



MEMORANDUM

To: David Ramsay, City Manager

From: Tracey Dunlap, Director of Finance & Administration

Date: September 22, 2008

Subject: Issue Paper – Longer-term Budget Strategy Discussion

Background

At the budget study sessions in May 2008, the City Council requested some information to begin a discussion on longer-term budget strategies that might be useful in planning for the future. This issue paper is intended to provide “food for thought” on this topic, which is expected to be discussed in greater detail as part of the March 2009 City Council Retreat.

It is important to recognize that the City has in place a number of policies that helped prepare for the current downturn, so that immediate drastic action was not required when the downturn began in early 2008. These policies allow for a more measured strategy to respond to the downturn:

- “Banked” property tax capacity – The City Council did not implement all of the property tax increases available to them in past years. While much of this banked capacity was used in 2006 to fund public safety service enhancements, the remainder (about \$145,000 per year) is available for use toward the budget gap. Note that the framework for balancing the 2009-2010 budget assumes that this remaining banked capacity will be used.
- Set aside reserves – The City has two reserves specifically for use in the current circumstances:
 - The Revenue Stabilization reserve is established to “address temporary revenue losses due to economic cycles or other time-limited causes”, and
 - The General Fund Operating Contingency is also available “to provide funding for unforeseen expenditure needs for general city programs.”
- Budgeted conservatively – A number of the assumptions embedded in the budget are conservative, such as the assumption that all staff positions are filled, sales tax receipts are budgeted on a one-year lag, etc.
- Implemented an economic development program – The City has actively pursued economic development opportunities in recent years with the intent to strengthen and diversify the City’s commercial base.

While a future downturn cannot be avoided, it can be planned for by continuing to be prepared and pursuing conservative budget policies that include:

- Replenishing reserves when times are better,
- Living within our means (ongoing revenue for ongoing services),
- Diversifying the revenue base, and
- Other potential policy choices that will be discussed later in this issue paper.

Factors contributing to the City’s current financial difficulties, some that we can control or influence but some that we cannot control, include:

- Significant reliance on sales tax, especially in the volatile construction sectors and economically sensitive sectors such as automotive,
- The reliance on sales tax also leaves the City vulnerable to business decisions by large tax producers,
- Statutory limitation on property tax growth from existing property,
- Use of one-time resources to fund increases in levels of service and/or new on-going programs,
- Growth in wages and benefits greater than inflation, exacerbated by a higher than expected inflation rate, and
- Substantial increases in commodity costs, such as gasoline and materials used in infrastructure maintenance and construction.

Potential Strategies

Put volatile revenues in the CIP where projects can be reprioritized or delayed to accommodate changes rather than attempting to change operating service levels. The City currently programs fixed dollar amounts into the CIP from taxes and general fund resources as follows:

- \$770,000 in on-going sales tax (\$270,000 for transportation, \$400,000 for technology [this will be reduced to \$200,000 per year to fund operating expenses that had previously been budgeted in the CIP] and \$100,000 for neighborhood connection program),
- \$800,000 in interest earnings (\$250,000 for public safety, \$300,000 for the technology initiative, and \$250,000 for general government projects [technology and facilities]), and
- An annual average of \$544,000 in gas tax revenues for street/transportation projects.

This approach means that variations in revenues are absorbed into the operating budget. For example, the recent increase in gas prices has resulted in a drop in gallons sold, which is the basis for the gas tax revenues (which are projected to drop by approximately 30%). With a fixed dollar amount programmed into the CIP, the full impact of the reduction was absorbed by the operating budget.

Kirkland may want to consider putting the some of the sales tax revenue from the “contracting” category into the CIP (at least the volatile portion) rather than a fixed dollar amount. In the past five years, the revenue from the contracting category has ranged from a high of \$3.3 million in 2006 to a low of \$1.5 million in 2003. As part of considering this policy, a more detailed analysis to establish a baseline level of sales tax from new construction would need to be conducted. Bellevue, Bothell, and Redmond put construction-related sales tax revenues into the CIP using a variety of approaches, which we will explore in more detail for the City Council retreat.

The City’s current policy is to budget sales tax revenues on a one-year lag, as a hedge against possible future economic events. At one time, the policy was to budget the sales tax revenue on a two-year lag, which provided an even greater hedge. It would be difficult to **return to a two-year lag** in the near term if events unfold as expected, because the transition would widen the 2009/10 shortfall. However, a return to a two-year lag may be worth considering if conditions develop more favorably. This change could also be accompanied by a policy of placing surplus receipts over the budgeted amounts into the CIP rather than using the growth to fund operating costs on a one-time basis, which can contribute to volatility in the operating budget.

Use one-time revenues for one-time purposes or said in the reverse – do not increase on-going expenditures unless you have a stable on-going revenue source. Over time, new programs and positions have been added using one-time cash resources and those activities are now in jeopardy with the decline in economic activity. There are a number of actions that would be recommended uses for one-time funds, including:

- Replenish reserves to target levels,
- Fund additional identified reserve needs, such as funding for major system replacements, network infrastructure needs, set asides to recognize accrued liabilities related to leave or toward volatile, cyclical expenses such as overtime and jail expense,

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- Begin setting aside funds for large projects, such as the Public Safety Facilities Expansion, to reduce future debt requirements,
- Consider projects that are truly one-time in nature (when the project is completed, the resources go away),
- Increase the General Fund CIP contribution on a one-time basis, possibly accelerating high priority projects or setting funds aside for future needs, and
- Retire long-term debt if economically advantageous to do so,

Even if some or all of the options above can be pursued, we would recommend that one-time resource not be used to hire staff to meet on-going needs or for new programs. New on-going needs should not be funded until on-going revenues can be identified to meet the need.

Further, when **on-going revenues increase more than budgeted in a year**, do not use all of the increase in the immediate year. Save some of it to maintain current service levels and absorb increases in on-going costs in subsequent years, restore desired service level reductions, and evaluate on-going service level enhancement needs identified in adopted planning documents. For on-going service level increases that cannot be supported from projected growth in on-going revenues, the City could develop an election strategy for the regular use of operating levies. In addition, the City should continue to pursue operating levies to fund the on-going costs associated with any capital bond votes. Further discussion on this topic will occur as we begin planning for the utility tax increase election in 2009 to balance the budget.

While there are some on-going **“unfunded mandates”** that the City cannot necessarily avoid (such as those imposed by the state or federal governments), the City can work to avoid self-imposing them. For example, staffing needs were identified relative to adoption of the tree ordinance, but not funded on an on-going basis as part of the adoption (although a portion has been funded from one-time funds). As new regulations are considered, the accompanying resource needs and on-going funding sources should be addressed. As new initiatives are undertaken, such as climate protection and sustainability, the question of “how do we fund it?” should be an integral part of the evaluation. Funding options may include imposing fees (where applicable), re-prioritizing existing efforts (reducing or eliminating lower priority activities to free up funding), increasing taxes (either those that the Council can increase or by pursuing an increase as part of a voted measure), and/or deferring implementation until on-going funding in excess of current needs becomes available.

As noted earlier, one of the causes of revenue volatility is the City's significant reliance on sales tax. The General Fund revenue sources in the 2007-2008 budget reflected sales tax is 28.6%, property tax is 16.5%, utility tax is 14.9%, and the business license fee is 2.5% (the remainder consists of a variety of interfund, intergovernmental, fee, and miscellaneous tax sources). By **diversifying revenue sources** to achieve a more sustainable revenue structure, greater stability might be achieved. The contemplated increases in utility taxes and restructuring of the business license fee would make progress in this regard. Increasing the utility tax results in a greater share of general fund revenue from this stable source that tends to grow with inflation. Restructuring the business license fee and surcharge will help to ensure that revenues from this source will increase with the growth in the employment base. Confirming that the business license fees are a permanent part of City's overall tax structure also reinforces the objective of revenue diversity.

Lastly, continuing to focus on **economic development** could assist the City in meeting its on-going revenue needs. Major developments that include significant retail and office uses are under consideration that could help better balance the City's revenue structure in the long-term.

Again, this overview is intended to be the beginning of a discussion of potential changes to the budget strategy. We expect that this will be a topic on the 2009 City Council Retreat agenda and that any changes selected might be implemented over a period of years.