

# Financially Constrained Cities and Commercial Real Estate Returns

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## SHORT OVERVIEW

When S&P downgraded Chicago's credit rating to BBB in January 2025, it raised a question now important to commercial real estate (CRE) investors: does the fiscal health of the host city itself shape property performance? With \$4.2 trillion in U.S. municipal bonds outstanding and \$1.4 trillion in unfunded public pensions, municipal balance sheets are no longer a background variable for institutional capital allocation. Combining NCREIF returns across the 100 largest U.S. metropolitan areas (2017-2023) with standardized fiscal fundamentals from the Stanford Municipal Finance Dashboard, we find that municipal fiscal health is a priced local risk factor in CRE markets. A one standard-deviation improvement in fiscal health raises quarterly returns by roughly 0.25 percentage points (~1% annually). Effects concentrate on appreciation rather than income returns, are strongest in office and self-storage, and are amplified in gateway markets and during the post-COVID period. Causal evidence from staggered state adoption of fiscal monitoring policies confirms that exogenous improvements in oversight raise CRE returns. Municipal fiscal metrics belong alongside traditional location and property fundamentals in CRE underwriting and asset allocation.

## RESEARCH QUESTIONS

- Is municipal fiscal health priced into commercial real estate returns, after controlling for standard demand, income, and real estate market cycle?
- Do effects operate through current cash flows (rents, NOI) or through forward-looking revaluation (risk premia, growth expectations, expected future taxes and services)?
- Where and when are these effects strongest -- by property type, market type, and time period?

## DATA AND METHODS

We build a CBSA-quarter panel covering 2017Q1-2023Q4 across the 100 largest U.S. metropolitan areas (1,982 CBSA-quarter observations). The key explanatory variable is the composite Final Score from the Stanford Municipal Finance Dashboard: an unweighted average of ten standardized indicators capturing reserves, debt burden, liquidity, revenue growth, pension and OPEB obligations, and net worth. Controls include FHFA house price changes, employment and population growth, household income, education, social vulnerability, natural disaster exposure, state-level municipal bond spreads, FBI crime rates, local amenity values, and land-use regulation. We use two complementary identification strategies. First, panel regressions with CBSA and year-quarter fixed effects, with standard errors clustered at the CBSA level. Second, a stacked difference-in-differences (DiD) design that exploits the staggered state adoption of Fiscal Monitoring Policies (FMPs) across eight cohorts between 2001 and 2017, using never-adopters and not-yet-adopters as controls.

## KEY FINDINGS

- **Magnitude:** A one standard deviation improvement in fiscal health is associated with about 0.25 percentage points higher quarterly CRE returns -- roughly 1% annually. Effects are stable across five progressively richer control sets.
- **Channel:** The effect concentrates on appreciation rather than income returns, indicating that fiscal information is priced through valuations and risk premia rather than near-term cash flows.
- **Predictive content:** Fiscal health forecasts CRE returns one to four quarters ahead, with declining but positive coefficients -- consistent with gradual information incorporation rather than permanent excess returns.
- **Property type and market heterogeneity:** Effects are strongest in office and self-storage; weaker in apartment, industrial, and retail. Effects are amplified in gateway markets and during the post-COVID period, when governance quality is most salient to investors.
- **Causal evidence:** State adoption of Fiscal Monitoring Policies raises CRE returns by 0.4 to 0.5 percentage points per quarter (1.6% to 2.1% annually), with no anticipation effects and no pre-trends -- most consistent with enhanced oversight reducing local governance risk premia.

## IMPLICATIONS FOR INVESTORS AND POLICYMAKERS

For institutional investors, municipal fiscal metrics carry incremental information beyond standard market and property fundamentals. Roughly 1% per year of long-horizon CRE returns is economically material, and fiscal screens belong alongside traditional location and property-quality metrics in asset allocation, gateway-market risk assessment, and post-pandemic positioning. Because the effect loads on appreciation, fiscal information matters for valuation and discount-rate calibration, not just cash flow projection. Accounting-based fiscal scores (such as the Stanford Final Score) and market-based municipal bond spreads are complements, not substitutes, each containing an independent signal in our data.

For municipal officials and policymakers, the findings sharpen the case that fiscal discipline carries spillover benefits beyond reduced borrowing costs and improved public services: it materially affects private capital formation through CRE asset values. Cities seeking to attract post-pandemic investment must credibly signal balance-sheet stability and governance quality, not merely offer tax incentives. The DiD evidence on Fiscal Monitoring Policies further suggests that institutional reforms that enhance transparency and oversight can improve CRE outcomes even in the absence of direct fiscal improvements, by reducing perceived governance risk. The key message is that municipal balance-sheet conditions are a priced local risk factor in CRE markets, and understanding this channel is important for both investors and policymakers.