CITY OF URBANA, ILLINOIS
HUMAN RESOURCES &
FINANCE DEPARTMENT

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

DATE: October 8, 2020

SUBJECT: **Financial Forecast for FY2022 – FY2026**

Introduction: Attached to this memo is the Financial Forecast for FY2022 – FY2026.

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.

This forecast is being provided earlier than usual because of the need to assess the impact of COVID-19 and the related recession on the City' finances.

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, October 12, 2020.

FINANCIAL FORECAST

FY2022 – FY2026

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. While we certainly know more than we did when this began, it is still unclear when a vaccine will be available and how quickly the economy will recover. Economic recovery is, in large part, dependent on how risk averse consumers are as we move into recovery.

The pandemic and resulting slow-down in economic activity have affected a wide variety of revenues including State and Home Rule sales tax, hotel/motel tax, food & beverage tax, video gaming taxes, and parking fines. In addition, the lack of current data on sales tax revenue, which is collected by the State, makes forecasting even more difficult.

The pandemic has accelerated the national trend towards increasing use of e-commerce. At the same time, changes in State law that attempt to level the playing field between online, and bricks and mortar retail were fully implemented on July 1, which should soften the impact.

FINANCIAL FORECAST: FY2022-FY2026

State diversion of local government revenue becomes increasingly likely as the State is also seeing widespread financial impacts. While the income tax diversion was eliminated for FY2021, the Worst Case scenario assumes the State will, once again, begin diverting 10% of the local government share of income taxes. If the constitutional amendment allowing a graduated income tax is not approved, legislators may consider this a more palatable option than increasing income taxes for all Illinois residents.

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.
- This year, the forecast is being provided earlier than usual, which means less data is available on current year financial performance. Because of that, results may diverge further from the forecast level than they have in recent years.
- The path to recovery from the pandemic and recession is very unclear at this point, and that is not likely to change until we have a clear timeline for a vaccine.

SUMMARY OF LIKELY PATH

The City finished FY2020 with a larger than expected fund balance, which provides flexibility. However, this would diminish over time and fall below the 20% policy goal around the end of FY2023. 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 trend must be reversed. If a recovery is prolonged, expenditure reductions or revenue increases will be required. Economic development, which could lead to faster growth of revenues, is critical in addressing this issue.

There is significant downside risk in this forecast due to the uncertain time for a vaccine and economic recovery, and the State's fiscal condition. Income tax diversion to the State's coffers is a real possibility. 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 FY2021 in better shape financially than at any time in recent years. This allows us the option of taking time to get a better understanding of the timeline for distribution of an effective vaccine, which is key to the economic recovery.

No budget reductions or revenue increases are required to maintain current services this fiscal year. However, we should plan for budget reductions and 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.

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 beginning in FY2023.

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 maintain reserves in the General Fund of at least 20% of recurring expenditures; this allows flexibility in responding to emergencies or unexpected events
- 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

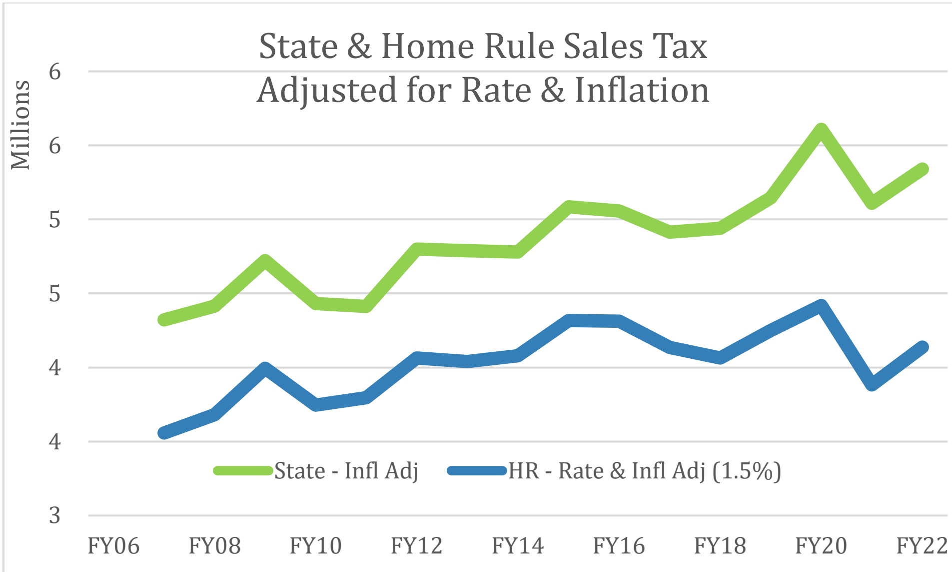
Due to the current recession, the City will likely not be in compliance with the policy of maintaining recurring expenditures at no more than 98.5% of recurring revenues for the duration of the forecast period. The path forward will require spending down fund balance to bridge the gap from recession 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.

Impact of COVID-19

COVID-19 and the resulting recession have had a significant negative impact on City finances. In addition to the Governor's Stay-at-Home (SAH) Order and phased recovery plan, consumers are faced with a degree of uncertainty that is unprecedented in recent years. Both the timing of widespread distribution of an effective vaccine and the level of consumer risk aversion will play a significant role in the economic recovery. This forecast assumes that a vaccine will be available and widely distributed before the end of calendar year 2021. However, after well over a year of modified behavior, consumers may be cautious about returning to normal behavior and spending patterns.

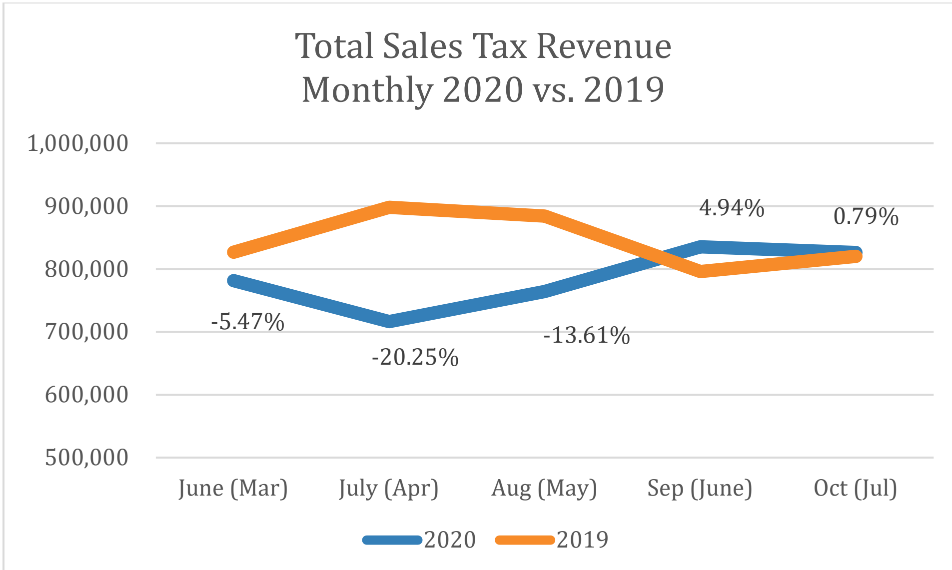
Sales Tax Trends

Long-term revenue trends are an important consideration in developing the forecast. Sales tax trends are of particular interest because they make up nearly one-third of General Fund revenues. The following chart shows both State and Home Rule sales tax revenue over the past 17 years, adjusted for both changes in the Home Rule sales tax rate and inflation.



In FY2019 and FY2020, sales tax revenue grew at a healthy pace, even when adjusted for inflation. "Real" (inflation adjusted) growth for State sales tax was 4.13% in FY2019 and 9% in FY2020. Real growth for Home Rule sales tax was 4.57% in FY2019 and 3.97% in FY2020. This is in contrast to the period from FY2015 through FY2018, when there was little growth in sales tax revenues relative to the rate of inflation. While some of the slow growth was driven by the State's collection fee on Home Rule sales tax, the overall trend was driven by increasing use of e-commerce.

The following chart shows total unadjusted sales tax revenue (State and Home Rule combined) for June through October 2020, which corresponds to sales made in March through July. This clearly illustrates the impact of the pandemic.



The chart above illustrates significant decreases in sales tax revenue beginning in June, which corresponds to the issuance of the Stay at Home (SAH) Order mid-March. The lowest month is a 20% decrease in July, compared with the same month in 2019. This corresponds to sales in April, which was the first full month of the SAH Order. We saw improvement in August, September, and October, reflecting sales in April, May, and June, as consumers adjusted to the new landscape. (Part of the increase over prior year in September revenue may be due to late sales tax payments that were actually due in earlier months.) The move to Phase 3 in late June, however, does not seem to have resulted in significant, additional improvement as October revenues, tied to July sales, were nearly even with the same month last year.

FY2021 unadjusted revenues are expected to decrease by about 7.8% for State sales tax and 11.1% for Home Rule tax, rebounding by 4.5% and 6.6%, respectively in FY2022. This significant rebound would still leave revenues lower than the FY2020 level, and revenues are not expected to reach the FY2020 level again until FY2023. The FY2021 decreases would be even worse, if not for sales of adult use cannabis.

Multiple changes in laws pertaining to sales tax collection also affect revenues. 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 failed to fully level the playing field between brick-and-mortar retailers and their online counterparts. It also did 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. 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, products are 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 were also 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). Previously, those sales were 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 remit tax based on the origin of the sale. For example, the City receives taxes from an Urbana business selling to a customer in Illinois.

Retailers with No Physical Presence in Illinois. If a retailer does not have a physical presence in Illinois, the tax is based on destination. This change was effective July 1, 2020. Those sales were previously subject only to use tax.

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 $750,000 from the General Fund will likely be required to supplement reserves.

Other Significant Expenditures

Some other expenditures are anticipated in the forecast related to the following –

1. using savings from a reduction in police staffing for One Door or a similar program
2. additional expenditures related to the pandemic to facilitate remote work, or for other essential supplies and services required in relation to COVID
3. additional spending for the proposed police records management system

FINANCIAL FORECAST: FY2022-FY2026

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 for health insurance rates.

KEY ASSUMPTIONS			
	Likely Scenario	**Best Case**	**Worst Case**
Indicators			
Consumer Price Index (CPI-U)	1.9% through FY24, then 2.03%	1.37%	2.5%
Construction Cost Index (CCI)	1.98% CY20, then 2.79% thereafter	2.5% CY20, then 2.5% thereafter	3% CY20, then 3.25% thereafter
Population	2020 census 42,214	Same	Same
Property Tax Rate	$1.3499	Same	Same
Assessed Valuation Base	+3% annually	+4% annually	+2% annually
Revenues			
Home Rule Sales Tax	10% decrease through Sep 2021, 5% through Mar 2022, then flat, Baseline FY23, 2% increase beginning FY24	Same, except 2.5% annual increases beginning FY24	Same, except 1% annual increases beginning FY24
State Sales Tax	8% decrease through Sep 2021, 3% through Mar 21, then flat, Baseline FY23, 2% increases beginning FY24	Same, except 2.5% annual increases beginning FY24	Same, except 1% annual increases beginning FY24
CARES Act / CURES Funding	$1.7M in FY21, no new expense	$1.7M in FY21, no new expense	$1.7M in FY21, no new expense
State Gaming Tax	Up 3% over baseline, beginning with Nov 2020 revenues, increases by 2% annually beginning FY23	Up 5% over baseline beginning Nov 2020, 3% beginning FY22	Shut down Nov 2020 through February 2021, then increases by 2% through Jun 2022, 1% beginning FY23
Hotel / Motel Tax	Down 50% through Jun 2021, down 25% through Dec 2021, down 15% through Jun 2022, baseline FY23, then grows by 3% annually	Down 40% through Jun 2021, down 25% through Dec 2021, down 10% through Jun 2022, baseline FY23, then grows by 5% annually	Down 60% through Jun 2021, down 35% through Dec 2021, down 20% through Jun 2022, baseline FY23, then flat

FINANCIAL FORECAST: FY2022-FY2026

KEY ASSUMPTIONS			
Food & Beverage Tax	Down 10% through Jun 2021, except Nov 21 – Feb 21 down 25%, down 5% FY22, FY23 baseline, plus 2% growth beginning FY22	Down 10% through Jun 2021, except Nov 21 – Feb 21 down 20%, down 5% through Dec 21, flat Jan – Jun 22, FY23 baseline, plus 5% growth beginning FY22	Down 20% through Jun 2021, except Nov 21 – Feb 21 down 30%, down 15% through FY22, FY23 baseline, then flat
Liquor Licenses	2x normal in FY21 due to delayed renewals, flat on new baseline FY22, then grows by 2% annually	Same FY21, 10% increase FY22, then grows by 5% annually	Same FY21, then 10% decrease FY22, then grows by 1% annually
Use Tax	$37.50 per capita FY21, then grows by 2.5% annually	Same, then grows by 3% annually beginning FY22	Same, then grows by 2% annually beginning FY22
Income Tax	$98 per capita FY21, flat FY22, then +2%	+2.5% beginning FY23	Decrease 5% in FY22, +1.75% beginning FY23
Income Tax Reduction	State retains 0%	State retains 0%	State retains 10% beginning FY22
User Fees & Licenses	Flat FY22, then increase with wages	Same	Same
Notices to Appear & Ordinance Violation Fines	Significant decreases as fewer violations are written, recovers in FY23	Same	Same
Building Permits	Flat FY22, then increase 5% annually	5% increase FY22, then 10% annually	Flat FY22 & FY23, then increase 5% annually
Police/Fire Pensions – Property Tax Revenue	Actuarial estimates, based on policy	Actuarial estimates, based on policy	Actuarial estimates, based on policy
Expenditures			
IMRF Rate	11.88% for CY20 and 11.66% for CY21, then increase 1.6% for 2 years, then levels out	Rate levels out after CY2021	Rate increases by 1.6% for 3 years, then levels out
COVID-related Expense not reimbursed	$250K	$150K	$350K
Police/Fire Pensions – Expense / Contributions	Actuarial estimates, based on policy	Actuarial estimates, based on policy	Actuarial estimates, based on policy
Supplies & Services	Inflation	0% in FY22, then inflation	Inflation + 1%
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	$750K FY22	$500K FY23	$1M FY22
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 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 20% of recurring expenditures provides a significant buffer, but in the long term a policy of 25% may be more appropriate.

RISK ASSESSMENT

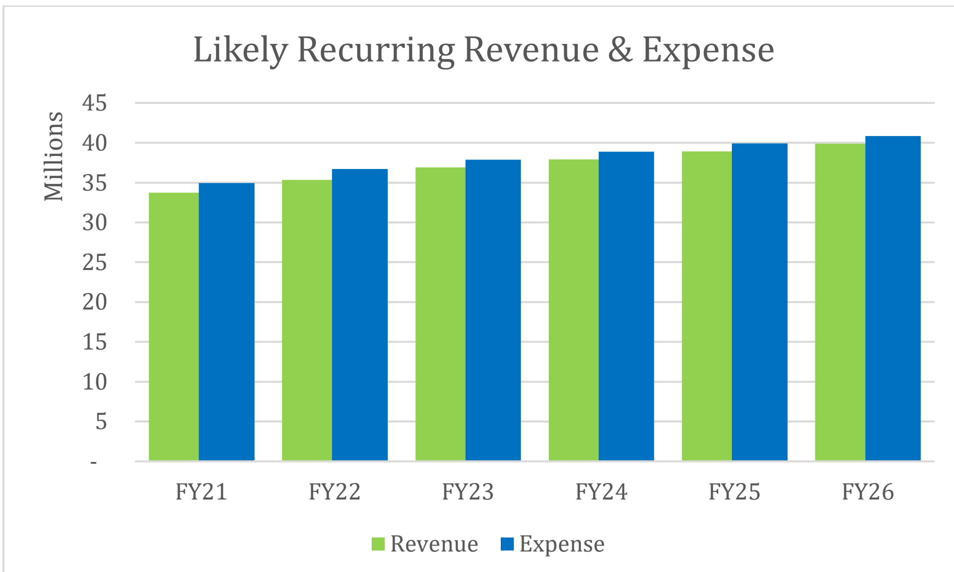
Because of the current pandemic and recession, there is considerable risk inherent in this forecast. This is unprecedented in recent history.

While the Likely scenario is based on assumptions that staff feels are most probable, there is 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, either through tax caps or increases in property tax exemptions, particularly if the constitutional amendment for a graduated income tax rate is not approved by voters.

FINANCIAL FORECAST: FY2022-FY2026

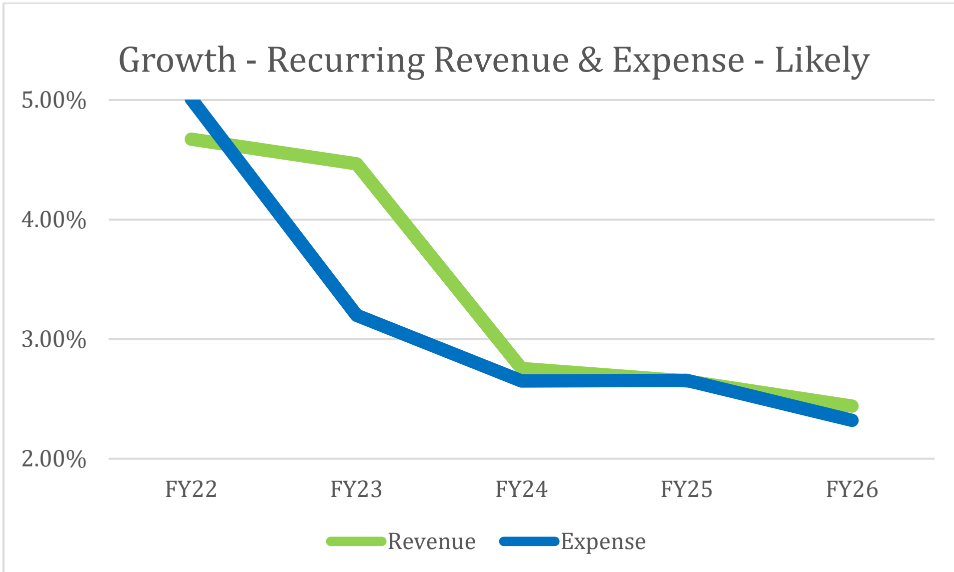
REVENUES & EXPENDITURES

Recurring revenues and expenditures for the Likely scenario are depicted in the chart below. Expenditures exceed revenues for each year from FY21 to FY26. 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 over the next year until there is more certainty.



As shown below, revenues grow relatively quickly in FY2022 and FY2023, as we see the bounce back from the recession. Ultimately, this is not enough to reverse the overall trend of recurring expenditures exceeding recurring revenues and the gap remains.

FINANCIAL FORECAST: FY2022-FY2026

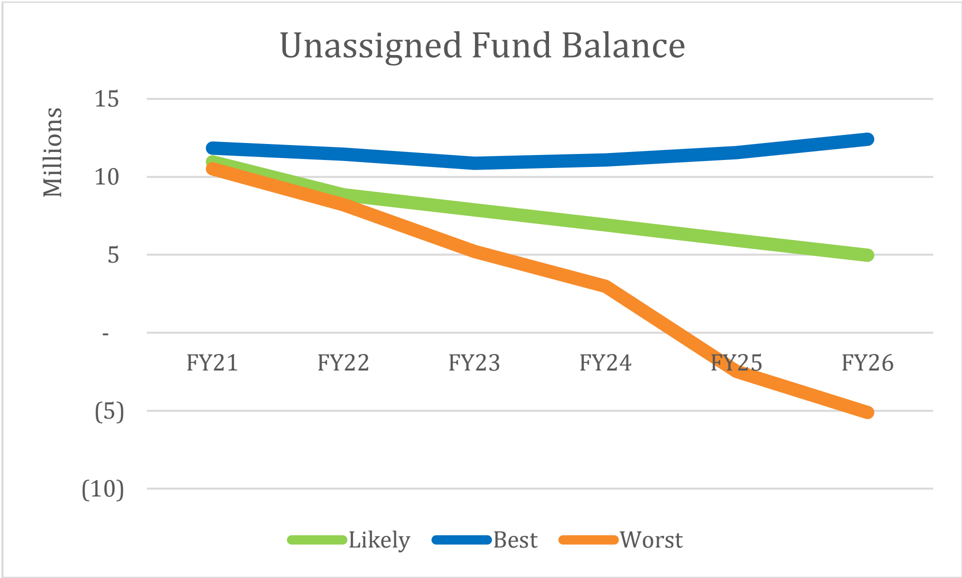


During this period, the release of new census data and incorporation of that data into the formula for distributing state-shared revenues also contributes to revenue growth in FY2023.

Increased development activity would also contribute to the closing gap, and additional, sustained development activity is the best option for eliminating this structural deficit.

FUND BALANCE

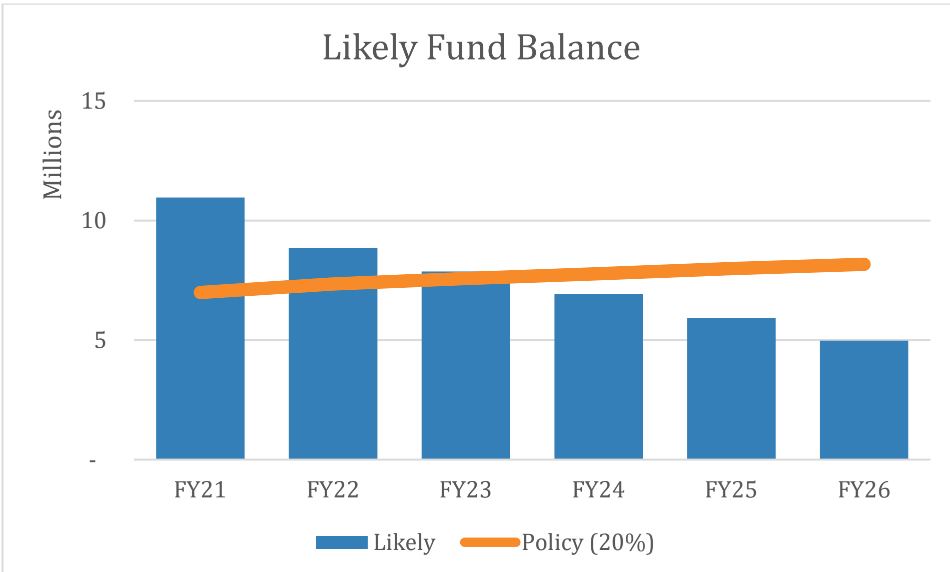
This chart shows that unassigned fund balance will decrease over time in the Likely scenario. In the Best Case, fund balance remains relatively stable, while in the Worst Case, reserves could be exhausted by sometime in FY2024. Of course, this will not occur because we would either reduce expenditures or increase revenues well before that point.



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.

FINANCIAL FORECAST: FY2022-FY2026

In the Likely scenario, the fund balance is expected to exceed the 20% fund balance goal through FY2023. However, if the trend is not reversed, fund balance could dip to about 12% by the end of FY2026.



Because of this trend, we should be extremely cautious about adding new, one-time expenditures, or considering new, recurring expenditures. Every item added to the budget potentially requires additional reductions down the line. Ideally, new expenditures would only be approved in conjunction with corresponding decreases.

Recommended Strategy

A clear plan is important to provide a foundation for decision-making. In particular, decisions about adding new 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. **Make Economic Recovery for Local Businesses a Priority.** Supporting local businesses during and after the pandemic and recession will underpin our local economic recovery.
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. **No New Expenditures.** No new expenditures (either one-time or recurring) should be added to the budget until we are certain that a recovery is underway and have a forecast that supports that. Any necessary expenditure increases should be offset with expenditure reductions elsewhere in the budget.
4. **Prepare for Expenditure Reductions or Revenue Increases.** Staff should begin to prepare contingency plans for expenditure reductions and revenue increases to be used if needed after the forecast is updated in fall 2021.
5. **Accelerate Next Financial Forecast.** The next financial forecast should be accelerated to fall in 2021. By that point, we can expect to have much more clarity on progress on a vaccine and economic recovery from the recession.
6. **Rebuild Reserves.** While spending down fund balance is necessary in the short-term, once a recovery is underway, we should focus first on rebuilding reserves in the General Fund.