CITY OF URBANA

Human Resources and Finance Department

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M E M O R A N D U M

TO: Mayor Diane Wolfe Marlin and City Council Members

FROM: Elizabeth Hannan, HR & Finance Director / CFO
Alyana Robinson, Financial Analyst

DATE: January 20, 2022

SUBJECT: **Financial Forecast for FY2023 – FY2027**

Introduction: Attached to this memo is the Financial Forecast for FY2023 – FY2027.

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.

Fiscal Impact: The Forecast itself has no direct fiscal impact. However, the recommended strategies are designed to ensure continued financial sustainability.

Recommendation: Review the attached Financial Forecast in preparation for the presentation on Monday, January 24, 2022.

FINANCIAL FORECAST

FY2023 – FY2027

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 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

Certain items merit special note because their impact on the forecast is so significant. Preparing this forecast was particularly challenging in light of the COVID-19 pandemic and resulting economic impacts. Economic growth in FY2021 showed a strong rebound as vaccinations allowed social and business activity to resume. However, the future path of the pandemic is unknown and has significant impact on the forecast.

The economic recovery from the COVID-19 pandemic declines have affected a wide variety of revenues including some of the major revenue sources in the General Fund such as State and Home-Rule sales tax, hotel/motel tax, and food & beverage tax. Current year-to-date figures show significant increases in revenues resulting from a quicker rebound than initially projected. This translates to positive projections for the remainder of FY2022. One of the key drivers of this significant increase is the positive consumer reaction due to the federal stimulus payments. However, with the end of stimulus payments and different COVID-19 variants emerging, there is still a high degree of uncertainty around the economic recovery.

FINANCIAL FORECAST: FY2023-FY2027

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.
- Emergence of different COVID variants shows that the pandemic is not over and that there is still a high degree of uncertainty on this path to recovery from the pandemic and recession.

SUMMARY OF LIKELY PATH

The City's revenues have rebounded from the pandemic declines more quickly than initially projected (although the durability of that rebound is uncertain). As a result, the projected FY2022 ending fund balance is larger than anticipated, which provides flexibility. However, it is likely that recurring expenditures will exceed the policy goal of 98.5% of recurring revenues during the entire period, as expenditures grow faster than revenues. This is sustainable for several years due to a healthy fund balance, and appears to correct over the five-year period. If a recovery is prolonged, revenue increases will likely be required to maintain current services. Economic development, which could lead to faster growth of revenues, is critical in addressing this issue.

The State's fiscal condition is also of concern. Income tax diversion to the State's coffers is always a possibility, without a legislated continuing appropriation. The threat of property tax caps or significant increases in exemptions also remains.

RECOMMENDED STRATEGY

With the leadership of the Mayor and the support of City Council, the City headed into FY2022 in better shape financially than at any time in recent years. No budget reductions or revenue increases are required to maintain current services next fiscal year. However, staff will continue to evaluate potential revenue sources over the next year so that we are prepared to take action when we have a better understanding of the timing and pace of recovery.

FINANCIAL FORECAST: FY2023-FY2027

Staff will prepare a resolution to increase General Fund minimum fund balance policy from 20% to 25% of recurring expenditures. The goal of this change is to maintain resilience so that we can maintain current services over the long term.

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 taxes. In addition, this year, several other revenue sources that are affected by the pandemic and resulting recession required additional detailed analysis. 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

Financial Policies

Normally, the forecast is based on the assumption that the budget will comply with the Financial Policies adopted by the City Council. Relevant policies include –

- the City will recommend reserves in the General Fund of at least 25% of recurring expenditures; this allows flexibility in responding to emergencies or unexpected events (Note: this is the proposed policy that City Council will be asked to approve)
- recurring expenditures will not exceed 98.5% of recurring revenues; this allows the City to respond to modest revenue fluctuations without reducing expenditures
- the City will maintain a stable property tax rate, which is currently $1.3499 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; a five-year transition period began with the 2018 tax levy

Exceptions to Financial Policies

Due to the current recession, the City will likely not comply with the policy of maintaining recurring expenditures at no more than 98.5% of recurring revenues for the duration of the forecast period. The path forward will require spending down fund balance to bridge the gap from recession to recovery. If expenditure reductions become necessary, our healthy fund balance will allow us to take time to consider our options thoughtfully. This is consistent with our plan to increase reserves to allow flexibility in dealing with emergencies and unexpected events.

Path Out of the Pandemic

Many of the assumptions about revenues are based on expectations about the course of the pandemic. In the Likely Case scenario, emergence of different COVID-19 variants will likely persist in the winter 2021-2022 where we expect to see little change in social and business activity, resulting to a slower recovery throughout 2022. Given the slower growth, we anticipate to reach to previous levels of affected revenues by 2023.

In the Best Case scenario, emergence of new COVID-19 variants subsides, and social and business activity normalize by end of 2022. There are no additional waves. Recovery growth will return to the pre-pandemic pace beginning 2023.

The Worst Case scenario assumes new COVID-19 variants continue to emerge throughout 2022, prolonging the downturn. Social and business activity is hampered through 2023, and as a result, we expect to see no growth in affected revenues and decreases in some revenues.

COVID-19 Impacted Revenues

The COVID-19 pandemic had unprecedented effects on the economy. Staff spent a great amount of time and effort on additional analysis for the following revenues due to significant changes caused by the pandemic. Current FY2022 first half results were reviewed and compared to both pre-pandemic (FY2019 and FY2020) and pandemic (FY2021) actual revenues to identify any trends and major events that resulted in a significant change. Staff then used this analysis as a basis to determine projections for this forecast.

a. Food & Beverage Tax

The City has seen stable food & beverage tax receipts in the current fiscal year. This is partially driven by an increase in the food & beverage tax from 1.5% to 2%, effective in March 2020, just as the pandemic was beginning.

FY2021 actual revenues were nearly $1.3 million, which was higher than anticipated. Revenues have continued at approximately this level throughout the pandemic. FY2023 revenue is expected to remain stable and then grow with inflation moving forward.

b. Hotel/Motel Tax

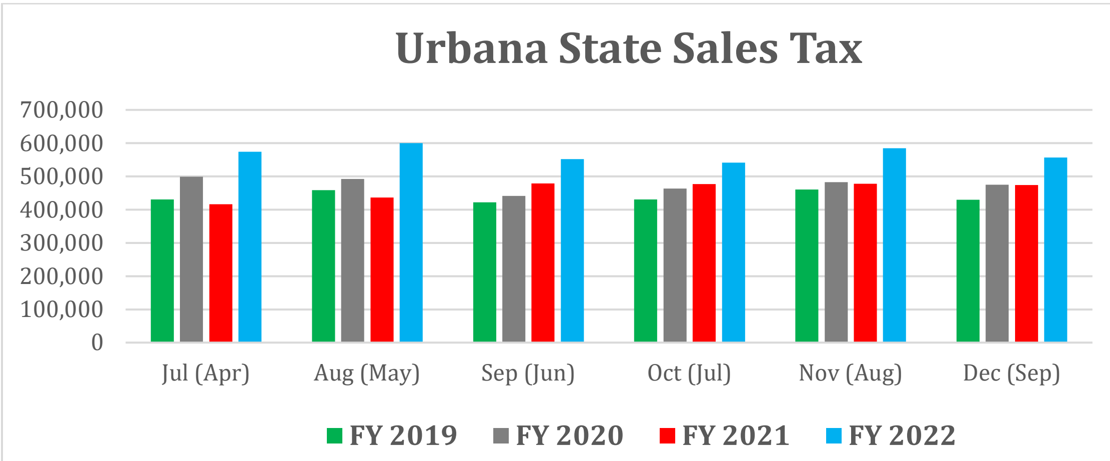
Hotel/motel tax revenues were significantly impacted by the pandemic during FY2021, decreasing from nearly $930K in FY2019 to a low of $490K in FY2021. In FY2022, the City has seen a rebound from the pandemic, with revenues expected to approach the pre-pandemic level.

Current fiscal year revenues are still on an upward trend and as a result, the projection anticipates healthy growth in FY2023. With the assumption of social and business activity to normalize by end of FY2023, revenues are expected to grow with inflation from FY2024-FY2027.

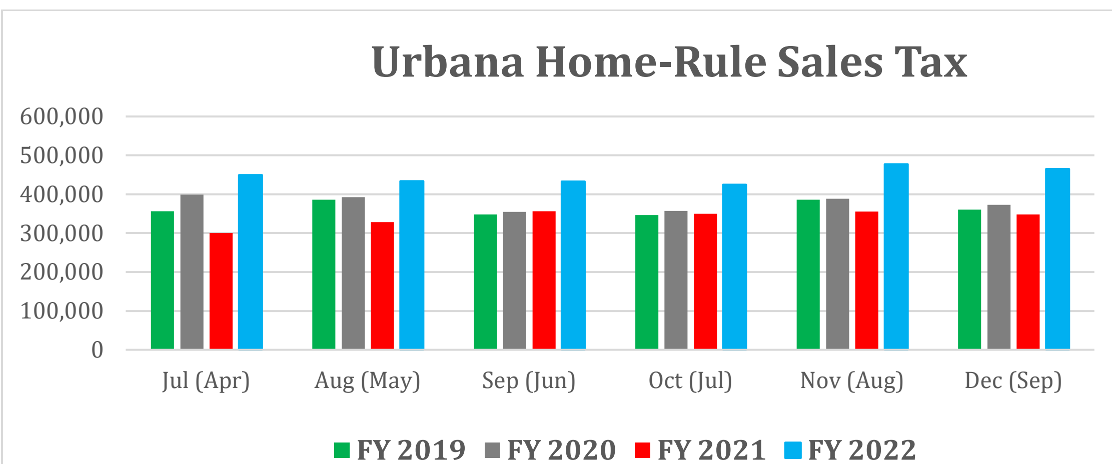
This does not include revenue related to the Hotel Royer because during the forecast period those revenues will be allocated to subsidizing development incentives.

c. Sales Tax

The most significant change in revenues is related to State and Home Rule sales tax. After economic declines due to the pandemic, the City has seen an upward trend in sales tax receipts in the first six months of the current fiscal year. The following charts show both State and Home Rule sales tax revenue in the last six months compared to the same months in prior years. These receipts represent sales that occurred from April through September (there is a 3-month lag from when the tax is collected and when the City receives the revenue).



FY2022 State sales tax receipts exceeded pre-pandemic figures by 29.56% YTD compared to the same months pre-pandemic in FY2019, up 19.63% compared to FY2020 and up about 24.05% compared to FY2021.



FY2022 Home Rule sales tax receipts show the same trend as State sales tax, exceeding pre-pandemic figures by 23.01% YTD compared to the same months pre-pandemic in FY2019, up 18.57% YTD compared to FY2020 and up about 28.62% compared to FY2021.

Because of this positive rebound in sales tax revenues, staff estimates FY2022 revenues to be 17% higher than FY2021 figures for State and Home Rule sales tax receipts. However, this significant increase is expected to be an anomaly. Beginning in FY2023 and in future years, staff anticipates recurring Sales Tax growth to slow down to 1.8% in FY2023, 3.6% in FY2024, 3.8% in FY2025 and 4% in FY2026 and FY2027, which aligns with the Illinois retail sales growth rate projected by IHS Markit. IHS Markit is a national economic forecasting firm, which prepared projections for the Illinois Governor's Office of Management and Budget. IHS Markit gives its baseline forecast a 50 percent probability.

Some of the major factors that contributed to the rise in sales tax revenues that we see during the recovery phase are (1) increases in disposable income from the federal stimulus payments and (2) a shift in consumer demand from services to goods. During the pandemic when the government implemented the lockdown, social distancing measures and business restrictions, it caused a shift in consumer demand away from services to goods. By spending more time at home, the willingness to spend on services has been altered as consumers limit activities that are perceived to be high-risk, such as in-person interactions. This change in consumer behavior is expected to be temporary as public health concerns subside, enabling consumption to return to a more pre-pandemic combination of spending on goods and services.

Sales tax trends are also affected by phased in changes required by the Illinois Marketplace Fairness Act that changed how and to which locality sales tax revenues accrue. These changes were phased in between January 1 and July 1, 2020.

Retained Risk Funding

Over the past few years, the fund balance in the Retained Risk Fund, which pays for liability and workers compensation claims, has been depleted. Next fiscal year, a one-time transfer of $600,000 from the General Fund will likely be required to supplement reserves. This is incorporated into the forecast.

Summary of Other Assumptions

The forecast is based upon assumptions about a variety of items. Some key assumptions are detailed in the following table. However, wages and some other assumptions are not detailed in the table due to potential impact on collective bargaining and negotiation for health insurance rates.

KEY ASSUMPTIONS

	Likely Scenario	Best Case	Worst Case
Indicators			
COVID-19 Pandemic	•Additional wave in winter 2021-2022 •Slow recovery •Expect to see little change in social and business activity through 2022	•No additional waves • Revenue growth to return to pre-COVID-19 pace •Social and business activity to normalize by end of 2022	•Multiple waves throughout FY2022 •Will see no growth in revenues and decrease in some revenues. •Social and business activity hampered through FY2022
Construction Cost Index (CCI)	2.68% CY22, then 3.0% thereafter	2.0% CY22 and forward	3.25% CY22, then 3.25% thereafter
Population	2020 census 38,336	Special census in 2023, population increase 40,000 effective in 2025.	Same as likely
Property Tax Rate	$1.3499	Same	Same
Assessed Valuation Base	+3% annually	+4% annually	+2% annually
Revenues			
Home-Rule Sales Tax	•Grows 18.57% change relative to pre pandemic months for sales that occurred in October through December of 2021, then 10% increase remainder of FY2022. •1.8%, 3.6%, 3.8%, 4.0% and 4.0% (IL retail sales growth rates from FY23-FY27 respectively – based on IHS Markit September 2021 forecast).	•Grows 18.57% change relative to pre pandemic months for sales that occurred in October through December of 2021, then 20% increase •0.5% higher than likely from FY23-FY27	•Slower projected growth rate 5% remainder of FY2022. •1% less than likely in FY23. •1.0% growth from FY24-FY27.

FINANCIAL FORECAST: FY2023-FY2027

KEY ASSUMPTIONS

State Sales Tax	• Sales tax grows 19.63% change relative to pre pandemic months for sales that occurred in October through December of 2021, then 10% growth remainder of FY2022. • 1.8%, 3.6%, 3.8%, 4.0% and 4.0% (IL retail sales growth rates for FY23-FY27 respectively – based on IHS Markit September 2021 forecast).	• Sales tax grows 19.63% change relative to pre pandemic months for sales that occurred in October through December of 2021, then 20% growth remainder of FY2022. • 0.5% higher than likely from FY23-FY27	• New variants wave continues, anticipate slower growth at 5% in the remaining of FY2022. •1% less than likely in FY23. •Flat from FY24-FY27.
Hotel / Motel Tax	• Projected 7.5% decrease relative to pre pandemic months the remainder of FY2022. • Revenues grows at 1.5% rate relative to last pre pandemic months from FY23 to FY27.	• Projected 2.5% growth relative to last pre pandemic months for the remainder of FY22. •3% growth in revenues from FY23 to FY27.	• Projected 15% decrease remainder of FY22. • Revenues stabilizes by FY23, then no growth from FY24 to FY27.
Food & Beverage Tax	• $1.3M base in FY22, then 3% growth annually.	• 5% growth from FY23 to FY27.	• Flat in FY2022, then 1% growth
Use Tax	• New census population at $39.70 per capita FY22, then grows by 2.5% annually.	• Same in FY23-FY24, then grows by 3% annually • Special census in FY23 with an estimated increase 40,000 population effective in FY25.	• Same, then grows by 1.5% annually
Income Tax	• $131.20 per capita FY22, flat FY23, then +2% • Also affected by new census population.	• Grows by 3% annually • Special census in FY23 with an estimated increase 40,000 population effective in FY25.	• Grows 1.5% from base
Police/Fire Pensions – Property Tax Revenue	Actuarial estimates, based on policy	Actuarial estimates, based on policy	Actuarial estimates, based on policy
Expenditures			
IMRF Rate	9.51% for CY22 and 10.50% thereafter	9.51% for CY22 and 9.50% thereafter	9.51% for CY22 and 11.50% thereafter
Police/Fire Pensions – Expense / Contributions	Actuarial estimates, based on policy	Actuarial estimates, based on policy	Actuarial estimates, based on policy
Supplies & Services	Inflation	Inflation	Inflation + 1%

FINANCIAL FORECAST: FY2023-FY2027

KEY ASSUMPTIONS			
Capital Improvement Transfers	Increase by CCI	Increase by CCI	Increase by CCI
VERF Transfers	+2% annually	+1.5% annually	+2.5% annually
Retained Risk – additional 1x transfer	$600K FY23	$400K FY23	$700K FY23
Underspending	2% below budget each year of forecast	Same	Same

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 for which funding may not be available in the future. The City's 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 at least 20% of recurring expenditures provides a significant buffer, but a policy of 25% has been recommended. Staff expects to bring that for approval in the near future, and this forecast is prepared on that basis.

RISK ASSESSMENT

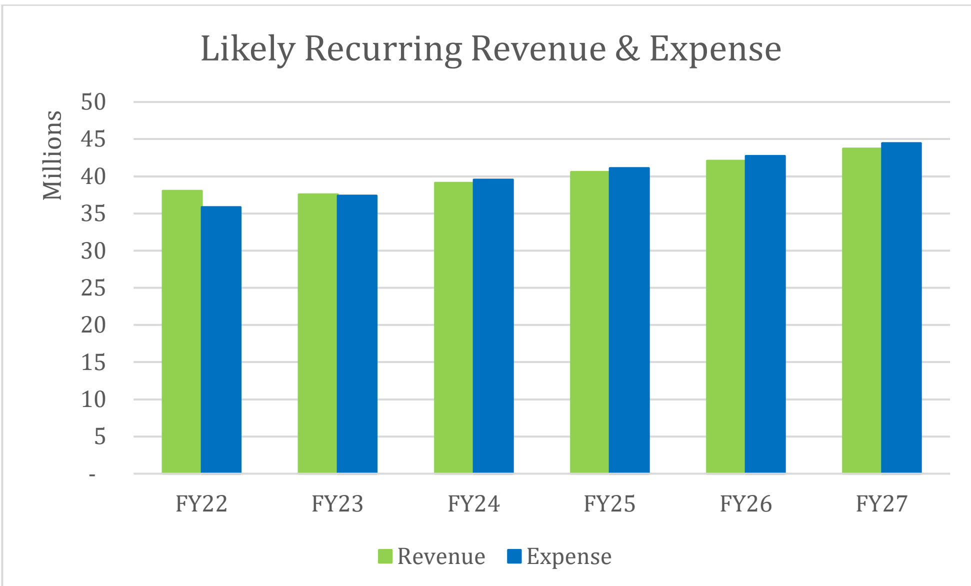
Because of the current pandemic and recession, there is considerable risk inherent in this forecast. This is unprecedented in recent history.

While the Likely scenario is based on assumptions that staff feels are most probable, there is downside risk in the forecast. However, given the current level of certainty, we could also end up doing better than the Likely scenario. Fortunately, because of our healthy fund balance, we have the ability to take a "wait and see" approach.

FINANCIAL FORECAST: FY2023-FY2027

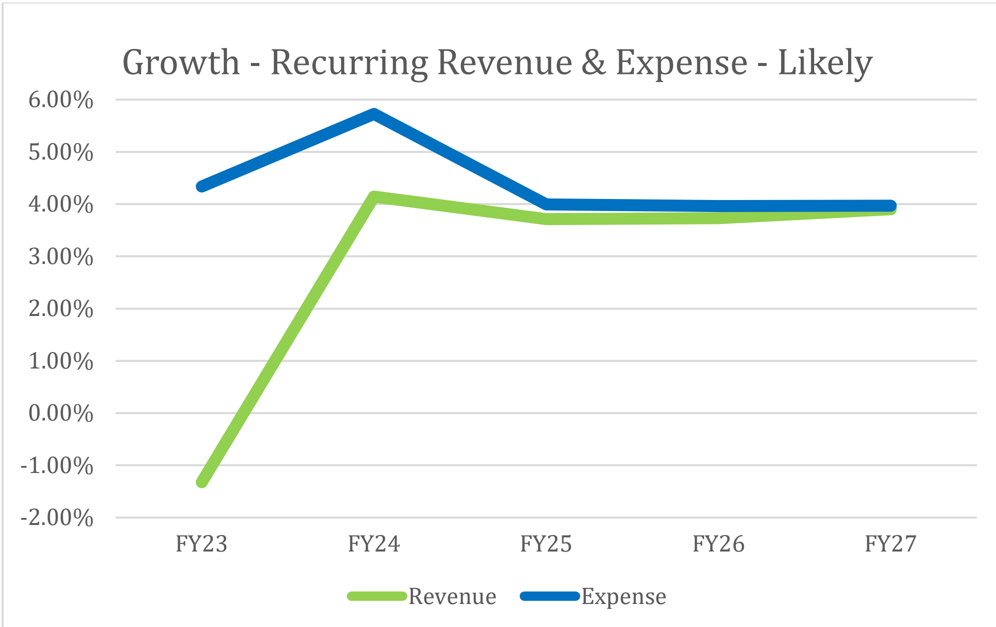
REVENUES & EXPENDITURES

Recurring revenues and expenditures for the Likely scenario are depicted in the chart below. Recurring revenues exceed recurring expenditures in FY2022 and FY2023. However, this reverses each year from FY2024 to FY2027 where recurring expenditures exceed recurring revenues. Normally, staff would recommend budget reductions or revenue increases in this situation. However, because of the City's healthy fund balance and the significant uncertainty about recovery from the recession, staff feels that is acceptable to draw down fund balance until there is more certainty.



As shown below, the rate of growth in recurring expenditures outpaces the rate of growth in recurring revenues throughout most of the forecast period because of anticipated slower economic growth during recovery from the recession. If revenues grow more slowly than expenditures over the long term, the City will be in a position of requiring revenue increases or expenditure reductions on an ongoing basis.

FINANCIAL FORECAST: FY2023-FY2027



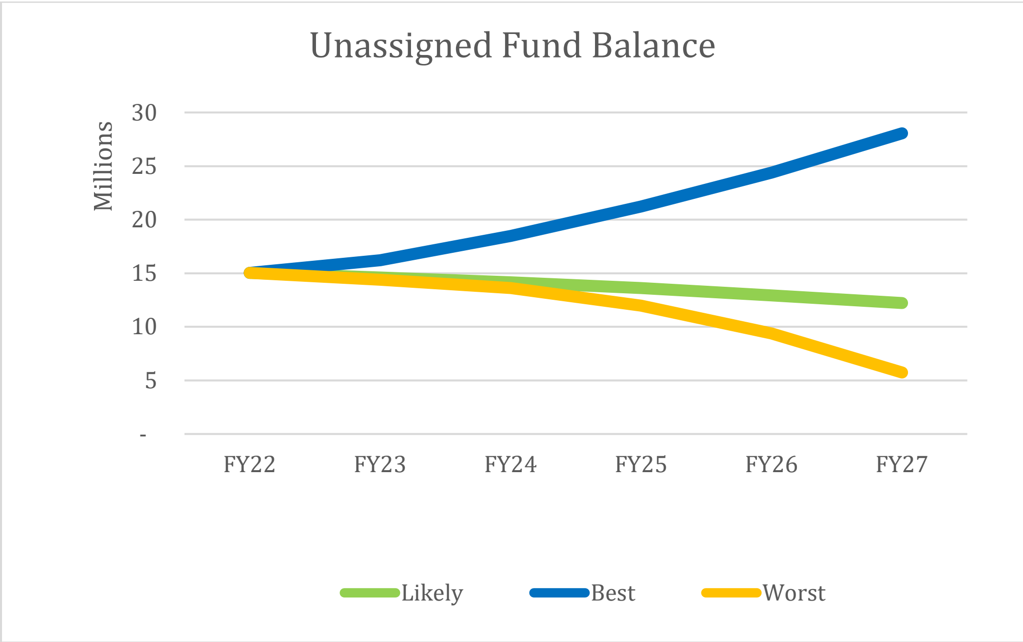
During this period, the release of new census data and incorporation of that data into the formula for distributing state-shared revenues also contributes to contraction of revenues in FY2023. Income tax and use tax distributions are based on population. The 2020 Census showed a decrease in the City of Urbana's population count from 41,250 to 38,336 (7.06% decrease). This decrease in population will result in lower distributions in income and use tax to the City in future years. (Revenues in other funds are also affected.)

The chart above shows the gap between growth in recurring revenues and recurring expenses closing by the end of FY2027. Increased development activity could contribute to the closing gap more quickly, and additional, sustained development activity is the best option for eliminating this structural deficit.

FINANCIAL FORECAST: FY2023-FY2027

FUND BALANCE

This chart shows that unassigned fund balance will remain relatively stable in FY23 and FY24, then decreases modestly throughout the forecast period in the Likely scenario. In the Best Case, fund balance will increase over time, while in the Worst Case it decreases over time.

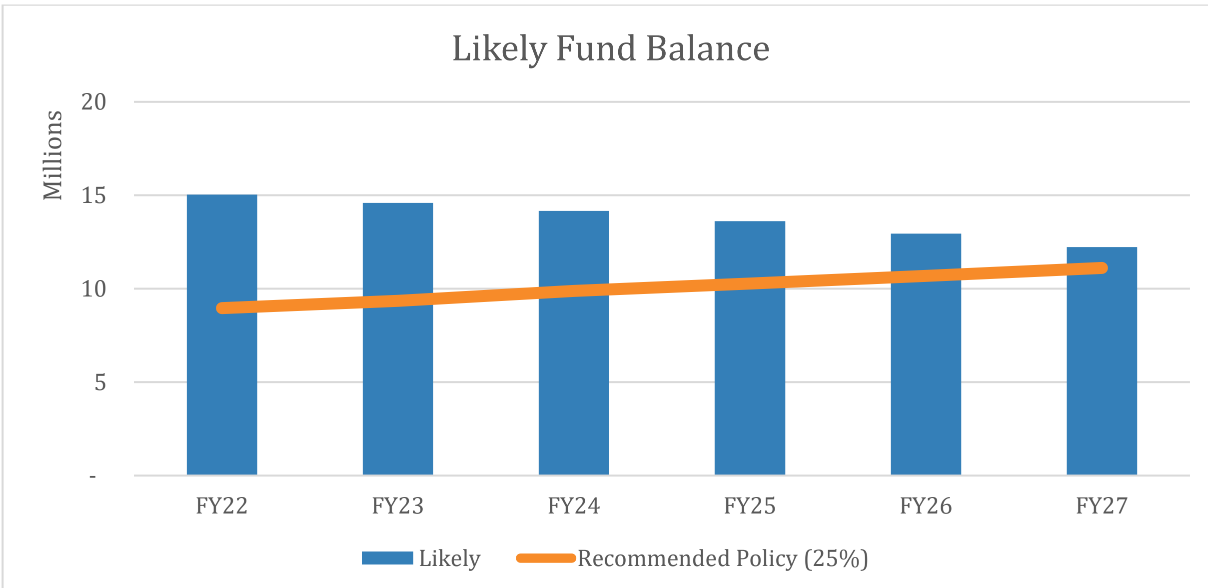


In the Likely scenario, the City would expect to be above the current policy goal, without significant adjustments to the budget for a couple of years, which provides some flexibility in how we respond to the pandemic.

If the best case scenario were to occur, those excess revenues would likely be allocated to one-time expenditures, such as additional funding for the Equity and Quality of Life (EQL) project, which is designed to fund smaller infrastructure improvements in underserved neighborhoods.

FINANCIAL FORECAST: FY2023-FY2027

In the Likely scenario, the fund balance is expected to exceed the recommended 25% fund balance goal throughout the forecast period. It is quite likely that the 25% minimum balance level is adequate to deal with a Worst Case scenario or an unexpected event such as a natural disaster or another economic downturn from the pandemic.



Recommended Strategy

A clear plan is important to provide a foundation for decision-making. Every significant decision that involves financial resources should be considered in the context of this plan.

The following strategies are recommended to position the City to prepare for the Likely scenario. However, we must be prepared for the entire range of outcomes.

The following actions are recommended –

1. **Make Economic Recovery for Local Businesses a Priority.** Supporting local businesses during and after the pandemic and recession will underpin our local economic recovery. This is consistent with new City Council priorities.
2. **Continue to Make Economic Development a Priority.** This is the best way to support long-term growth of the tax base, which will provide more stable revenues.
3. **Update Fund Balance Policy**: Update the policy on fund balance to provide for a 25% minimum fund balance as a percent of recurring expenditures. This is appropriate, based on guidelines provided by the Government Finance Officers Association (GFOA). If the reserves will go below 25%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.
4. **Focus on Maintaining Current Services.** Until there is a resolution to the COVID-19 pandemic, the focus must be on maintaining current services. We are not able to reliably maintain new, recurring expenditures with current revenues at this time.
5. **Plan for Revenue Increases.** Staff will update estimates for potential new revenue sources and assess their feasibility and impact on residents to be prepared for future discussion, if new revenues are needed to fund new or expanded services. No options remain for reducing current expenditures, without significant decreases in service levels, after several years of budget reductions.