CITY OF URBANA, ILLINOIS
FINANCE DEPARTMENT

M E M O R A N D U M

TO: Mayor Diane Wolfe Marlin and City Council Members

FROM: Elizabeth Hannan, Finance Director

DATE: January 17, 2019

SUBJECT: **Financial Forecast for FY2020 – FY2024**

Introduction: Attached to this memo is the Financial Forecast for FY2020 – FY2024.

Discussion: The City's Financial Policies require that Finance staff prepare a forecast for the General Operating Fund annually. This is a means of assessing the City's future fiscal condition to provide context for significant budget decisions.

Based on the Financial Forecast attached to this memo, $500,000 in net expenditure reductions and $250,000 in new revenues are recommended for FY2020, with additional expenditure reductions or revenue increases expected to be required over the following three years. More details on the financial projections and recommended strategies are included in the attached report.

Fiscal Impact: The Forecast itself has no direct fiscal impact. However, the strategies that are recommended include significant budget reductions and revenue increases for FY2020, and additional budget reductions and revenue increases in future years.

Recommendation: Review the attached Financial Forecast in preparation for the presentation on Tuesday, January 22, 2019.

FINANCIAL FORECAST

FY2020 – FY2024

CITY OF URBANA

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Summary

FORECASTING, IN GENERAL

Preparing a financial forecast is challenging because of the large number of economic, demographic, and policy variables involved. Many factors are beyond our control, and cannot be known with certainty in advance. We can make reasonable assumptions about these variables to produce a forecast. However, the only certainty is that the forecast will not be precisely accurate in predicting the future. It is, however, useful for examining trends, which allows us to strategize for both fiscal risks and opportunities.

The City's Financial Policies require that Finance Department staff prepare an updated forecast annually.

GENERAL FUND FOCUS

The focus of this report is the City's General Operating Fund, which provides funding for most basic City services, such as police protection, fire suppression, and most public works services.

KEY DRIVERS OF FORECAST

Some items merit special note because their impact on the forecast is so significant. First, the budget for FY2019 included a net reduction of recurring expenditures of about $500K. The impact of those decisions is evident in the improved outlook included in this forecast.

The national trend towards increasing use of e-commerce, rather than shopping in bricks and mortar stores continues to be a concern, particularly because 28% of General Fund revenues come from sales tax. Urbana is not unique in this respect – this is an issue for cities across the United States. While FY2019 sales tax results appear on track for better performance, this does not make up for years of slow growth. In addition, the likelihood of a recession, perhaps in 2020, is increasing, and this would undoubtedly have a negative impact on sales tax and other revenues.

State diversion of local government revenue continues to affect the forecast. While those diversions were reduced for FY2019, State-shared revenues have been curtailed from FY2017 levels. For FY2019 that included imposing a 1.5% (down from 2%) administrative fee on Home Rule sales tax revenue and diverting 5% (down from 10%) of the local government share of income taxes. The effect of these changes is a reduction in General Fund revenues of about $250K in FY2019. Given the magnitude of the State's fiscal crisis, there continues to be a strong possibility that these diversions may grow in the future.

On the expenditure side, the Illinois Municipal Retirement Fund (IMRF) has revised assumptions about investment earnings, which increases unfunded liability and, therefore, increases pension contributions. Revision of this assumption is expected to result in an increase in the City's contribution rate from 9.59% for 2019 to 14.39% for 2022.

On a positive note, a number of development opportunities are on the horizon. The resulting growth in the City's tax base is essential to the City's financial future. Many of these developments will occur within the enterprise zone, so the impact on property tax revenue is not immediate, but is reflected in later years of the forecast.

The impact of the U.S. Supreme Court decision in *S. Dakota v. Wayfair* and expanded use tax collection in Illinois will certainly increase use tax revenues. However, the City has yet to receive any revenue under the new law, which was effective in October 2018, and the impact is difficult to predict.

CAUTIONS

- This forecast should be used to evaluate strategy and make course corrections. It is not intended to be accurate at a detailed level.
- Forecasting is prone to error and those errors are amplified as we look further into the future because the forecast for each year builds on prior years. Therefore, we should place less reliance on the later years in the forecast in making decisions about the budget.

SUMMARY OF LIKELY PATH

It is likely that without corrective action, recurring expenditures will exceed the policy goal of 98.5% of recurring revenues by FY2021. Expenditures will grow faster than revenues, resulting in an increasingly large gap; fund balance will decrease at an accelerating rate. By the end of the forecast period, if not earlier, the fund balance would dip below the current policy goal of 15% of recurring expenditures.

SUMMARY

There is significant downside risk in this forecast due to the increasing likelihood of a national recession and the State's fiscal situation. Most economic forecasts agree that the probability of a recession within the next couple of years has increased to the point where it is more likely than not.

It also seems increasingly likely that the State will continue to divert local revenues. The threat of property tax caps or significant increases in exemptions remains. Any additional diversion of revenue or limitations on property taxes would accelerate the decline in fund balance.

CORRECTIVE ACTIONS

Putting the City on a path to fiscal sustainability will continue to involve difficult and challenging decisions. It is likely that a combination of budget reductions and revenue increases will be required over a period of years. The total required is likely to be about $2 million on a recurring basis, which is about 6% of estimated General Fund expenditures for FY2019. Expenditure reductions and revenue increases can be phased in over a period of several years as we adjust to this new reality.

ANNUAL UPDATES TO FORECAST

Annual updates of the forecast will be essential to ensure that adjustments to the plan can be made in a thoughtful way. This will help us to avoid over- or under-correcting.

Methods & Key Assumptions

METHODS

It is not practical to develop detailed forecasts for every item in the budget. Forecasting for expenditures is accomplished by grouping expenditures into categories, which tend to be affected by common "drivers." For example, personnel costs are broken into salaries and directly related expenses, pensions, and discretionary personnel expenses, such as overtime. Discretionary personnel expenses can generally be controlled by management, at least to some extent. Some line items are forecast at a detailed level either because they are very large or tend to be highly variable. All one-time expenditures are factored out when projecting recurring expenditures.

Staff develops projections for major revenue sources at a detailed level because of their significant impact on the budget. Particular attention is paid to sales, income, and property tax. Other revenues, such as user fees, are aggregated. For example, most user fees, which are based on the City's cost of providing services, are predicted to increase with wages.

KEY ASSUMPTIONS

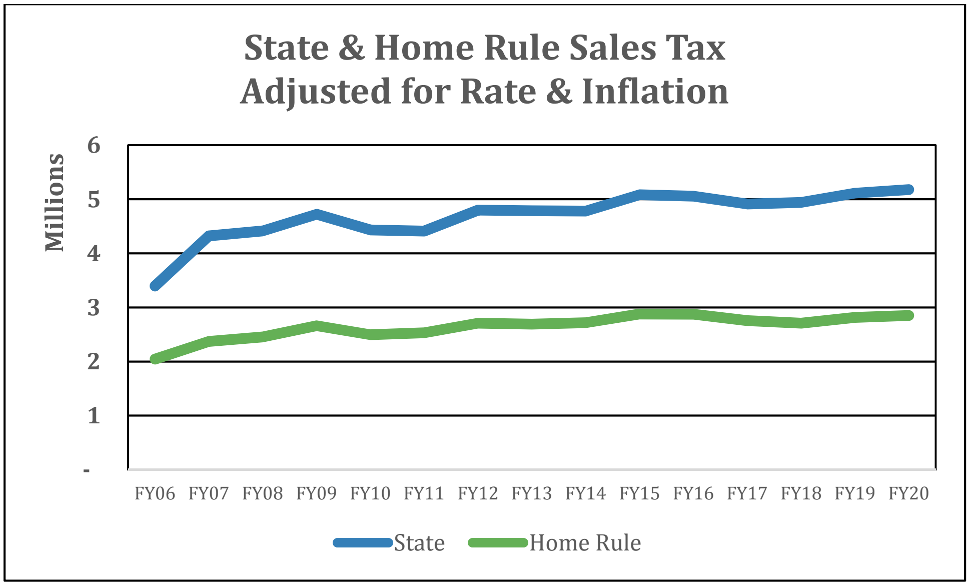
Compliance with Financial Policies

First, the forecast assumes that the budget will comply with the Financial Policies adopted by the City Council. Relevant policies include –

- the City will maintain reserves in the General Fund of 15% of recurring expenditures
- recurring expenditures will not exceed 98.5% of recurring revenues
- the City will maintain a stable tax rate, which is currently $1.3550 per $100 of assessed valuation (long term goal is a rate of $1.3152, equal to the City of Champaign)
- capital improvement transfers will increase based on the construction cost index
- public safety pensions will be funded based on amortizing 100% of unfunded liability over 20 years

Sales Tax Trends

Long-term revenue trends are an important consideration in developing the forecast. Sales tax trends are of particular interest because they make up 28% of General Fund revenues. The following chart shows both State and Home Rule sales tax revenue over the past 12 years, adjusted for both changes in the Home Rule sales tax rate and inflation.



While we have seen modest growth in the past, there was little growth in sales tax revenues relative to the rate of inflation between FY2015 and FY2018. In FY2018, inflation adjusted State sales tax grew by only 0.56% and Home Rule sales tax decreased by 1.71%. While part of the FY2018 decrease was driven by the State's collection fee on Home Rule sales tax, the overall trend is driven by increasing use of e-commerce, as discussed above. The projection for FY2019 is 3.1% higher than FY2018 revenues. While growth in the current fiscal year appears healthy and is built into the base for projections going forward, the Likely scenario assumes that long-term growth in sales tax revenues will not keep pace with inflation.

Summary of Other Assumptions

The forecast is based upon assumptions about a variety of items. Some key assumptions are detailed in the chart on the following page. However, wage assumptions are not detailed in the chart due to the potential impact on collective bargaining.

METHODS & KEY ASSUMPTIONS

KEY ASSUMPTIONS			
	Likely Scenario	**Best case**	**Worst Case**
Consumer Price Index (CPI-U)	2.25%	2%	2.5%
Construction Cost Index (CCI)	2.9% CY19, then 3%	2.75%	3.5%
Population	+0.5% annually	Same	Same
Property Tax Rate	$1.355	$1.3152	$1.355
Hospital Property Taxes	No	Yes, limited exemptions	No
Assessed Valuation Base	+2% annually	+3%	+1%
Sales Tax	-1% from inflation	+0.5% from inflation	-1.5% from inflation
Use Tax	+2.5% from inflation	+3% from inflation	+1.5% from inflation
Income Tax	+2%	+2.25%	+1.75%
Income Tax Reduction	State retains 5%	State retains 0%	State retains 10%
User Fees & Licenses	Increase with wages	Same	Same
Building Permits	No increase	No increase	No increase
Health Insurance	2.35%, 10%, 10%, 5% thereafter	2.35%, 5%, 10%, 10%, 5% thereafter	2.35%, 10%, 10%, 8% thereafter
Police/Fire Pensions - Revenue	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy
IMRF Rate	9.59% 2019, increase 1.6% for 3 years	9.59% 2019, increase 1.6% for 2 years	9.59% 2019, increase 1.6% for 4 years
Police/Fire Pensions - Expense	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy
Supplies & Services	Inflation	0% in FY19, then inflation	Same as Likely
Capital Improvement Transfers	Increase by CCI	Increase by CCI	Increase by CCI
VERF Transfers	+2% annually	+1.5% annually	+2.5% annually
One-time VERF Transfer	$120K annually through FY2031	Same	Same
Underspending	2% below budget each year of forecast	Same	Same

FORECAST

Forecast

INDICATORS OF FISCAL HEALTH

We use two primary indicators of fiscal health in this forecast.

Recurring Expenditures as a Percent of Recurring Revenues

This measure indicates the ability to sustain expenditures for programs and services over the long-term and ensures that the City does not make long-term commitments (such as new positions) for which funding may not be available in the future. The City's new policy of budgeting recurring expenditures at not more than 98.5% of recurring revenue provides a cushion against modest fluctuations in recurring revenue so that expenditures will not exceed revenue.

Fund Balance as a Percent of Recurring Expenditures

This measure indicates the City's ability to withstand economic downturns, finance cash flow given variability of revenue streams throughout the year, provide a stable tax rate, respond to natural disasters, and provide for unanticipated needs or unexpected opportunities. The City's current policy of maintaining a fund balance of 15% of recurring expenditures provides a buffer, but may not be adequate in the long term.

RISK ASSESSMENT

While the Likely scenario is based on assumptions that staff feels are most probable, there is significant downside risk in this forecast. Given the State's financial condition, it seems likely that the Illinois Legislature will look to continue diversion of municipal revenues and impose restrictions on the ability of local governments to raise revenue through property taxes, whether through tax caps or significant increases in property tax exemptions.

Staff believes that there is <u>**very little chance**</u> that the Best Case scenario will play out, but there is a more significant risk that the reality could be closer to the Worst Case Scenario.

There are a couple of specific ways in which these risks factor into the forecast and it is helpful to have an understanding of those risks when reviewing the forecast.

FORECAST

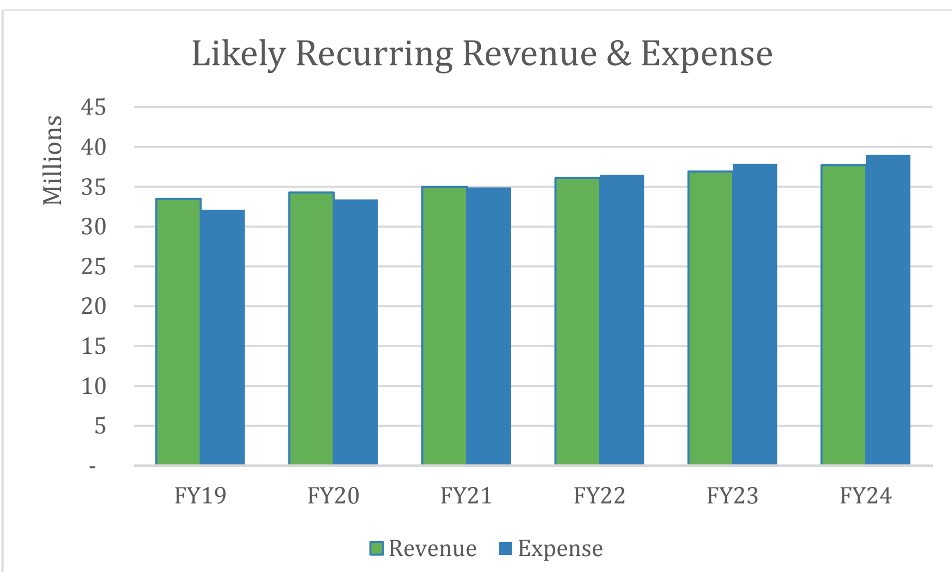
Recession. A recession is likely to occur within the next couple of years. This is reflected in relatively slow growth in sales tax revenues and, in the Worst Case, scenario, no growth in base equalized assessed valuation (EAV) from 2021 through 2024.

Income Tax. The Likely scenario assumes that current State imposed 5% reduction in the local government share of income tax will continue. That diversion reduces General Fund revenues by about $200,000. Staff has relied on estimates provided by the Illinois Municipal League (IML), which appear to be conservative. Irregularities in collections and "make up" payments are factored into their projections.

Use Tax. The impact of the *Wayfair* decision on use tax revenue is difficult to predict. With no revenues upon which to base predictions, the assumption used in the Likely scenario is that the increase will be about $3.20 per capita or $132K on an annual basis.

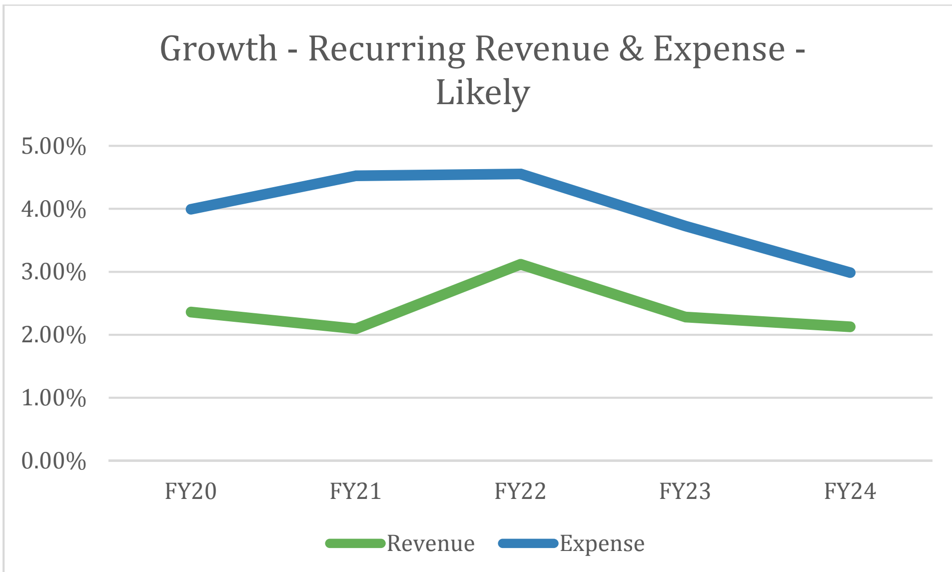
REVENUES & EXPENDITURES

Recurring revenues and expenditures for the Likely scenario are depicted in the chart below. As you can see, expenditures exceed revenues beginning in FY2021 and the gap grows larger over time. This indicates that the predicted level of expenditures is not sustainable with current sources of revenue in this scenario.



FORECAST

As show below, the rate of growth in recurring expenditures outpaces the rate of growth in recurring revenues throughout the forecast period. As long as revenues grow more slowly than expenditures, the City will be in a position of requiring revenue increases or expenditure reductions on an ongoing basis.

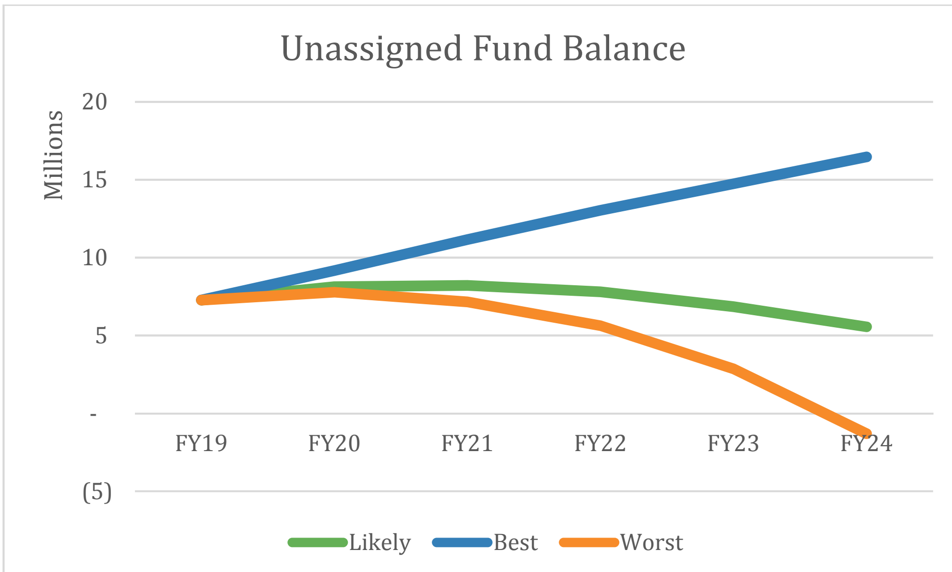


We expect that towards the end of the forecast period, the gap will begin to close. This is due in part to release of 2020 census data, which will result in an adjustment to the per capita distributions for income, use and PPRT taxes from the State. Urbana is currently experiencing modest population growth of about 0.5% annually, while the State as a whole has seen a slight decrease in population since the last census. Development activity also contributes to the closing gap, and additional, sustained development activity would be one of the best options for eliminating this structural deficit.

FORECAST

FUND BALANCE

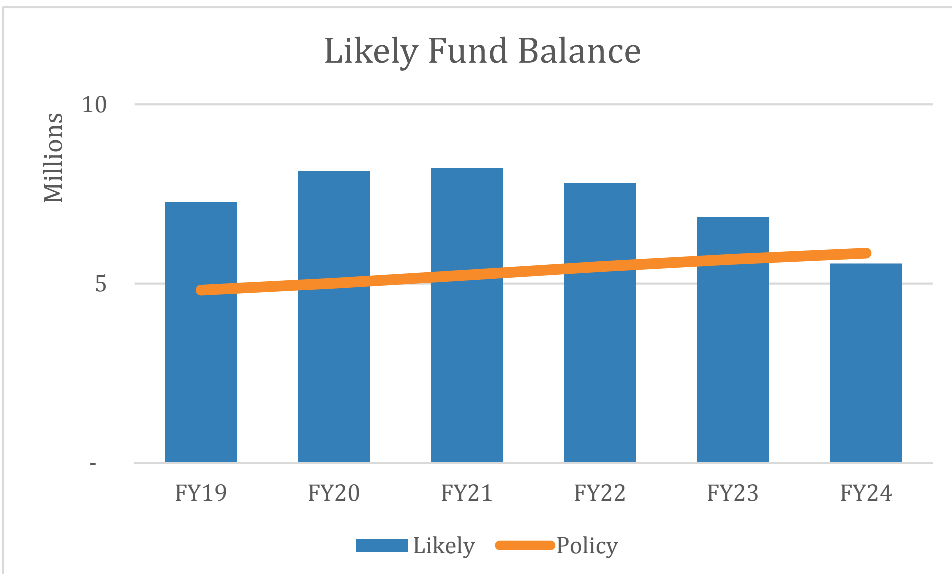
This chart shows that unassigned fund balance will decrease over time in both the Likely and Worst Case scenarios.



In the Worst Case scenario, the decline occurs more quickly. However, even in the Likely scenario, the City would expect to be below the current policy goal by the end of the forecast period, without significant adjustments to the budget.

FORECAST

Focusing on the Likely Scenario, you can see that while fund balance is expected to exceed the 15% fund balance goal in the current fiscal year, it declines each year after FY2021, until (absent any significant budget reductions or revenue increases) we are below the goal at the end of the forecast period. This occurs because the growth in fund balance in the early years is driven by expenditure reductions and revenue increases, which do not occur in the later years of the forecast. Without ongoing expenditure reductions or revenue increases, the budget is not sustainable.



In addition, it is quite likely that the 15% balance level is not adequate to deal with a Worst Case scenario, or unexpected events such as a natural disaster.

CORRECTIVE ACTION

Corrective Action

SIMULATED CORRECTIVE ACTION

There are many options for corrective action. As an example, the following charts illustrate the impact of an additional $1 million in expenditure reductions over two years beginning in FY2020, combined with $1 million in revenue increases, phased in over three years beginning in FY2020. This is used to illustrate that with the right timing, some combination of $2 million in expenditure reductions and/or revenue increases would likely be adequate, assuming the Likely scenario is reasonably accurate.

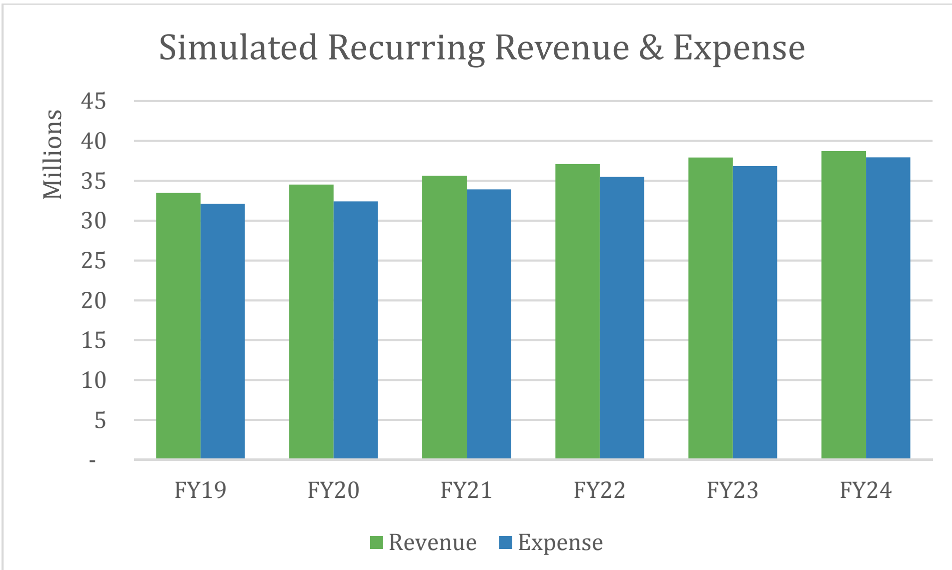
A phased approach is recommended both to allow adequate time to consider options and assess the impact of proposed changes, as well as to take account of changing conditions that may affect future financial forecasts.

The corrective action required to address the Worst Case scenario would be in excess of $7 million, or more than 20% of current General Fund expenditures.

CORRECTIVE ACTION

REVENUES & EXPENDITURES

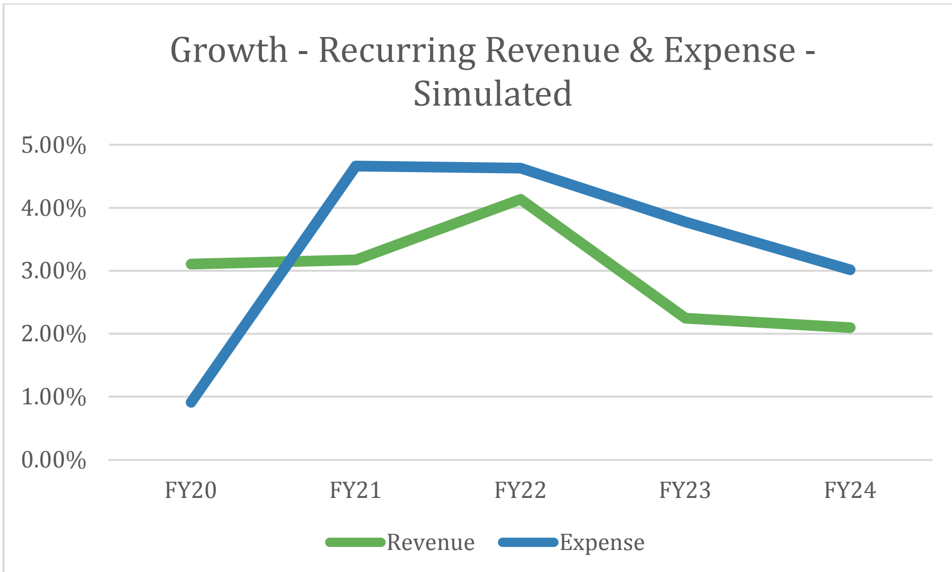
In this simulated scenario, which includes the changes described above, recurring revenues and expenditures are closely aligned, as shown below, but even after the corrections, the gap between recurring revenue and expense is closing.



One way to address this gap is through continued focus on economic development, which will drive increases in the tax base.

CORRECTIVE ACTION

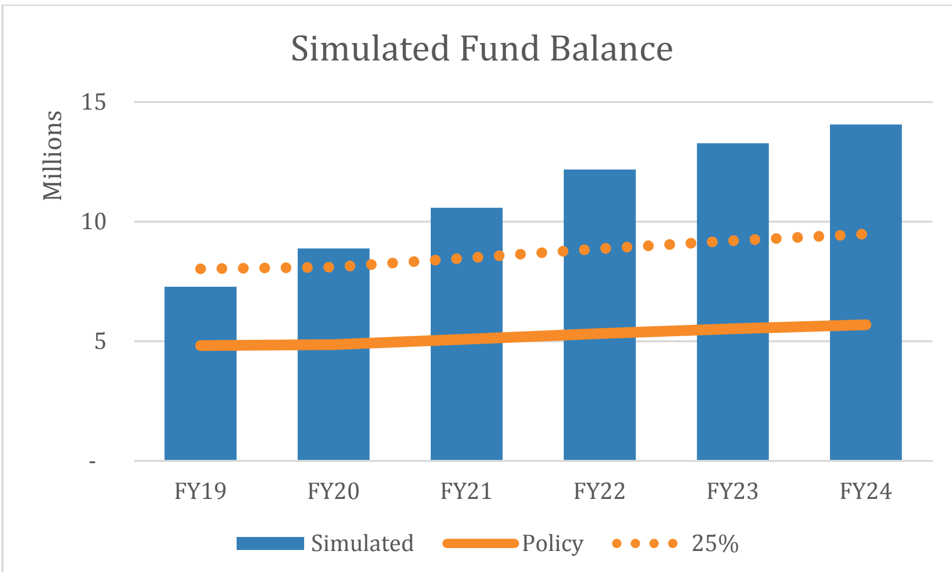
Growth in revenues and expenditures also match more closely over time with the adjustments described above.



CORRECTIVE ACTION

FUND BALANCE

The following chart shows that, with these changes, fund balance grows considerably and exceeds the current policy of maintaining an unassigned fund balance of 15% of recurring expenditures. The dotted line illustrates 25% of recurring expenditures, which is likely a more appropriate fund balance in the long term.



As a practical matter, the City would most likely not retain a fund balance in excess of the policy goal, whether that is 15% or some other level. Any excess fund balance could be used to pay for one-time expenditures, which could include capital improvements or supplementing self-insurance reserves.

RECOMMENDED STRATEGY

A clear plan is important to provide a foundation for decision-making. In particular, decisions about staffing – whether to add positions, or fill vacant positions – will be informed by the plan. In fact, every significant decision that involves financial resources should be considered in the context of this plan for corrective action.

CORRECTIVE ACTION

The following strategies are recommended to position the City to respond to the Likely scenario. However, given the State's fiscal condition, it is prudent to be prepared for the Worst Case scenario.

The following actions are recommended –

1. **Share the Forecast with City Staff and Ask for Input.** Brief City staff on the forecast and ask for suggestions on balancing the budget. Specific suggestions will be solicited for revenue increases and alternate methods of service delivery.

2. **Plan for Corrections.** Plan for $500K in net expenditure reductions and $250K in new revenues in FY2020, and additional reductions and new revenues in future years.

    a. **Evaluate Priority of City Services.** Staff will produce an inventory of programs funded from the General Operating Fund, which will be prioritized. The focus of budget reductions will be lower priority programs that contribute less directly to organizational priorities. Those lower priority programs will be evaluated for potential savings and considered for reduction or elimination.

    b. **Evaluate Revenue Options.** Staff will evaluate available revenue options, giving priority to sources of revenue that are likely to grow at least at the rate of inflation over time. Other factors to assess include whether new revenues would put the City at a competitive disadvantage, workload related to implementation and administration, an assessment of whether the burden falls on residents or non-residents, and whether the burden falls disproportionately on any particular segment of the City's population.

    c. **Assess Opportunities to Use Alternate Methods of Service Delivery.** Staff will identify services that could potentially be delivered through alternate methods. This could include contracting services or making cooperative arrangements with other units of local government to provide services. These would be identified and a short list would be created for further study. These opportunities would be very unlikely to affect the FY2020 budget. The impact is likely to be seen in FY2021 and beyond.

d. **Offer Voluntary Separation Incentives (VSIP).** An updated VSIP program will be offered. If some or all reductions can be accomplished through voluntary separations, that is preferred.

3. **Limit Expenditure Increases.** While some new funding for current programs and services will be unavoidable, we will limit requests for new funding. The focus will be on one-time expenditures that will improve efficiency or productivity. While not all of these initiatives will result in staffing reductions, they may head off the need for future staffing increases as workloads inevitably increase over time. Any increases would be offset with additional reductions.
4. **Build Reserves.** When possible, focus on using one-time revenue or savings to build reserves. This could include increasing the fund balance in the General Fund, or other reserves such as self-insurance reserves in the Retained Risk Fund.
5. **Financial Policies – Fund Balance.** Consider revising the policy on fund balance to provide for a larger fund balance as a percent of recurring expenditures. Up to 25% would be appropriate, based on guidelines provided by the Government Finance Officers Association (GFOA). This appears to be achievable in the near term. (Current policy is 15 %.)
6. **Continue to Make Economic Development a Priority.** This is the best way to support long-term growth of the tax base, which will help to resolve the structural deficit.