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Revenue Forecasting and the Fragility of Traditional Wisdom.

The lesson for cities from the experiences of the past decade: Even revenue sources long considered reliable can be volatile.

One of the most significant managerial challenges for state and local budget officers is to accurately forecast revenues and expenditures in coming years. Errors are inevitable, of course, and yet many elected officials continue to live in the hazy delusion that once they've balanced a budget based on seemingly solid forecasts, it's going to stay balanced. This, as we know all too well in hindsight, is often not the case; forecasting is as much art as science, and predicting upcoming revenues precisely can be as much attributable to luck as to intellect.

Consider the National League of Cities' annual survey conducted at the start of the Great Recession. It asked a sample of city chief financial officers: "Overall, would you say that your city is better or less able to meet financial needs in the current fiscal year than last year? In the next fiscal year compared to this fiscal year?"

The response to the survey suggested that, overall, most CFOs and their staffs were blind to an upcoming fiscal disaster despite warning signs such as the unfolding subprime mortgage crash. Over half (55 percent) responded that they expected their city would be in a better position in 2008 to meet their financial needs than in 2007. When asked the question in 2008 about their fiscal position in 2009, that percentage plummeted to just over 20 percent. No great surprise there. It's much easier for fiscal managers to make an accurate prediction of hard fiscal times when they're already dealing with them.

One element of overoptimistic thinking among budget managers as the recession began was the notion that sales taxes would continue to provide a steady flow of revenues. Nearly one in four (24 percent) of cities that collected sales taxes were confident in 2008 that 2009 would be a healthy year for their economies. In fact, state and local general tax receipts fell by $16 billion in 2009 from their 2008 levels, a decline of 3.5 percent as the recession hiked unemployment and diminished consumer spending.

But although the recession's negative impact on sales taxes should not have been the surprise it was, it's perhaps easier to understand why the decline in property values and the tax revenues based on them was so largely unforeseen, given the traditional management wisdom among the men and women responsible for keeping programs intact without the need to raise taxes.

The widely held belief is that the property tax is reliable. That' s part of the reason why many cities have long been happy to depend so heavily on their property taxes, despite the fact that citizens tend not to like them very much for understandable reasons: For one thing, in most communities the bill arrives once a year, so its size is opulently evident. Additionally, it can be painful to accept the idea that an ostensibly good thing — rising property values — only pays off when the property is sold. Up until then it's increasingly difficult to pay ever-rising levies.

Still, the benefits of property taxes to cities have long made them an attractive source of revenue. For one thing, when property values drop, tax receipts don't immediately plummet –they take some time to find a new equilibrium point. Further, property is immovable. When taxes on your home go up, you can't loft it into the air and move it to a lower-tax community. Unlike the volatile sales and wage taxes, the traditional thinking among budget forecasters is that the property tax can be counted on to moderate the ups and downs of other government revenues.

But logic to the contrary, it turns out that property taxes aren't necessarily and always an immutable source of revenue on which forecasters can count. Consider Albuquerque, a city that witnessed solid year-over-year increases in its property tax receipts between 2002 and 2010, from $72 million to $133.3 million — an average annual growth rate of 10 percent. Then the effects of the Great Recession on property values hit in 2011, and the year-over-year growth rate between fiscal years 2011 and 2018 didn't even keep up with inflation, averaging 1.3 percent per year.

Although the impact on Albuquerque's total budget was modest due to the city's heavier reliance on other taxes, the less-than-robust growth in the real-estate market contributed to the city's forecasts of drawing down reserves in the near term and projecting deficits for next year. As painful as that may be, Albuquerque has fared better than some cities with its property taxes: Miami also expected a typical bump in property tax revenues in 2010, but instead experienced a nearly $20 million downturn from the previous year, followed by a $37 million decline in 2011.

The lesson in all this is that elected officials and financial managers must be prepared for the notion that traditional wisdom is not immutable and that counter-cyclical devices — a robust rainy day fund remains a terrific tool — are critical parts of a well managed city.

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