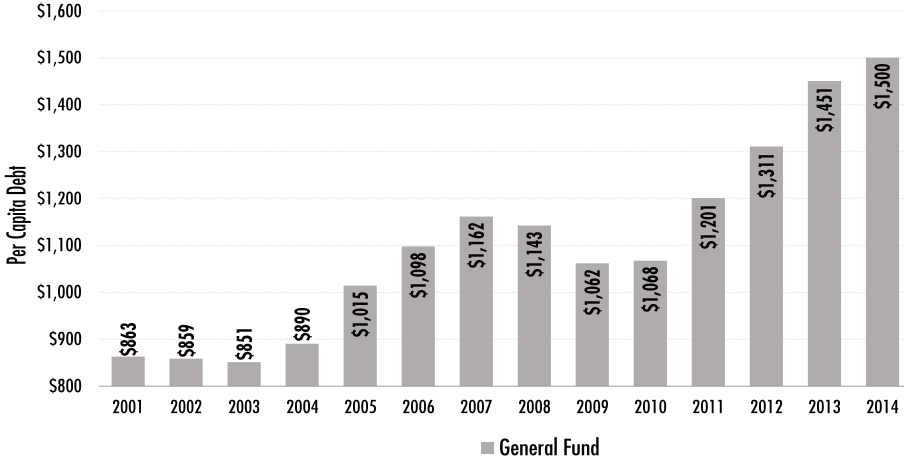
an unfavorable trajectory since 2009. As noted above, these trends mirror declining reliance on TIF, as well as dramatic reductions in construction of new residential units and commercial space. Capital-improvement spending since the Great Recession has remained lower than it was in any year prior to 2010 during the period studied.

The most notable lesson from these trends is that municipalities will likely continue facing difficulties increasing funding for capital-improvements through traditional means. This will create new incentives for innovative strategies, such as private-public partnerships, value-capture arrangements, and developer contributions to infrastructure – a topic returned to below. While many of these ideas still relate to real estate, experience suggests that municipalities will also need to look differently at utilities (electricity, natural gas, stormwater, wastewater, and drinking water).

MUNICIPAL GENERAL FUND BALANCE

General fund balances, when expressed on a per capita basis, have seen relatively large increases between 2001 and 2014, with particularly dramatic growth since 2009. Numerous municipalities have, impressively, seen annual increases above 10% in their general fund balances (Figure 5). Additionally, in 2014, none of the observed municipalities reported a negative general fund balance, which is an improvement upon years prior to 2012, when several municipalities reported negative balances.

FIGURE 5
Trends in Per Capita General Fund Balances



Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

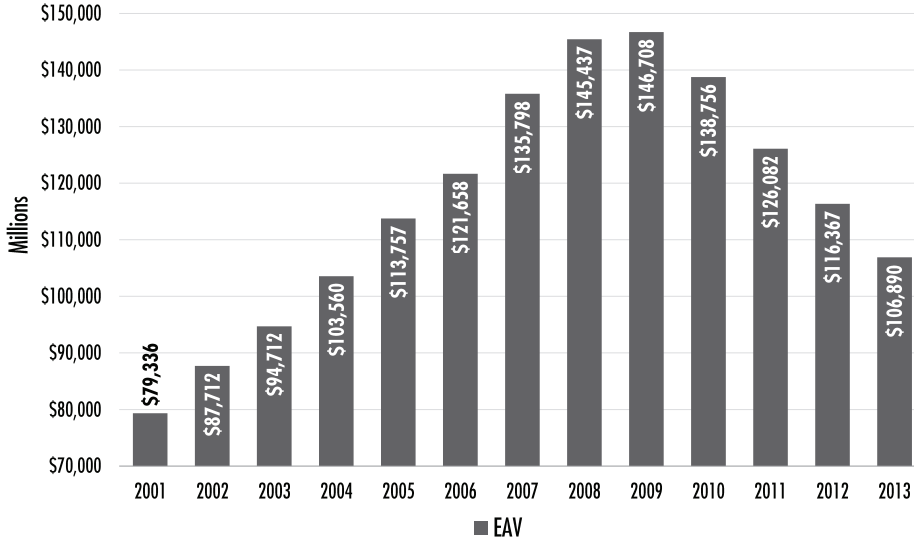
The trend in per-capita debt has followed an up-down-up pattern, falling from $1,162 to $1,062 between 2007 and 2009 (a 4.4% annualized rate of decrease), only to recover substantially, growing to $1,500 per municipal resident in 2014. Of all the metrics considered in our analysis, this one is among the most favorable.

MUNICIPAL EQUALIZED ASSESSED VALUES

Measurement of EAV includes the total value of all properties located within the municipality, regardless of whether they are residential, industrial, commercial, or any other categorization. Not all municipalities report this metric. Those that do not were omitted from the calculations.

EAVs in the Chicago region have increased annually at a rate of 2.5% between 2001 and 2013, although the trend turned negative after 2008, falling – disturbingly – at an annual rate of 7.6% between 2009 and 2013 (Figure 6). Today, valuations remain well below those prior to the Recession.

FIGURE 6
Trends in Equalized Assessed Values

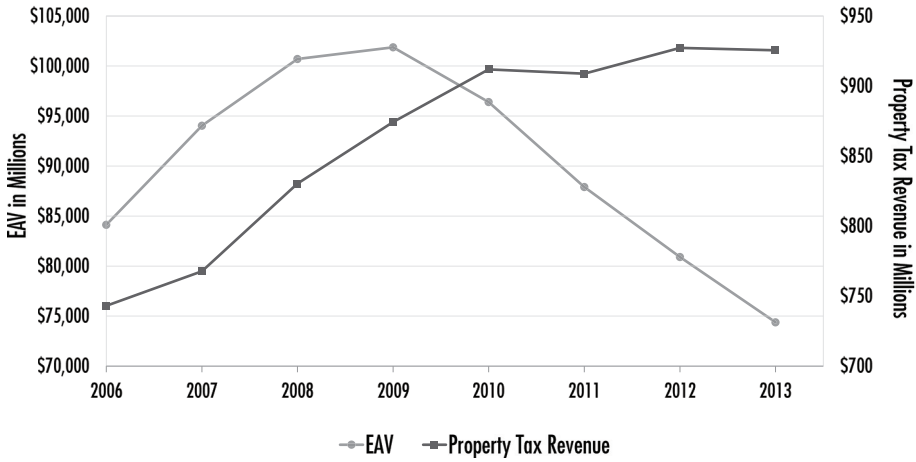


Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

Despite these trends, there has been sluggish but nonetheless persistent growth in property-tax collections (Figure 7). Among the 72 municipalities that report aggregate property-tax revenues and EAV values, we found that valuations *decreased* at an annual rate of 7.6% (the same as the complete sample), while property-tax revenues *increased* at a rate of 1.4%. Although this indicates that municipalities have, to some extent, raised their property-tax rates in order to offset the decline in property values, the extent of increases appears to have been relatively small, likely due, in part, to statutory limits on maximum property-tax rates. Once these maximum rates are reached, municipalities can only grow revenue through increases in property value. News reports for 2016 suggest that the property value trend appears finally to be tilting in the positive direction, which, of course, bodes well for municipal finance.

FIGURE 7

Trends in Property Tax Revenue in 72 Communities



Source: *U.S. Census & Comprehensive Annual Financial Report-Unaudited Statistical Section*

Municipal leaders concerned over property values will likely take little solace in knowing that over the entire period from 2001 to 2013, EAVs have appreciated at a 2.5% annual rate. Although property values have, in general, stabilized since 2013, the modesty of the growth has created enormous stress in some locales, particularly those that are near their statutory tax-rate limits. While preliminary data from 2016 points to more significant growth in values, the pace of home construction in the region, as well as retail and office development, appears to remain well below pre-Recession thresholds.

MUNICIPAL RETAIL SALES

The upward trajectory of sales is a particularly positive trend for communities reliant on sales taxes. Although annualized growth over the entire period from 2001 and 2014 has been a modest 2.0%, growth rates have averaged 4.5% between 2009 and 2014 (Figure 8). Retail sales totaled $68.4 billion in 2014, more than $3 billion higher than any other year analyzed in the study. While many municipalities are capitalizing on this trend by tactically pushing sales-tax levels upward, it is important to note that this strategy is more difficult for non-home rule municipalities.

FIGURE 8
Growth in Retail Sales, 2001-2014

Source: *Illinois Department of Revenue*

For all types of communities, however, the market for retail space is significantly more complex than it was a decade ago, in part due to the impact of Internet spending and the dramatic growth in the amount of retail space per capita. This year, there has been surprising weakness in retail brands, including Nordstrom, the Gap, Banana Republic, Sears, Macy's, and JC Penney. While well-located retail shopping centers are performing, the national pace of store closings for 2014 and 2015 is only about half of the modern-day high set in 2009; retail appears poised for a significant shake-out, particularly in secondary locations. Please refer to the article "Retail

Construction in Illinois: Why the Slump?", appearing on page 123 and prepared by the authors of this report, for additional perspective.

ANALYSIS AND IMPLICATIONS

The dataset used to generate these charts is a versatile tool that can help local officials and development professionals improve their understanding of the financial landscape. It can help these stakeholders monitor the relative performance of their community to that of neighbors or the region as a whole, offering "benchmarks" to gauge financial health more accurately.

Too often, local officials, especially those serving on village boards on a volunteer or part-time basis, remain unaware of the lessons from communities outside their village's boundaries. Unlike corporate board members, who continuously monitor how their company's revenues, costs, and profits are faring against the backdrop of peer organizations, officials on municipal boards are often not presented with information allowing for such comparisons, partially since data are so difficult to obtain. By helping fill the void, the dataset can be used to encourage decision makers to act decisively when results move in a negative direction. (Officials interested in such comparisons are encouraged to reach out to the research team from AECOM and the Chaddick Institute, who plan to continuously update the data fields as new information becomes available.)

Taken as a whole, the results paint a portrait of a municipal sector responding vigorously to a downward shock in revenues. The dramatic fall in employees following the start of the Great Recession adds significant complexity for those seeking employment in the municipal sector. The reduction in hiring has affected many other sectors, including universities offering programs in law enforcement, public administration, and social work. Although inflows have largely rebounded since the Recession, it appears that municipalities will remain cautious in adding personnel. However, rising fund balances suggest that some additional hiring might be around the corner.

While the analysis suggests that a partial recovery in municipal finance is underway, our experience yields a mixed outlook for at least four reasons.

1. IMPACT OF THE INTERNET

Although municipalities have long focused on access to lifestyle and quality-of-life amenities for their residents, factors linked to the growth of the Internet are gradually changing the nature of how "place" is defined, with looming

fiscal consequences. The challenge begins with the reality that a majority of local government revenues tend to be place-based (i.e., linked to location; e.g, property tax) and transaction-based (e.g., sales tax, which is accounted for by point of sale). While the Internet's impact on retail spending is already a concern, its ability to blur what was once a clear line between where people work and where they live suggests that economic activity (transactions) will be increasingly disconnected from "place," with working and shopping from home (or other places) being among the most prominent examples. Over time, this disconnect will add to pressure on municipal finances.

2. STATUTORY LIMITS ON TAXES

Revenues are often constrained by statutory limits on tax levies, with notable examples being caps on property-tax rates and distinctions based on home-rule status. Although larger home-rule cities have a greater level of flexibility, smaller communities face greater apparent constraints. As the current market is framed by modest growth in property values, practical constraints on growth in municipal revenues are apparent. Adding to this puzzle is the reality that a majority of municipal revenues are "fund based" (i.e., the "General Fund"), which often limits the ability of a municipality to optimize investments across funds, resulting in fragmentation and inflexibility.

3. UNCERTAINTY OVER INFRASTRUCTURE

The traditional reliance among municipalities on TIF to fund infrastructure has heightened interest in new real estate development. Our analysis, however, suggests that retail markets, particularly in the suburbs, are increasingly saturated with commercial space, reducing the number of new projects that can drive this method of financing. With core funding for capital improvements already constrained by limited revenue growth, the current environment reinforces the need for new approaches to fund local infrastructure. While the funding gap for infrastructure is growing, the definition of what qualifies as "substandard" arguably varies from community to community more than it has in the past. This leaves local officials with incomplete knowledge about how to set priorities and possibly improve sharing in costs and benefits of investment.

4. THE IMPACT OF UTILITY DEREGULATION AND THE EMERGENCE OF RENEWABLE ENERGY AND MICROGRIDS

Although a small number of Illinois municipalities have turned to stormwater utility fees to reduce pressure on general fund revenues, our experience suggests

that factors linked to deregulation of electricity markets may necessitate that communities look similarly at fees in the sector. The emergence of renewable energy sources and microgrids have the potential to create both disruptions as well as opportunities for local units of government.

While grappling with these issues, municipal officials will feel pressure to pursue "shared services" with other governments (see related article on page 15). Achieving this will require overcoming problems stemming from traditional accounting systems that make it difficult to efficiently share or allocate costs between municipalities, particularly in infrastructure reinvestment. Nonetheless, it is encouraging that emerging technologies are allowing for more efficient and transparent ways of allocating costs between locales. In the midst of the profound changes made evident in the trends outlined in this study, municipalities must continue to expand their financial toolbox to keep their "fiscal house" in order.

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[1] In March 2008, the Cook County Board increased the county sales tax rate from 0.75% to 1.75%, on the heels of a smaller mass transit tax increase that occurred in April 2008. For Chicago, these increases boosted the overall city tax rate to 10.25%, the highest rate of any major city in the U.S. at that time.

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