WHEN THE LEVEE BREAKS

What Broke Nashville's Finances and What to Do About It

INTRODUCTION

On April 28, 2020, John Cooper unveiled the updated version of his first budget as Metro Nashville mayor. In what he dubbed a "crisis budget," Mayor Cooper called for some cuts, delayed cost increases, and most notably, proposed a 31.7 percent property tax increase.[1] While the proposed hike took many by surprise, it isn't all that unexpected. Despite opposing a tax hike while campaigning for mayor last year, the mayor stated that the possibility of increasing property taxes was "left open" back in January.[2] His reasoning for pursuing one now? The city-wide shut down in response to the COVID-19 pandemic and impact from the March tornadoes created a projected $447 million budget shortfall over the next 16 months, with $216 million of it coming in the next fiscal year.[3] While the double whammy of COVID-19 and the tornadoes may be the straw that broke the proverbial camel's back of Metro's finances, this budget crisis has existed for years.

While Mayor Cooper certainly faces a tall task in balancing this year's budget, a $332 million tax hike is a mere band-aid for the true problems that underlie Metro's financial woes. Years of ballooning spending, growing debt, and unrealistic promises during years of historic physical and monetary growth, as well as a lack of structural guardrails, created this crisis. Nashvillians instinctively know this, and it is why most have previously opposed a property tax hike. Even Mayor Cooper acknowledged as much in a questionnaire for the *Tennessean* during the campaign, saying, "A properly managed city should be able to thrive with a 4.5 percent revenue increase. Metro needs a return to fiscal stewardship. I don't feel good about asking taxpayers to pay more in taxes when we aren't properly managing the money we already have."[4] Declining revenues due to COVID-19 and the recent tornadoes are just the catalysts, setting off a crisis years in the making. Understanding these underlying factors is crucial if the city is to ever recover and prevent a similar situation in the future. Had Metro government been wiser in recent years by living within its means and reigning in long-term liabilities, it could have built a rainy-day fund to avoid a record tax increase. Sadly, there could not be a worse time for a tax hike, with businesses and workers struggling to get back on their feet, many of whom are still forcibly closed by the mayor's stay-at-home mandate.

1. Adam Tamburin and Yihyun Jeong, "Nashville would see 32% property tax hike, deep cuts under Mayor John Cooper's budget." *The Tennessean*. April 28, 2020. https://www.tennessean.com/story/news/politics/2020/04/28/nashville-mayor-john-cooper-budget-calls-property-tax-hike/3028749001/.
2. Yihun Jeong, "Nashville Mayor John Cooper gears up for budget process, says option for property tax hike "left open." *The Tennessean*. January 29, 2020. https://www.tennessean.com/story/news/politics/2020/01/29/nashville-budget-mayor-john-cooper-says-property-tax-hike-left-open/4598883002/.
3. Metro Nashville Mayor's Office, "Budget Presentation for Fiscal year 2021." https://www.nashville.gov/Portals/0/SiteContent/MayorsOffice/docs/news/Cooper/BudgetPresentation-200428.pdf.
4. David Plazas, "Where David Briley and John Cooper Stand on the Issues Facing Nashville." *The Tennessean*. August 25, 2019. https://www.tennessean.com/story/opinion/columnists/david-plazas/2019/08/26/nashville-mayoral-election-briley-cooper-positions-issues-compaired-questions-answers/2095112001/.

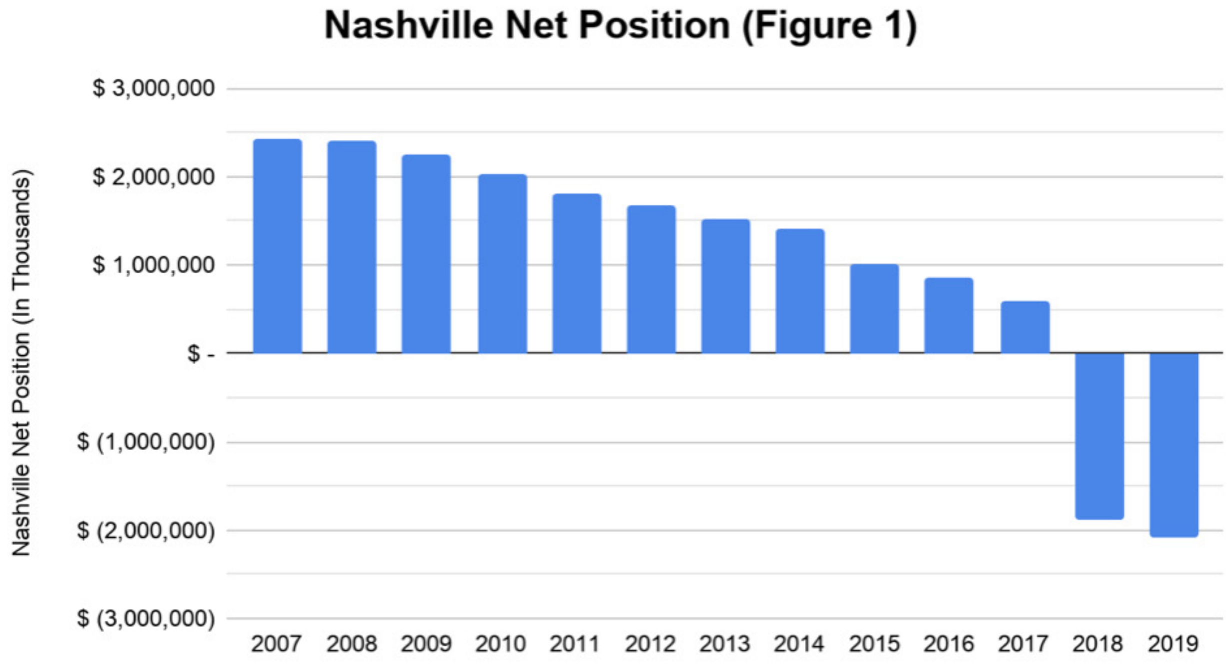
With the lack of fiscal stewardship in Metro's recent history, real long-term structural reforms must be implemented before any tax increases are considered, even in light of COVID-19 and the March tornadoes.

This report offers the following solutions to get Nashville's fiscal house in order:

1. Reform the Pension System
2. Reform Healthcare & Post-Employment Benefits
3. Rightsize the Government Workforce
4. Renegotiate & Reign in Corporate Welfare Deals
5. Enact a Spending Cap

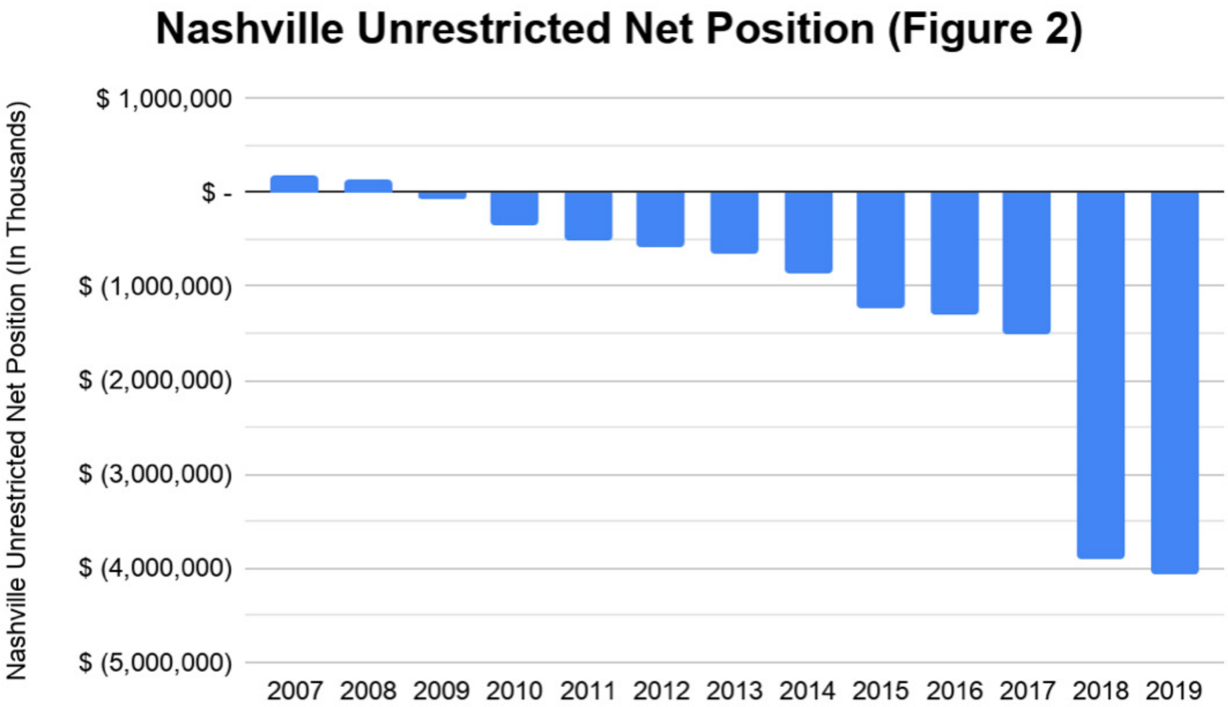
CHAMPAGNE TASTE ON A BEER BUDGET

Like most cities and states, Nashville is required to balance its budget. However, the city's budget is not the best indicator of its financial health. Budgets in some cases are just as much political documents as they are financial documents and tend to overinflate revenues and underestimate expenses. To get a truer sense of a government's finances, one should look at the Comprehensive Annual Financial Report (CAFR), which is governed by standard accounting principles. Here we can get a sense of Nashville's true assets and liabilities and its overall financial health. Unsurprisingly, it's not good. Every year since 2007, Nashville's finances have weakened, with its Net Position becoming negative for the first time in 2018, well before the tornado or COVID-19 shutdown. Net Position is simply all of the government's resources minus all of its liabilities.



Source: Nashville CAFRs 2007-2019

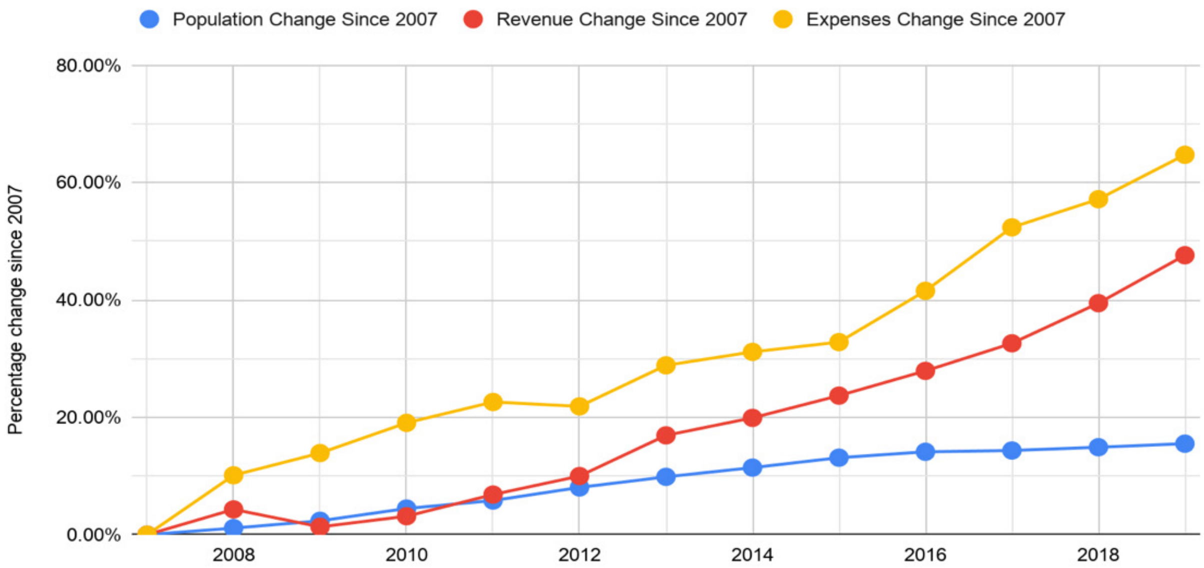
The massive drop in 2018 is largely due to a mandated change in reporting requirements by the Governmental Accounting Standards Board (GASB). Starting in 2018, GASB required more transparency around pensions and retiree health benefits (discussed in more detail later). Still, Nashville had already been on a declining trajectory for years. However, this still doesn't present the full picture, as all assets are not created equal. Many of Metro's assets are limited or restricted for specific purposes. For example, if a family owns their house but does not have the money to pay their electric bill, they shouldn't sell their house to do so. Therefore, the better measure of a government's financial health is its Unrestricted Net Position, which tells us if it is truly living up to its balanced budgeting requirement, or is simply deferring costs to future taxpayers.



Source: Nashville CAFRs 2007-2019

With a fiscal year 2019 Unrestricted Net Position of over $4 billion, Nashville has been unable to fulfill its promises for years, with a clearer picture only coming in recently with mandated increases in transparency. One reason for this downward trend has been the rapid growth in Nashville's spending. As a city grows there will naturally be increases in taxes collected and spending. And while Nashville's population has certainly grown, its revenue and especially its spending have far outpaced population growth.

Metro Nashville Revenue, Expenses, and Population Growth (Figure 3)



Source: Nashville CAFRs 2007-2019

Nashville has blossomed from a quaint Southern city to the national "It City," with millions of tourists visiting every year. With that popularity came the biggest economic boom the city has ever seen, including skyrocketing home values. Some have blamed the current crisis on Metro failing to take advantage of this boom by failing to adjust property tax rates after the most recent property reappraisal.[5] There are costs associated with economic growth and accommodating the millions of tourists that put Nashville on the national map. But when the city's population has increased by just over 15 percent and its revenue by nearly 48 percent over that same timeframe, even without raising taxes after the most recent reappraisal, any budget deficit clearly demonstrates a lack of fiscal discipline on behalf of city leaders.

That lack of discipline has not gone unnoticed. One clear example of this has been the doling out of taxpayer money to companies in the form of corporate welfare. Nashville's corporate welfare deals have come under increased scrutiny during this time.[6] These incentives can erode the city's tax base, making it harder to provide vital services in the long-run. While supporters say incentives to corporations grow the city's economy, most deals look like flat out waste. In fact, since 2015, the Beacon Center has identified more than $300 million by Metro Nashville in waste, fraud, and abuse in our annual *Pork Report*. Some notable examples include the $14 million given to Opryland to build an indoor water park that was originally inaccessible to county residents, $1.5 million taken from Metro Nashville Public Schools to cover the cost of the TIF program, or $3.5 million in infrastructure improvements for Lifeway to move its headquarters a few blocks.

5. Steven Hale, "Boom City Bust: Did Nashville Blow its Boom Years." *Nashville Scene*. May 7, 2020. https://www.nashvillescene.com/news/cover-story/article/21131715/boom-city-bust-did-nashville-blow-its-boom-years.
6. Sandy Mazza, "Did Tennessee taxpayers get a good deal with $102M Amazon payment?" *The Tennessean*. November 19, 2018. https://www.tennessean.com/story/money/2018/11/19/critics-worry-amazon-incentives-drain-community-services/1989884002/.

If Nashville is to ever get its fiscal house in order, city leaders will need to be more fiscally responsible and implement numerous structural reforms.

TREAT THE PROBLEMS, NOT THE SYMPTOMS

Reform the Pension System

If Nashville is going to reverse this downward spiral, it will need to reign in spending and reduce its long-term liabilities. One opportunity is to reform the city's pension plans. Metro operates several defined benefit plans that require no contributions from Metro employees.[7] While the city has funded these plans relatively well (funding the general employee pension plan by 96 percent and the smaller teacher pension plan by 48 percent), doing so requires massive contributions by the Metro government. In fact, since 2015 Metro has contributed over $696 million to its various pension plans.[8]

Metro Nashville Pension Contributions (Figure 4)

Metro Pension Contributions	Dollars since 2014
Employer Contributions:	$696,100,793
Employee Contributions:	$0

Contrast this to the Tennessee state government, which passed pension reform in 2014. All state employees hired after June 30, 2014 were enrolled in the new Hybrid Plan that consists of a defined benefit and a defined contribution portion.[9] Metro should consider the same reform, or better yet, moving solely to a defined contribution plan for all new hires. Doing so would begin to stem the growth of long-term liabilities and reduce necessary contributions, freeing up more revenue.

Reform Healthcare and Post-Employment Benefits

In addition to its pension system, Metro must consider reforms to its retiree healthcare and other post-employment benefits (OPEB). Due to recent mandated changes in reporting, the full extent of Nashville's OPEB liabilities, and how unsustainable they are, have become clear. When compared to several peer cities, one can see how much of an outlier the city's retiree benefits are and the drain this creates on its finances.

7. Metro Nashville Department of Human Resources, "Service Pension Retirement Benefits." https://www.nashville.gov/Human-Resources/Benefits/Service-Pensions.aspx.
8. Metro Nashville Department of Finance, "Comprehensive Annual Financial Report, 2019." October 31, 2019. https://www.nashville.gov/Portals/0/SiteContent/Finance/docs/CAFR/CAFR%202019.pdf.
9. Tennessee Department of Treasury, "Hybrid Retirement Plan for State Employees and Teachers." April 2019. https://treasury.tn.gov/Portals/0/Documents/Retirement/Forms%20and%20Guides/Active%20Members/HybridMemberGuide.pdf.

OPEB Liabilities (as of 2018) of Nashville and Selected Peer Cities (Figure 5)

	Nashville	Louisville	Indianapolis	Jacksonville	Denver
Total OPEB Liability	$3.889 Billion	$345 Million	$233 Million	$188 Million	$285 Million
Fiduciary Net Position	$0	$0	$11.9 Million	$0	$73.8 Million
Net OPEB Liability	$3.889 Billion	$345 Million	$221 Million	$188 Million	$211 Million
Covered Payroll	$878 Million	$345 Million	$312 Million	$379 Million	$542 Million
Annual OPEB Expenses	$243 Million	$305 Million	$18 Million	$9.8 MIllion	$16 Million
Net OPEB Liability as a Percentage of Covered Payroll	443%	113%	71%	49%	39%

Several reasons exist for Nashville's predicament. First, while some cities have begun setting aside funds to cover OPEB liabilities similarly to a pension (Fiduciary Net Position), Nashville continues to utilize a pay as you go method. Second, Nashville's benefits are more generous. In a recent study presented to the Blue Ribbon Commission, a special commission tasked with finding savings for the city, analysts described the multiple reasons why Nashville finds itself in such a hole:

> While Nashville's benefits are provided on a sliding scale, the percentages are more favorable to employees than those of the Peer Cities. In addition, Nashville has based required employee contributions on projected "pay-go" financing requirements which means contributions are at a level sufficient only to cover benefits as they come due. Therefore Nashville's liability continues to grow at a rapid pace as employees accrue service time at a much faster rate than they contribute.[10]

Starting to pre-fund these future liabilities and reduce Metro employees' benefits accrual will do the most to curb its debt crisis.

Rightsize the Government's Workforce

Additionally, Metro should look to rightsize its workforce. Recently, Metro has come under fire for recurring pay freezes and foregoing cost of living adjustments for city workers.[11] In fact, earlier this year Metro Council leaders noted how pay for Metro employees was falling behind peer cities and stated that Nashville "must be

10. Elliot Davis Consulting, "A Study of Metro Nashville/Davidson County Finances." March 9, 2020. https://www.nashville.gov/document/ID/3093da24-1c64-47cc-9218-7effc8065afa/Metro-Finance-Study.
11. Yihyun Jeong, "Nashville looks to freeze employee pay plan, eliminate cost-of-living adjustment - again." *The Tennessean*. April 14, 2020. https://www.tennessean.com/story/news/politics/2020/04/14/nashville-freeze-employee-pay-plan-eliminate-cost-living-adjustment-again/2988465001/.

willing to generate the revenues needed...That may well require a property tax increase."[12] However, this is not the full picture. While Metro employee pay may be falling behind, this is partly due to Metro having to pay a larger number of employees. Metro has a considerably higher number of employees than many of its peers.

Number of City Government Employees (Figure 6)

	Population (2018)	Employees-Full Time Equivalent (FTE)	FTE Per 1,000 Residents
Nashville-Davidson Co.	692,587	8,726	12.599
Louisville-Jefferson Co.	770,517	5,819	7.552
Indianapolis-Marion Co.	954,670	7,013	7.346
Jacksonville-Duval Co.	952,861	7,374	7.739
Denver-Denver Co.	716,492	10,175	14.201

Among the selected cities, Nashville has the second largest staff per one thousand residents. Metro should look for ways to streamline and combine positions through voluntary separations, furloughs, and reduction in forces. Additionally, the city should avoid filling many positions as they become open. While Metro could use some of these savings to increase employee pay to compensate for increased workloads, reducing payroll costs would provide additional flexibility to the city's finances. In time, Metro may be able to reduce its square-footage needs and sell off unused office space, especially when combined with moving as much staff as possible to a full-time remote basis. In light of COVID-19, many employers are moving to a more flexible work environment or remote model. Increased remote work could improve employee morale and further reduce costs. By rightsizing its staff, Metro could reduce long-term unfunded liabilities, cut expenses, and free up much needed cash flow.

Renegotiate and Reign in Corporate Welfare Deals

Metro should seek to renegotiate every outstanding economic incentive deal to provide additional cash flow. While the long-run economic benefits of incentives are hotly debated, they undoubtedly reduce short-term cash flow, which Nashville can ill afford at this time.

Mayor Cooper has already demonstrated success in this regard, securing an additional $12.6 million per year from renegotiated payment-in-lieu-of-taxes (PILOT) payments from the Music City Center and another $10 million annually from Water Services.[13] Metro should pursue similar renegotiations with private companies that have received PILOTS and tax increment financing deals (TIFs). While Metro tends to utilize TIFs more

12. Jamie McGee, "Metro Council committee: Pay Metro workers more, even if it means property tax increase." *The Tennessean*. February 10, 2020. https://www.tennessean.com/story/news/local/2020/02/07/nashville-council-metro-workers-pay-study/4658801002/.
13. Yihyun Jeong, "Nashville gets state approval for budget after officials outline financial fixes." *The Tennessean*. December 11, 2019. https://www.tennessean.com/story/news/2019/12/11/nashville-finances-fixes-state-comptroller-approval-mayor-john-cooper/2631891001/.

than PILOTs, in the most recent year, 12 PILOTs cost the city more than $8.7 million in lost revenue.[14] Similarly, the city should consider a moratorium on new incentive deals to provide more certainty to the city's long-term financial picture and to stop eroding its existing tax base.

Enact a Spending Cap

Finally, while many of the city's large liabilities come from built in costs like pensions and retiree benefits, as previously shown, the lack of pure fiscal discipline by city leaders created a situation where expenses grew exponentially compared to the city's population growth. This high spending wasted years of large revenue growth and eroded any semblance of a rainy-day fund. While large amounts of spending will always be discretionary, Metro could add structural guardrails to prevent spending from growing faster than the city at large. Metro could look to a stronger version of the state government's Copeland Cap, which prohibits the state from increasing spending at a rate higher than the previous year's economic growth without a separate vote acknowledging that rate of spending growth. One way to strengthen that model could be to place a hard cap on the growth of non-capital expenses, not to exceed the growth of the city's economy, as measured by population plus inflation.

IF IT KEEPS ON RAINING

Mayor Cooper has stated that there is no other way to bring the city back from the financial brink without a massive property tax increase, even though many businesses cannot operate as the city remains partially shut down to fight the COVID-19 pandemic. However, without structural reforms, Nashville's impossible promises, bloated size of government, and lack of fiscal discipline will continue to plague the city. If these changes are not made, it won't be long until Nashville is broke yet again, just at an even higher level. Therefore, before any tax increase is considered, Metro should first focus on reducing long-term liabilities, rightsize its government workforce, stop eroding away its tax base, and place caps on the growth of spending. Enacting these types of reforms will do far more than a massive permanent tax increase to restore citizen's faith in the fiscal stewardship of the city and set Nashville up for long-term prosperity.

14. Metro Nashville Department of Finance, "Comprehensive Annual Financial Report, 2019." October 31, 2019. https://www.nashville.gov/Portals/0/SiteContent/Finance/docs/CAFR/CAFR%202019.pdf.

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