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 4, 2018

SUBJECT: **Financial Forecast for FY2019 – FY2023**

Introduction: Attached to this memo is the Financial Forecast for FY2019 – FY2023.

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 budget reductions are recommended for FY2019, with additional reductions or revenue increases expected to be required over the following four years. To accomplish ongoing reductions in expenditures, staff is preparing an inventory of City services that are funded from the General Fund. Those services will be evaluated based on how they contribute to high level City goals, and prioritized accordingly. These reductions are expected to affect City services.

More details on the financial projections and recommended strategies are included in the Financial Forecast report.

Fiscal Impact: The Forecast itself has no direct fiscal impact. However, the strategies that are recommended include significant budget reductions for FY2019, and additional budget reductions and possible revenue increases in FY2020 through FY2023.

Recommendation: Review the attached Financial Forecast in preparation for the presentation by the Mayor and Finance Director on January 8, 2018.

FINANCIAL FORECAST

FY2019 – FY2023

CITY OF
URBANA

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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 national trend towards increasing use of e-commerce, rather than shopping in bricks and mortar stores is increasingly concerning, particularly because 28% of General Fund revenues come from sales tax. Growth in sales tax revenue has not been keeping pace with the rate of inflation. This is a national issue and will require action at the federal level. However, the Marketplace Fairness Act, which would at least begin to address this situation, seems to be stalled. Urbana is not unique in this respect – this is an issue for cities across the United States.

At the same time, the State continues to make decisions that directly affect the City's budget. For FY2018 those decisions included imposing a 2% administrative fee on Home Rule sales tax revenue, diverting 10% of the local government share of income taxes, and diverting a portion of personal property replacement tax (PPRT) revenues. The effect of these changes is a reduction in General Fund revenues of about $500K in FY2018. There is little reason to believe that the impact of the State's fiscal crisis on local governments will not grow in the future.

In addition, the new federal tax bill limits state and local tax (SALT) deductions to $10,000 for property and income tax or sales tax. The current SALT deduction decreases the net cost of taxes, resulting a reduced cost for taxpayers. Reducing this exemption is likely to result in increased pressure on the State Legislature to limit property taxes. It would also limit the incentive for home ownership and, therefore, put downward pressure on home prices, which is likely to reduce growth in assessed value.

On the expenditure side, public safety pension costs are a key driver of expenditures in the forecast. The City must move towards a sustainable path for pension funding or face the inevitable consequence of much higher costs in the future.

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, expenditures will exceed revenues beginning in FY2019. Expenditures will grow faster than revenues, resulting in an increasingly large gap, and accelerating the decrease in fund balance. By FY2022, if not earlier, the fund balance would be exhausted, leaving the City without resources to pay for important City services.

There is significant downside risk in this forecast due to the State's fiscal situation. It 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.

SUMMARY

CORRECTIVE ACTIONS

Putting the City on a path to fiscal sustainability will 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 $2.5 million on a recurring basis, which is about 7.6% of General Fund expenditures. Reductions 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.

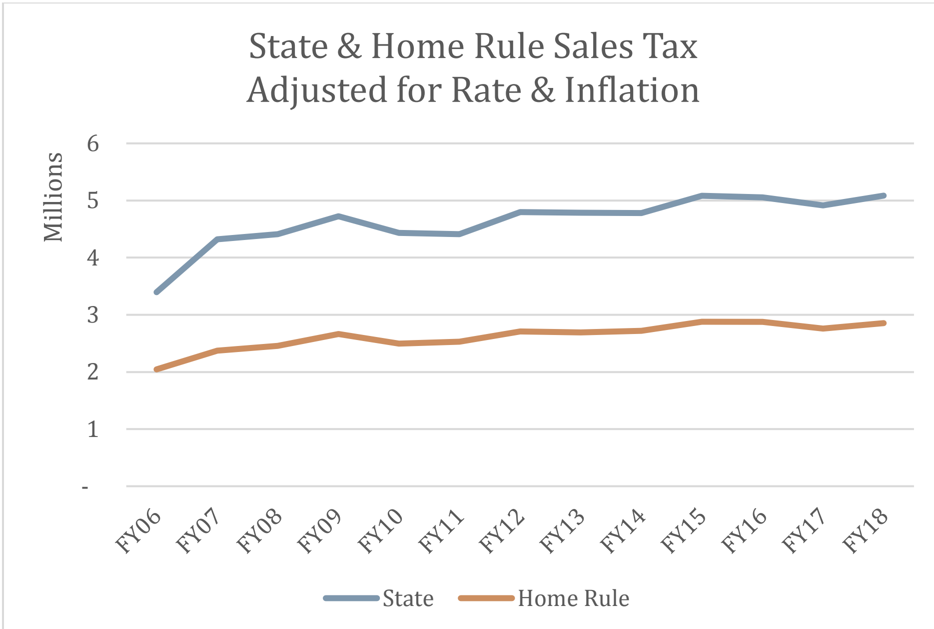
KEY ASSUMPTIONS

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 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

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.

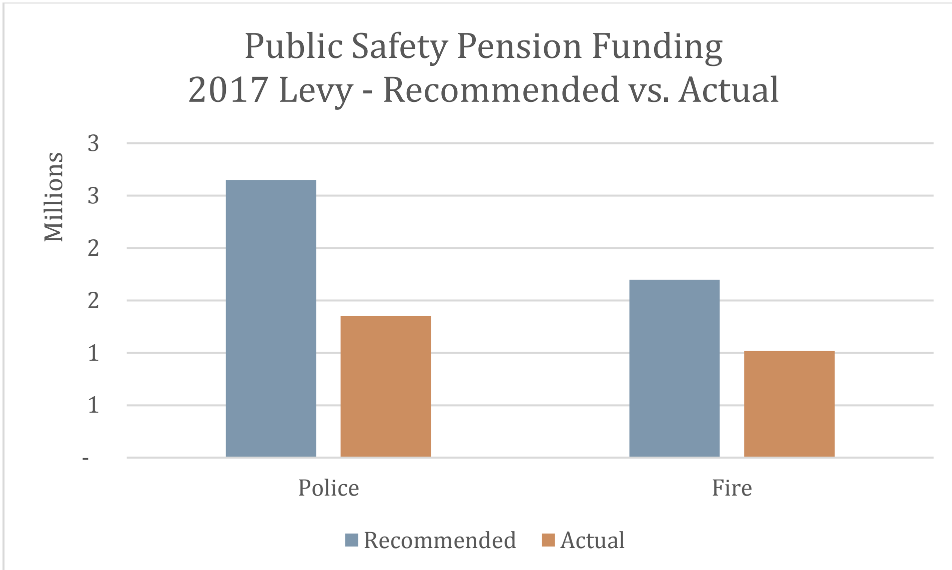


While we have seen modest growth in the past, there has been little growth in sales tax revenues relative to the rate of inflation since FY2015. In FY2017, inflation adjusted State sales tax declined 2.85% and Home Rule sales tax declined by 4.12%. This is very likely related to increasing use of e-commerce, as discussed above. The Likely scenario assumes that growth in sales tax revenues will not keep pace with inflation.

Public Safety Pension Costs

As the City Council is aware, the City is currently funding public safety pensions at the minimum required by State law, and has been funding at this level for several years now. The tax levy for pensions was reduced over two years to this level in order to avoid budget reductions to pay for wage increases. The long-term implications of this decision are concerning. This practice will lead to much higher long-term costs. The following chart illustrates the gap between current pension funding levels and funding based on the previous plan of paying down 100% of unfunded liability by 2033.

METHODS & KEY ASSUMPTIONS



Resolving this issue will likely require increasing the number of years to reach full funding and substantial increases in amount of funding provided by the City on an annual basis. The Likely Scenario assumes that pension funding will be increased by $1.25 million over five years in increments of $250,000. While this adds to the need to reduce other expenditures, if not addressed now, the City will face much higher costs in the future.

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, because the City is actively engaged in collective bargaining, wage assumptions are not detailed in the chart.

METHODS & KEY ASSUMPTIONS

KEY ASSUMPTIONS			
	Likely Scenario	**Best case**	**Worst Case**
Consumer Price Index (CPI-U)	2.25 – 2.5%	2 – 2.25%	2.5 – 2.75%
Construction Cost Index (CCI)	3%, then = inflation	2%	4%
Population	+0.5% annually	Same	Same
Property Tax Rate	$1.355	Same	Same
Assessed Valuation	+2.5% annually	+3.5%	+1.5%
Sales Tax	-1% from inflation	+0.5% from inflation	-1.5% from inflation
Use Tax	+1% from inflation	+2.5% from inflation	-1.5% from inflation
Income Tax	+1% - 2%	+1.5% - 2%	+1% - 2%
Income Tax Reduction	State retains 10%	State does not retain	State retains 10%
User Fees & Licenses	Increase with wages	Same	Same
Building Permits	No increase	No increase	No increase
Health Insurance	4% 2019, then 4.5%	4% throughout	4% 2019, then 5.5%
Police/Fire Pensions	6.5% base increase	5.5% base increase	7.5% base increase
Unfunded Liability (step up over 5 years)	+$1.25M, incremental	+$1M, incremental	+$1.5M, incremental
IMRF	Rate is stable	Rate is stable	Rate is stable
Police/Fire Pensions	+6.5% annually	+5.5% annually	+7.5% annually
Police/Fire Pensions – Unfunded Liability	+$1.25M annually, incremental increases for 5 years	$1M annually, incremental increases for 5 years	$1.5M annually, incremental increases for 5 years
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	$180K annually for 15 years beg. FY2017	Same	Same
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 (such as new positions) for which funding may not be available in the future. However, the City's policy of budgeting recurring expenditures equal to the level of recurring revenue means that even relatively small fluctuations in recurring revenue can result in a budget that is no longer balanced.

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 cushion.

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 **very little chance** that the Best Case scenario will play out, but there is considerable 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

Income Tax. The Likely scenario assumes that the State imposed 10% reduction in the local government share of income tax will continue. While the original legislation imposes this reduction for only one year, it seems very likely that this diversion will become permanent. That diversion reduces General Fund revenues by about $400,000.

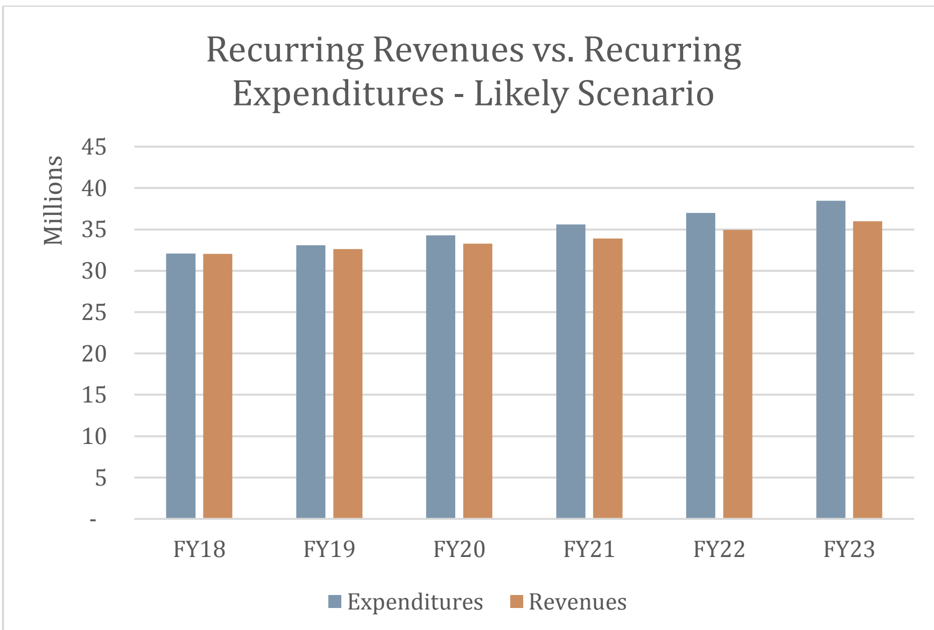
Property Tax. A number of limitations on local government property taxes have been proposed over the last two years. The latest proposal included significant increases in homestead and senior homestead exemptions. This proposal would have reduced General Fund revenue by about $460,000 annually. This reduction is reflected only in the Worst Case scenario.

It seems very unlikely that Illinois cities will escape the upcoming legislative session unscathed. If one or the other of these risks occurs, we will be closest to the Likely scenario. If both occur, we would be on a path closest to the Worst Case scenario.

FORECAST

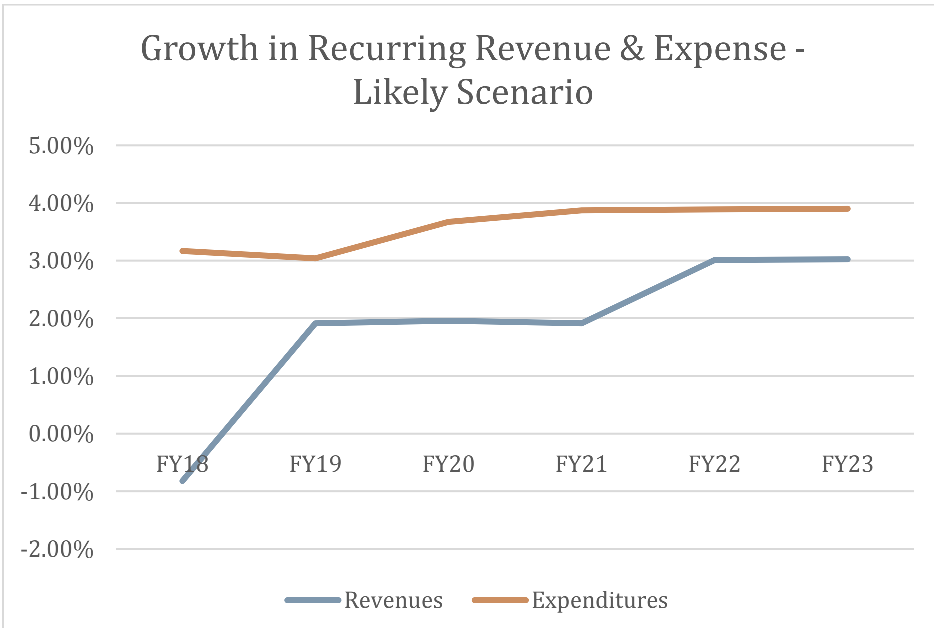
REVENUES & EXPENDITURES

Recurring revenues and expenditures for the likely scenario are depicted on the chart below. As you can see, expenditures exceed revenues beginning in FY2019 and the gap grows larger over time. This indicates that the predicted level of expenditures is not sustainable with current sources of revenue, even in the Likely 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 revenues grow more slowly than expenditures, the City will be in a position of making expenditure reductions on an ongoing basis.

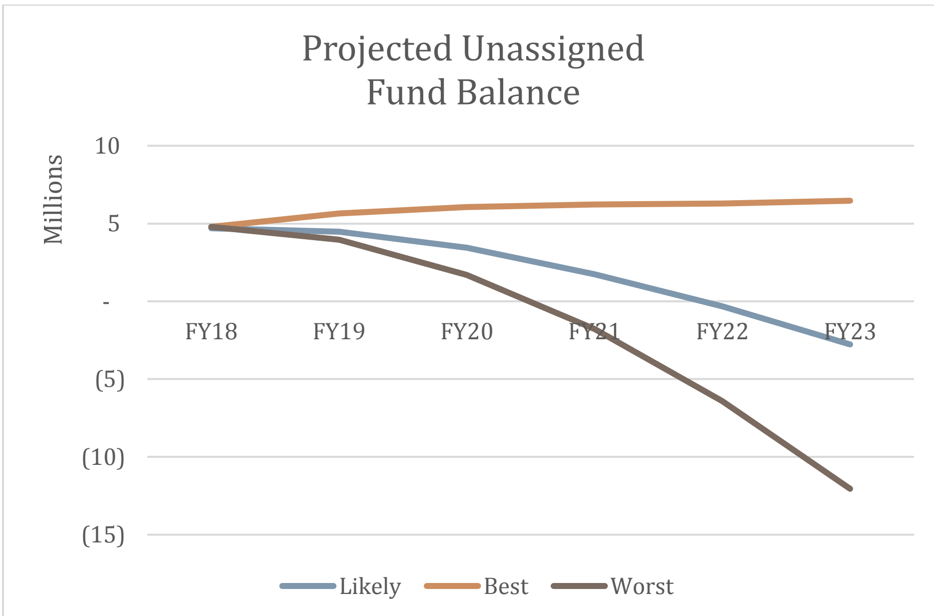


We expect that towards the end of the forecast period, the gap will begin to close. This is due to release of 2020 census data, which will result in an adjustment to the per capita distributions for income, use and PPRT taxes from the State. Urbana is currently experiencing modest population growth of about 0.5% annually, while the State as a whole has seen a slight decrease in population since the last census.

FORECAST

FUND BALANCE

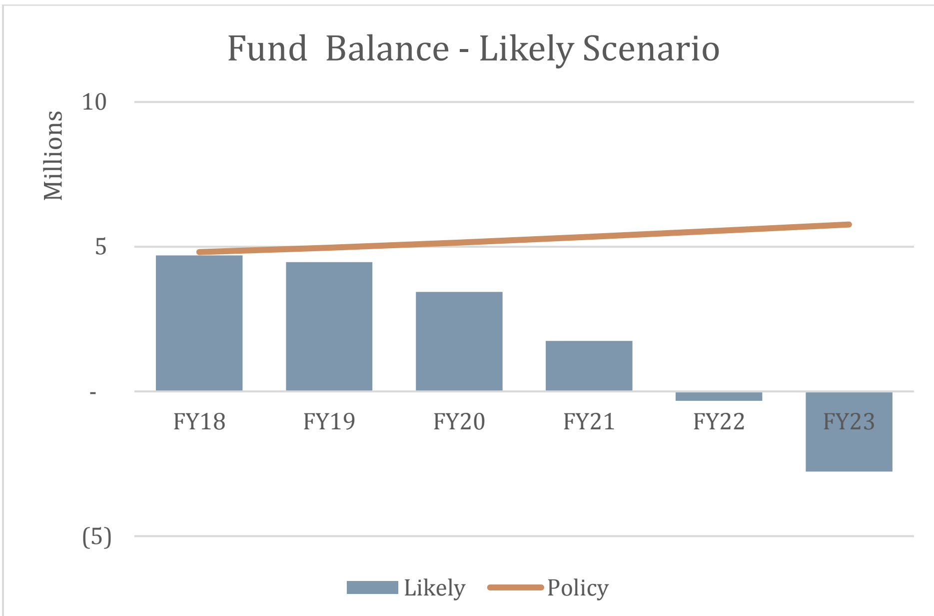
This chart shows that unassigned fund balance will decrease over time in both the Likely and Worst Case scenarios.



In the Worst Case scenario, the decline occurs more quickly. However, even in the Likely scenario, the City would expect to see a deficit in the General Fund in FY2022, without significant adjustments to the budget.

FORECAST

Focusing on the Likely Scenario, you can see that while the City is close to the 15% fund balance goal in the current fiscal year, it declines each year, until (absent any significant budget reductions or revenue increases) the City runs out of cash in FY2022. Based on the magnitude of the problem, it is likely that a combination of expenditure reductions and revenue increases will be required.



As early as FY2019, reserves are below the current 15% policy, which does not allow adequate funds to deal with a Worst Case scenario, or unexpected events such as a natural disaster.

Corrective Action

SIMULATED CORRECTIVE ACTION

There are many options for corrective action. As an example, the following charts illustrate the impact of $1.5 million in expenditure reductions, phased in over three years beginning in FY2019, combined with $1 million in revenue increases, phased in over four years beginning in FY2020. This is not a specific recommendation, but is used to illustrate that with the right timing, some combination of $2.5 million in expenditure reductions and/or revenue increases would likely be adequate, assuming the Likely scenario is reasonably accurate.

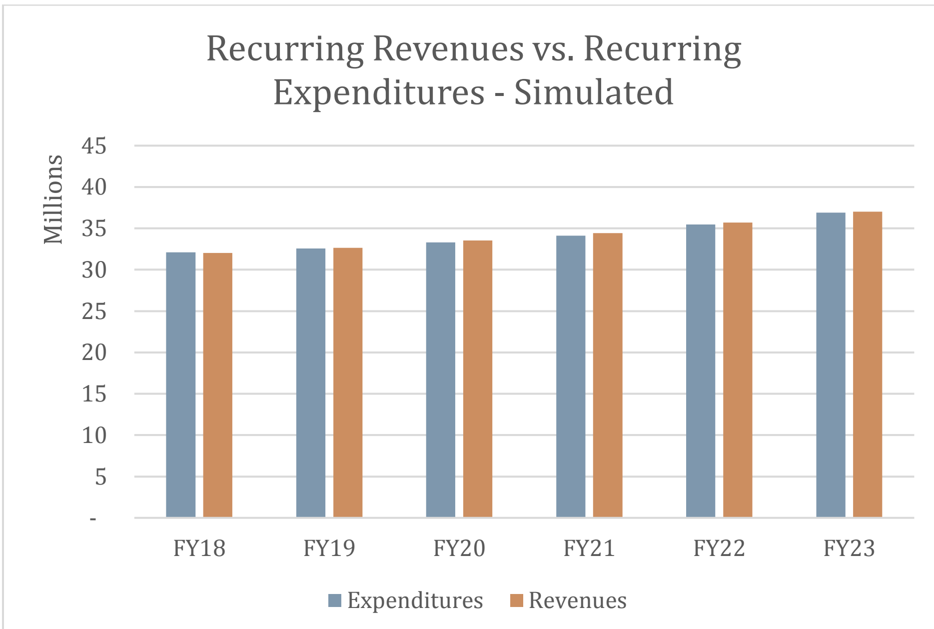
A phased approach is recommended both to allow adequate time to consider options and assess the impact of proposed changes, as well as to take account of changing conditions that may affect future financial forecasts.

The corrective action required to address the Worst Case scenario would be in excess of $6 million, or more than 12.8% of current General Fund expenditures.

CORRECTIVE ACTION

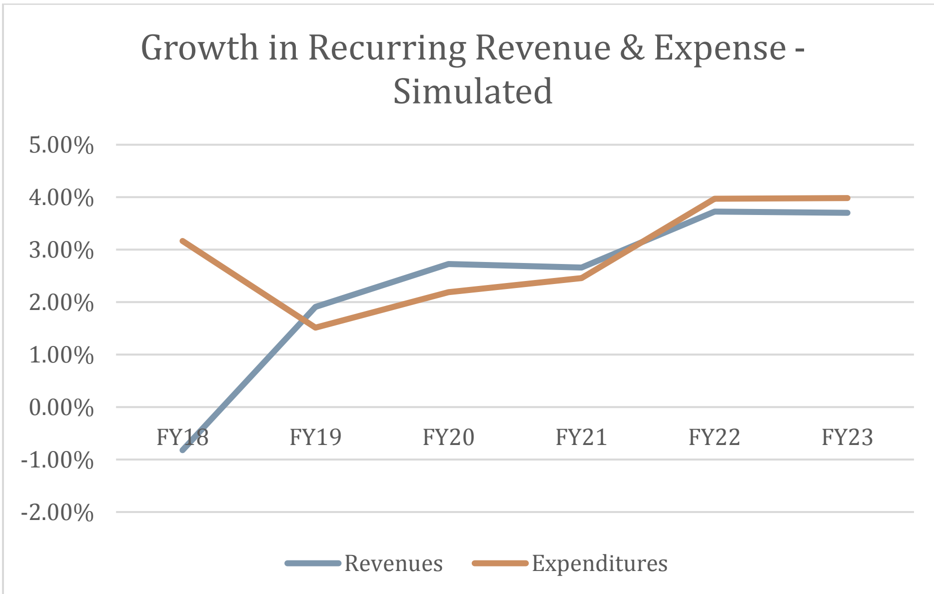
REVENUES & EXPENDITURES

In this simulated scenario, which includes the changes described above, recurring revenues and expenditures are closely aligned, as shown below.



CORRECTIVE ACTION

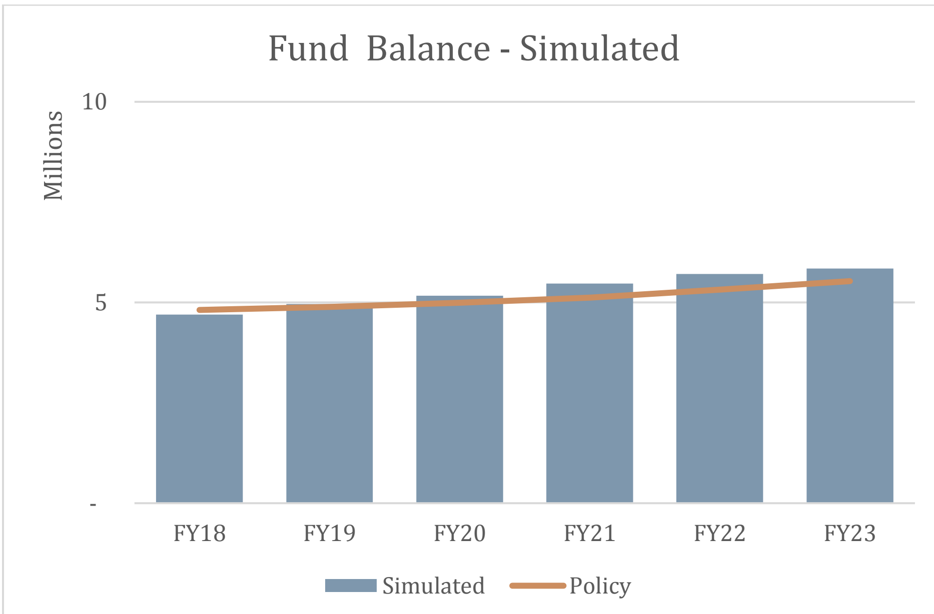
Growth in revenues and expenditures also match more closely with the adjustments described above.



CORRECTIVE ACTION

FUND BALANCE

The following chart shows that, with these changes, fund balance is generally consistent with the current policy of maintaining an unassigned fund balance of 15% of recurring expenditures.



CORRECTIVE ACTION

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.

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 establish a method for accepting suggestions on budget reductions or revenue increases.

2. **Plan for Budget Reductions.** Begin to plan for $500K in budget reductions in FY2019, and $750K in budget reductions or new revenues in FY2020.

    a. Implement a "soft" hiring freeze for all but commissioned police officers and firefighters to minimize the need for layoffs. Other critical positions may be considered on a case-by-case basis.

    b. Offer a second round of voluntary separation incentives (VSIP) after identifying specific cuts, but prior to eliminating positions.

3. **Evaluate Revenue Options.** Evaluate available revenue options, giving priority to sources of revenue that are likely to grow at least at the rate of inflation over time.

4. **Limit Expenditure Increases.** Limit requests for new funding. Focus 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.

5. **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 creating a reserve outside of the General Fund. This will buy time for full evaluation of options and sound decision-making.

CORRECTIVE ACTION

6. **Prepare a Prioritized Inventory of City Services.** Staff is currently developing an inventory of programs funded from the General Operating Fund. Those services will be prioritized in terms of how they contribute to accomplishment of high level Mayor & City Council Goals. The focus of budget reductions will be lower priority programs that contribute less directly to those organizational priorities. This will also tie in to the Council goal setting process, which is expected to take place during the month of February.
7. **Financial Policies – Recurring Expenditures.** Revise financial policies to reflect a target of recurring expenditures budgeted at less than the level of recurring revenues. This will allow for a margin of error in budgeting. This may be difficult to achieve for FY2019, but in the long term, this is a more prudent policy. A level of about 97.5% may be appropriate, given the current structural deficit. (Current policy is 100 %.)
8. **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 is likely not achievable in the short term, but should be adopted as a goal. (Current policy is 15 %.)