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
Don Ho, Financial Analyst

DATE: February 6, 2020

SUBJECT: **Financial Forecast for FY2021 – FY2025**

Introduction: Attached to this memo is the Financial Forecast for FY2021 – FY2025.

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, no expenditure reductions are required in the upcoming budget. 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 recommended strategies are designed to ensure continued financial sustainability.

Recommendation: Review the attached Financial Forecast in preparation for the presentation on Monday, February 10, 2020.

FINANCIAL FORECAST

FY2021 – FY2025

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. The impacts of those decisions relevant to these items are evident in the improved outlook included in this forecast. This forecast assumes that the City will receive no additional revenues from hospital property taxes.

The national trend towards increasing use of e-commerce, rather than shopping in bricks and mortar stores continues to be a concern, because 30% 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 FY2020 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 2021, is increasing, and this would undoubtedly have a negative impact on sales tax and other revenues.

On June 21, 2018, the United States Supreme Court (USSC) overturned prior precedent in South Dakota v. Wayfair. The court ruled that individual states have the authority to implement laws that require remote retailers to collect and remit taxes to the state where the purchaser lives. The manner in which these taxes filter through to cities is detailed in the Sales Tax Trends section of this report.

State diversion of local government revenue continues to affect the forecast. The State imposes a 1.5% administrative fee on Home Rule sales tax revenue and diverts 5% of the local government share of income taxes. This results in a reduction in General Fund revenues of about $250K in FY2021. Given the magnitude of the State's fiscal crisis, there continues to be a possibility that diversions may increase 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 (based on current City policy) from 11.88% for 2020 to 15.08% for 2022. Over the five-year period, IMRF contributions are expected to increase by $125,000 on a recurring basis, after accounting for both wage increases and changes in the contribution rate.

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.

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

Looking ahead, it is likely that recurring expenditures will not exceed the policy goal of 98.5% of recurring revenues by FY2025, which is positive. In the longer term, however, expenditures will continue to grow faster than revenues. Economic development, which could lead to faster growth of revenues, is critical in solving this issue.

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 have a negative impact.

RECOMMENDED STRATEGY

Several years ago, staff identified a need to make budget adjustments totaling $2.5 million by reducing recurring expenditures and/or increasing recurring revenues. Since then, the City has made many difficult decisions to achieve this goal, including multiple budget reductions and selected revenue increases. Significant adjustments were made in the FY18, FY19, and FY20 budgets to address the structural budget deficit, restore adequate public safety pension funding, and rebuild General Fund reserves.

With the leadership of the Mayor and the support of City Council, the City is now heading into FY21 in better shape financially than we have been for the last 5 years. Assuming no major changes in our forecast assumptions, no additional budget reductions or additions are recommended for the near future. This is largely due to the approval of new revenue increases by the City Council in FY20.

Because expenditures continue to grow more slowly than revenues over the forecast period, we need to exercise constant vigilance. For most of the period of this forecast, we have solved the immediate disparity between revenue and expense growth, but a recurrence of the structural imbalance looms on the horizon. Economic development remains a critical solution to this challenge over the long term, which is why the commencement of our efforts to rewrite the Comprehensive Plan and develop a true economic development strategy are essential.

In the coming weeks, the City Council will be asked to consider increasing the General Fund minimum fund balance from 15% to 20% of recurring expenditures and decreasing the Vehicle and Equipment Fund (VERF) funding level from 90% to 85%. The goal of these changes is to enhance the resilience of our financial situation.

METHODS & KEY ASSUMPTIONS

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 –

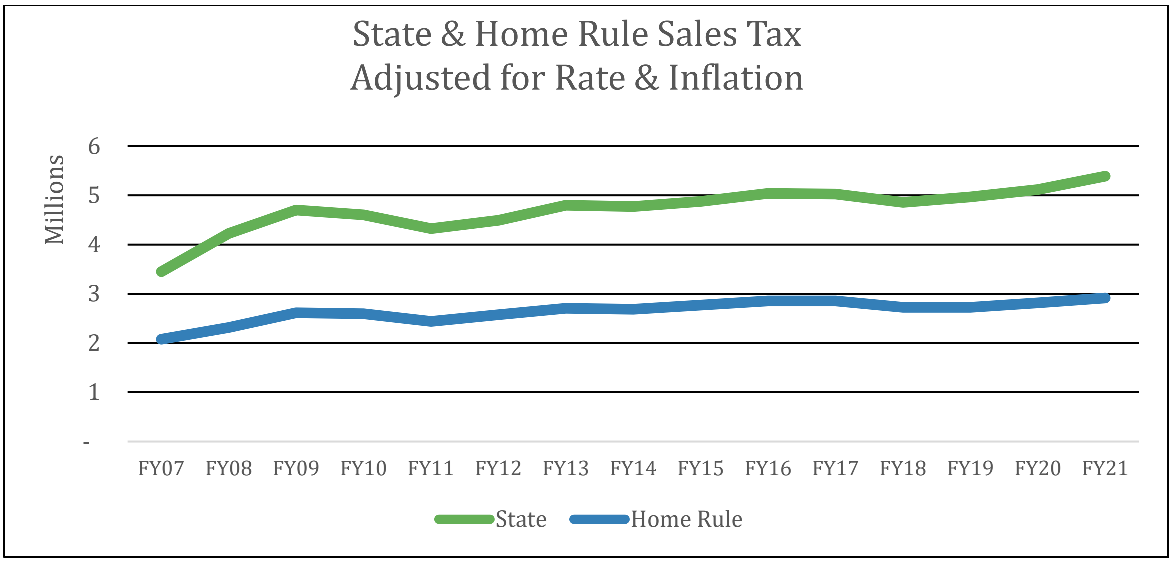
- the City will maintain reserves in the General Fund of at least 15% of recurring expenditures
- recurring expenditures will not exceed 98.5% of recurring revenues
- the City will maintain a stable property tax rate, which is currently $1.3499 per $100 of assessed valuation (long term goal is a rate 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, beginning with the 2018 tax levy

One exception is that the Likely scenario assumes the VERF funding policy will be modified as described below.

METHODS & KEY ASSUMPTIONS

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 30% of General Fund revenues. The following chart shows both State and Home Rule sales tax revenue over the past 15 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. While much of the slow growth 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. In FY2019, inflation-adjusted State sales tax grew by 2.38% and Home Rule sales tax increased by only 0.06%.

The projection for FY2020 is about 3% higher than FY2019 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.

The State started collecting the use tax related to remote sales in October 2018. While the required collection of the state's use tax on certain remote sellers was a step in the right direction, use tax fails to fully level the playing field between brick-and-mortar retailers and their online counterparts. It also does not allow municipalities to collect any locally-imposed sales taxes on e-commerce products being used or consumed in their communities.

The “Leveling the Playing Field for Illinois Retail Act” was signed into law by Gov. Pritzker on June 28, 2019 to require both remote retailers and marketplace facilitators (companies that provide marketplaces for third party retailers) to collect and remit the state and locally-imposed Retailers’ Occupation Tax (sales tax), provided they meet certain thresholds.

Marketplace Sales by Illinois Retailers. Currently, marketplace facilitators are required to collect state and local sales tax on marketplace sales made by Illinois retailers, based on the origin (the local retailer’s location). If, for example, for products shipped from a warehouse located in Illinois, the sales tax is remitted to the community where the shipment originates.

Marketplace Sales by non-Illinois Retailers. On July 1, 2020, marketplace facilitators will also be required to collect state and locally-imposed sales taxes on all marketplace sales by non-Illinois retailers based on the destination (the shipped-to location or the pick-up location). Currently, those sales are subject only to the use tax.

Retailers with Physical Presence in Illinois. Retailers that have a physical presence in Illinois and do not sell through a marketplace will see no change in how their sales tax is collected. For example, if a community has a local retailer that ships products to Illinois customers, that sales tax will still be determined at the origin of the sale.

Retailers with No Physical Presence in Illinois. If a retailer does not have a physical presence in Illinois, the tax will be based on destination, beginning July 1, 2020. Those sales are currently subject only to use tax.

Summary of Other Assumptions

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

METHODS & KEY ASSUMPTIONS

KEY ASSUMPTIONS			
	Likely Scenario	**Best case**	**Worst Case**
Consumer Price Index (CPI-U)	2.2%	2%	2.4%
Construction Cost Index (CCI)	2% CY20, then 2.9%	2% CY20, then 2.5%	2.5% CY20, then 3.25% forward
Population	0.5%	Same	Same
Property Tax Rate	$1.3499	Same	Same
Hospital Property Taxes	No	No	No
Assessed Valuation Base	+3% annually	+4% annually	+2% annually
Sales Tax	2.2%	2.7%	1.2%
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
Police/Fire Pensions - Revenue	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy	Actuarial estimates – new funding policy
IMRF Rate	11.88% for CY20, increase 1.6% for 2 years	Rate levels out after CY2021	Rate increases by 1.6% for 3 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 FY21, then inflation	Inflation + 1%
Capital Improvement Transfers	Increase by CCI	Increase by CCI	Increase by CCI
VERF Transfers	+2% annually, 85% funding level	+1.5% annually, 85% funding level	+2.5% annually, 90% funding level
Underspending	2% below budget each year of forecast	Same	Same
Cannabis Sales	$7.5M	$10M	$5M

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 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 at least 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 continue to divert municipal revenues and impose restrictions on the ability of local governments to raise revenue through property taxes, whether through tax caps or increases in property tax exemptions.

Staff believes that it is unlikely 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

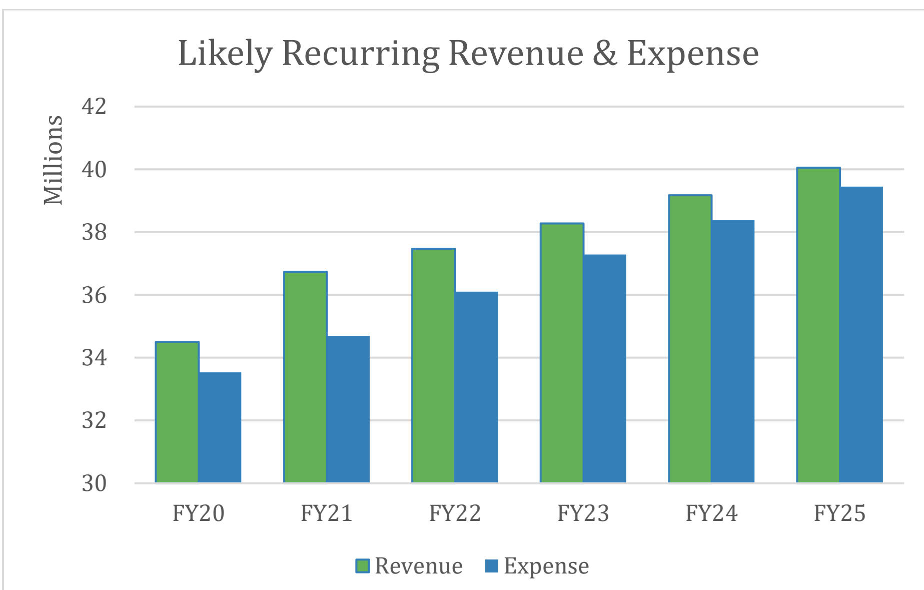
Recession. A recession may occur within the next couple of years. This is reflected in relatively slow growth in sales tax revenues and, in the Worst Case, scenario, no growth in base equalized assessed valuation (EAV) from 2022 through 2025.

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.

Sales & Use Tax. The impact of the "Leveling the Playing Field for Illinois Retail Act" on sales and 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 City will receive less use tax and more sales tax. Use tax will decrease by as much as $195,000 annually and sales tax will increase by as much as $300,000 annually from this decision.

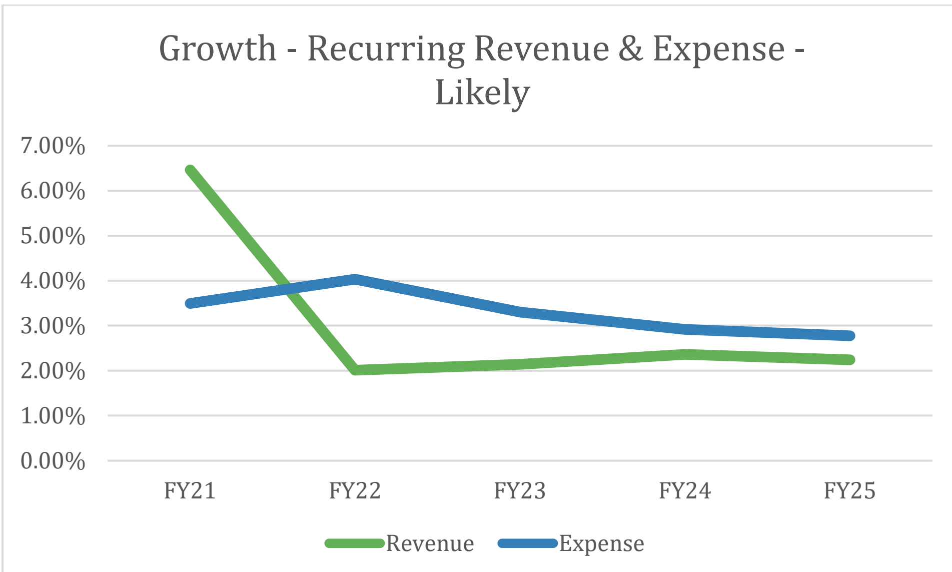
REVENUES & EXPENDITURES

Recurring revenues and expenditures for the Likely scenario are depicted in the chart below. As you can see, revenues exceed expenditures from FY21 to FY25, which is positive. However, the gap grows smaller over time. This indicates that the predicted level of expenditures may not be sustainable with current sources of revenues in the longer term.



FORECAST

As show below, the rate of growth in recurring expenditures outpaces the rate of growth in recurring revenues starting FY22. In FY21, recurring revenues are higher than recurring expenditures because of revenue increases that were approved by City Council in FY20. 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.



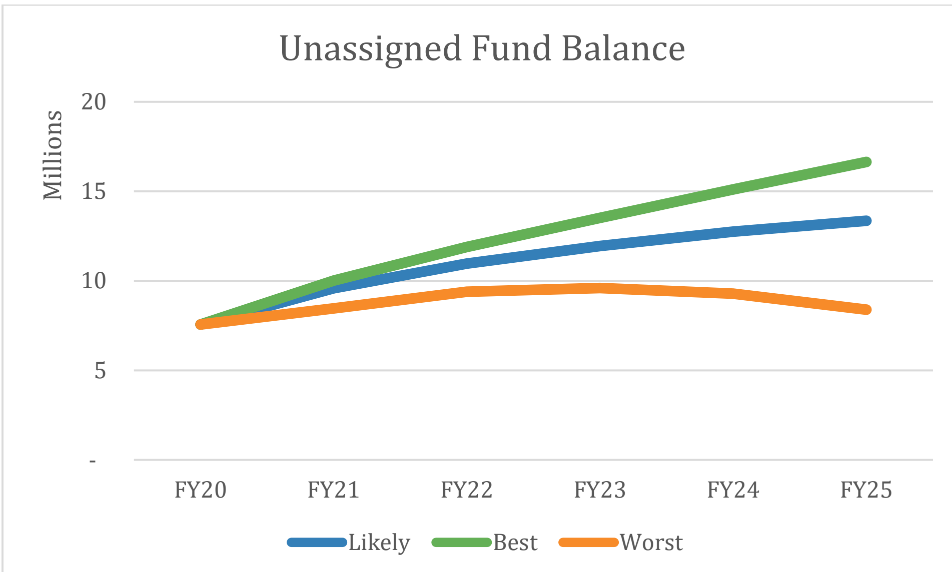
Our goal is to close the gap between growth in recurring revenue and recurring expenses. We expect that towards the end of the forecast period, the gap will begin to close. This is due in part to release of 2020 census data, which will result in an adjustment to the per capita distributions for income, use and Personal Property Replacement 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. Revenue growth in FY21 is unusually high, due to revenue increases recently approved by the City Council. In FY22, growth returns to a more normal level.

FORECAST

FUND BALANCE

This chart shows that unassigned fund balance will increase over time in the Best and Likely Scenarios and will decrease over time in the Worst Case scenario.

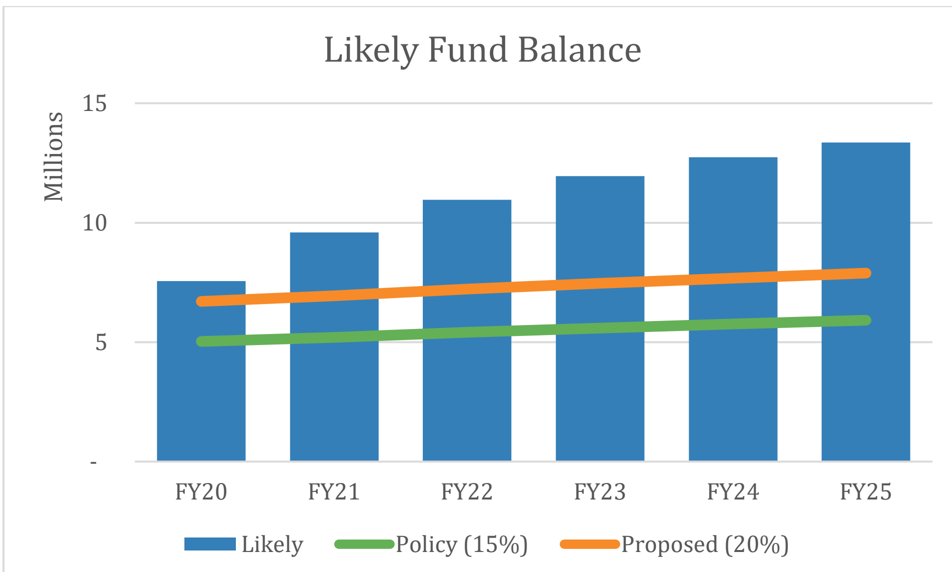


In the Likely scenario, the City would expect to be above the current policy goal, without significant adjustments to the budget. However, there is a high possibility that it will start declining after FY25.

FORECAST

Focusing on the Likely Scenario, the fund balance is expected to exceed the 15% fund balance goal throughout the forecast period and increase each year after FY2020.

In addition, it is quite likely that the 15% minimum balance level is not adequate to deal with a Worst Case scenario or an unexpected event such as a natural disaster. Staff therefore recommends increasing the minimum fund balance to 20% of recurring expenditures.



Any excess fund balance would most likely be allocated to one-time expenditures.

Recommended Strategy

A clear plan is important to provide a foundation for decision-making. In particular, decisions about adding new recurring expenditures will be informed by the plan. In fact, 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, given the State's fiscal condition, it is prudent to guard against the Worst Case scenario.

The following actions are recommended –

1. **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.
2. **Update the Current Financial Policies**:
   a. Fund Balance: Consider revising the policy on fund balance to provide for a larger minimum fund balance as a percent of recurring expenditures (current policy is 15%). A minimum of 20% to 25% would be appropriate, based on guidelines provided by the Government Finance Officers Association (GFOA). A minimum of 20% appears to be achievable in FY21.

   b. Vehicle & Equipment Replacement Fund (VERF) Funding Policy: Consider lowering the funding from 90% to 85%. After extensive analysis, staff concluded that 85% funding level is sustainable and will not require the City to issue debt.
3. **Limit Expenditure Increases.** While some new funding for current programs and services will be possible, we will limit requests for new funding. The focus will be on one-time expenditures to meet critical needs. Any new recurring increases would need to be offset with additional recurring revenues or reductions in other expenditures.
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.

RECOMMENDED STRATEGY

5. **Assess Opportunities to Use Alternate Methods of Service Delivery.** Staff will continue to explore 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.