



MEMORANDUM

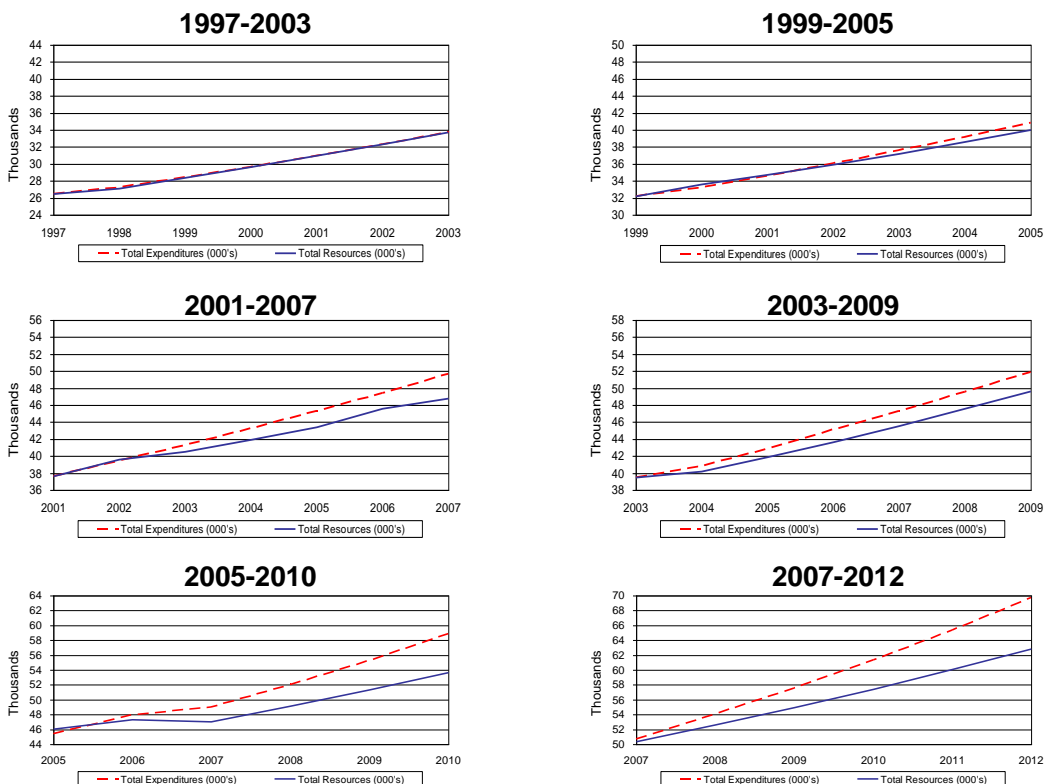
To: Kurt Triplett, City Manager
From: Tracey Dunlap, Deputy City Manager
Date: September 9, 2016
Subject: BUDGET BALANCING STRATEGIES (MINDING THE GAP)

WHY IS THERE A GAP?

Over the past 15-20 years, the City of Kirkland, like many cities in the State of Washington, has projected a General Fund deficit in future years. This issue paper will identify why the forecast consistently shows this imbalance, how the City has balanced the budgets during this timeframe, and discuss budget balancing strategies into the future.

At the March 23, 2007 City Council Retreat, a presentation on this topic included a slide which illustrated the evolution of the financial forecast since 1997, shown below.

Forecast Evolution 1997-2007



As the graphic shows, the forecast for 1997-2003 showed revenues and expenses roughly in balance for the forecast period – what happened? A number of events since 1999 have impacted both revenue and expenditure growth, including property tax increase limitation initiatives, revenue fluctuations due to economic conditions, and expenditure growth rates that exceed the rate of revenue growth. Specific events with significant revenue impacts (negative and positive) include:

- 1999: Passage of Initiative 695 (repealing motor vehicle excise tax and requiring voter approval of all tax and fee increases). Estimated loss of \$660,000 per year. Later declared unconstitutional, but the Legislature approved reduced vehicle license fees.
- 2000: Passage of Initiative 722 limiting property tax increases to 2%; later ruled unconstitutional.
- 2001: Passage of Initiative 747 limiting property tax increases to the lesser of the implicit price deflator (IPD) or 1% as of 2002; later ruled unconstitutional, but the Legislature approved legislation imposing the limits. The previous limit was 6% per year.
- 2002: General economic downturn begins in mid-2002, plus the loss of Home Base, Apple Computer, and Kirkland Nissan (major sales tax producers). Sales tax revenue decreases over 12% in 2001-2002.
- 2006-2009: Council authorizes use of remaining banked property tax capacity.
- 2008-2012: Impacts of the Great Recession in Kirkland, including:
 - Sales taxes falling from a peak of \$16.5 million in 2007 to a low of \$12.2 million in 2009, a decrease of \$4.3 million over two years. Note that revenues did not recover to 2007 levels until 2013, despite sales tax from the annexation areas starting in 2011.
 - Interest earnings falling from a peak of \$4.8 million in 2007 to a low of \$0.65 million in 2014, despite a growing investment balance.
 - New construction increase to property taxes falling from 3.94% in 2007 to 0.34% in 2011.
 - State Legislature reduces shared revenues to cities, including liquor profits/taxes.
- 2011-2012: Kirkland annexes the Juanita, Finn Hill, and Kingsgate areas effective June 1, 2011 and begins to receive annexation sales tax revenues from the State starting in 2011.
- 2012: Voters pass Proposition 1 Streets Levy and Proposition 2 Parks Levy.

To further illustrate the impact of the property tax limitation measures, the table that follows shows what the property tax revenues would be today if those limitations were not in place. The first column shows the actual levy (which included the 1% optional increase starting in 2003), followed by the levy amount if the City had been able to take the 6% per year increase available prior to 2002, and a column that shows what the revenues would be if the levies were increased by inflation (CPI-W). Note that years where the CPI difference decreases reflect years where the applicable CPI was less than 1% or negative.

Property Tax Revenues at Different Increase Rates					
Tax Year	Actual (at 1%)	At 6%	Difference	At CPI-W	Difference
2002 (last year at 0%)	8,778,766	9,217,704	438,938	9,033,350	254,584
2003	9,734,432	10,682,039	947,607	10,042,957	308,525
2004	10,022,151	11,518,246	1,496,095	10,317,246	295,095
2005	10,275,198	12,359,858	2,084,660	10,732,018	456,820
2006	11,594,182	14,362,784	2,768,602	12,208,870	614,688
2007	12,348,780	15,873,251	3,524,471	13,432,746	1,083,966
2008	12,962,420	17,311,236	4,348,816	14,375,071	1,412,651
2009	13,446,442	18,685,021	5,238,579	15,630,280	2,183,838
2010	13,681,190	19,865,757	6,184,567	15,593,736	1,912,546
2011 (before annex.)	13,962,487	21,154,407	7,191,920	15,621,032	1,658,545
2012 (after annex)	20,063,060	28,617,729	8,554,669	23,037,468	2,974,408

Kirkland was not alone in its experience during this timeframe. Attachment A contains information published by the Association of Washington Cities (AWC) that chronicles the events that have resulted in similar revenue challenges for cities state-wide.

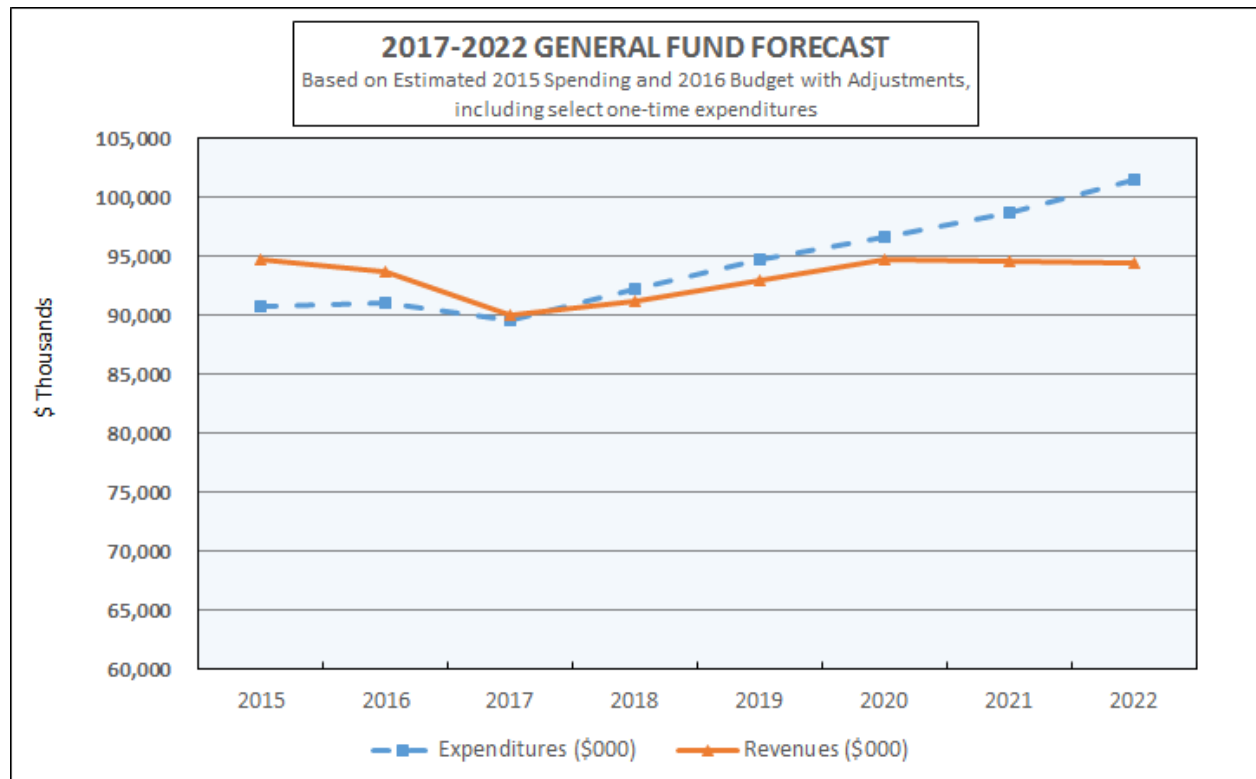
Kirkland added staff between 1997 and 2007 averaging 13 FTEs per year addressing service level needs including public safety, development services, and technology, as well as adding new programs including economic development and neighborhood traffic control. Wages increased to keep the City competitive in the job market and healthcare-related benefit premiums more than doubled between 1998 and 2007, with the annual increases in 2002-2004 at well over 10%.

All of these events have resulted in a situation where:

- Revenue increases are needed just to maintain existing service levels,
- During periods where revenue increases cannot keep up with growth, service levels will decline,
- On-going increases in levels of service can contribute to a wider gap, and
- Capital investments will generally add operations and maintenance costs on an on-going basis.

In addition, the 2011 annexation produced challenges and opportunities for Kirkland. The challenges include dependence on almost \$4 million per year of annexation sales tax credit revenue from the State which will expire in 2021. The opportunities included the ability to preserve staffing during the revenue downturn of the Great Recession rather than laying off a large number of staff and the ability to evaluate options for how services would be provided to the larger City.

The forecast for 2017-2022 from the May 2016 City Council Retreat on the following page reflects the cumulative impacts of all of these events, but also reflects the impacts of many of the actions that the City Council has taken to balance the budget over the years, as described in the next section.



	2015	2016	2017	2018	2019	2020	2021	2022
Total Expenditures	90,747	91,093	89,591	92,171	94,724	96,573	98,666	101,549
Total Revenues	94,781	93,692	90,075	91,195	92,964	94,742	94,592	94,483
Net Resources	4,033	2,599	484	(976)	(1,761)	(1,832)	(4,074)	(7,066)
Less Developmnt Rev>Budget	(1,400)	(2,274)	-	-	-	-	-	-
Biennial		2,959		(492)		(3,592)		(11,140)

HOW HAVE WE ADDRESSED THE GAP?

The City Council is required to adopt a balanced budget, which is why the projected gaps do not materialize. To do that, each budget process has required the City Council to make a variety of difficult decisions to balance the budget. The good news is that the City does not need to close the gap for the entire forecast period, but only for the budget years, although tools implemented in the budget years can help the gap in the future. The available tools fall into three broad categories:

Tax and Fee Policies

- Property tax increases (banked capacity and voted levy lid lifts)
- Utility tax increases (Council approved for city utilities and voter approved for private utilities)
- Business tax increases (changes in structure or new)
- Fees and Charges (increases and new)

Expenditure Management

- Staffing levels/level of service
- Compensation growth (salary and benefits)
- Efficiency/productivity

Economic Development

- New construction property tax
- Sales tax from new or expanded businesses

Kirkland has applied all three categories of tools successfully over the years. The matrix on the following page is a summary of the various tools applied to each budget cycle that required the Council or staff to take specific action. Note that Economic Development tools are an indirect result of the Council's actions related to land use and tax policy, as well as overall economic conditions, so are not shown explicitly on the matrix.

One challenge with the revenue tools is that if the additional revenues are intended to close the gap, they cannot be used to fund additional services. It is also more difficult to articulate for voters that voted-increases are needed to maintain current service levels, although the City was successful in that regard with the 2012 Parks and Transportation levies.

A challenge with revenues from new development is that they can be volatile based on economic conditions or come with attendant costs or other financial commitments, such as the \$15 million infrastructure commitment associated with Totem Lake redevelopment.

Expenditure management is always a priority, but some aspects can be more challenging to implement given collective bargaining agreements and macroeconomic conditions. The City has made progress controlling cost growth by moving toward fixed wage increases and managing health benefit cost growth through the Healthy Kirkland Initiative.

Strategy	Annual Budgets							Biennial Budgets					
	<99	99	00	01	02	03	04	05-06	07-08	09-10	11-12	13-14	15-16
New Revenue Source													
Surface water management fee	✓							✓			✓		✓
Revenue generating regulatory license fee						✓							
Surface water utility tax					✓								
Cost of service interfund charge/updates	✓								✓	✓			
EMS Transport Fee											✓		
Levy Lid Lifts						✓						✓	
Increased Tax Rate or Fee													
Increased property tax rate	✓		✓			✓	✓	✓	✓	✓	✓	✓	✓
Increased utility tax rate						✓		✓		✓			
Increased parking fines			✓		✓								
Increased development fees		✓	✓		✓				✓			✓	✓
Increased other fees										✓	✓		
Increase/restructure business license fee										✓			
Change to Sales Tax Assumptions													
Reduced CIP allocation			✓							✓			
Reduced sales tax lag to 1 year*								✓	✓	✓	✓	✓	
Use of One-time/Time Limited Revenue Sources													
Sales tax audit proceeds							✓						
Interest income								✓					
Annexation Sales Tax Credit											✓	✓	✓
Planned Use of Reserves													
Rainy Day Reserve						✓	✓	✓					
Rate Stabilization Reserve									✓				
Development Services Reserve									✓	✓	✓		
Expenditure Reductions													
Non-labor Expenditure Reductions					✓	✓	✓			✓	✓	✓	
Workforce/Positions Reductions										✓	✓	✓	
Furloughs										✓			
Fixed Rate or No Cost of Living Adjustment											✓	✓	✓
Restructure Medical Benefits											✓		✓
Other Strategies													
Reduced budgeted benefit rate to citywide avg					✓			✓					
Reduction in state retirement rates					✓					✓			
Efficiencies	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

* Restored use of a modified 2-year lag for sales tax in 2015-2016, a conservative approach to help with future budget balancing.

WHAT DOES THIS MEAN FOR THE FUTURE?

Absent substantial changes in the State of Washington's tax system, city governments will continue to be challenged by expenditures that grow faster than revenues. This situation makes local government finances particularly dependent on economic development and overall economic conditions and places the focus of budget deliberations on taking actions that make progress on closing the gap in the future. The good news is that Kirkland has successfully applied a full range of tools to balance the budget in the past and has strong prospects that economic development will help in the near future with the redevelopment of Park Place into Kirkland Urban and Totem Lake Mall. The bad news is that the City will need to continue to take concrete steps to balance the budget each cycle just to sustain current service levels and to absorb the loss of the annexation sales tax credit levels in 2021.

The 2015-2016 Budget Message concluded with presentation of a "Wants, Needs, and Resources" framework, which will continue to guide the process and is repeated starting below. The actions taken to balance the 2017-2018 budget and make progress on the framework are articulated in the budget message.

EXCERPT FROM 2015-2016 BUDGET MESSAGE

Wants, Needs and Resources Framework

The 2015-2016 budget represents a first step at prioritizing the City's "Wants, Needs, and Resources", which will be a continuing focus through 2021 and beyond. To provide a structure for this process into the future, we offer the following "Wants, Needs, and Resources" Framework.

Identifying the "Wants and Needs"

There are five primary ways that "Wants and Needs" will be identified between now and 2021:

- Citizen Surveys and Public Outreach to Neighborhood Associations, Business organizations, advocacy groups and residents which inform the Kirkland Quad Chart,
- Kirkland 2035 Community Outreach and Planning Process,
- Council Goal review and updates,
- Programmatic reviews of Departments or services that are highlighted by Quad Chart performance, or necessary to make progress on Council Goals,
- Department and City-wide Budget development where operational and capital needs are identified by professional staff and the public.

Most Capital Improvement Project (CIP) "Wants and Needs" will be identified initially through the current Kirkland 2035 Planning processes, particularly the Parks Recreation and Open Space (PROS) Plan, Transportation Master Plan, Surface Water Master Plan, and Water and Sewer Comprehensive Plan updates. These project lists will then be reviewed and updated by the City Council as part of future biennial budget processes. Note that the 2015 CIP update is "off-cycle" by one year due to the extensive Kirkland 2035 Planning process. The Council agreed to postpone the CIP update process until the Kirkland 2035 Plans are complete. In future years the CIP will likely be synchronized with the budget process.

CIP needs will also be identified through public outreach to Neighborhood Associations, Business organizations, advocacy groups, residents, "Suggest a Project" ideas, the Neighborhood Safety Program and Corridor Studies such as the Juanita and 100th Avenue Corridor Studies.

Identifying and Sequencing the "Resources" through 2021

Most on-going revenue sources, such as property tax, business license fees, utility tax and sales tax are analyzed in depth every two years as part of the biennial budget process, with an update at the mid-biennium. In addition, considerable sums have been set aside as part of the 2015-2016 preliminary budget to fund capital projects that will come from the Kirkland 2035 Plans. These unallocated revenues include Real Estate Excise Tax (REET I and II), sales tax revenue collected above projections, park and transportation impact fees generated by the rebound in development activity, unexpended fund balances, and potentially sales tax revenues resulting from growth (intentionally excluded by the modified two-year lag).

Key strategies to develop sufficient revenues to fund the desired services and close the gap between the diverging lines include:

- Replenish reserves (see Fiscal Policies adopted by R-4948 later in the document)
- Generate new revenue through economic development – Park Place, Totem Lake Mall, Google expansion, Waterfront revitalization
- Moderate the growth of employee wages and benefits to lower cost of future levels of service through collective bargaining, the budget process and the Healthy Kirkland Plan
- Generate new revenue through ballot measures

These strategies are prioritized by the City Council through the Council Goals and the City Work Program. **Council Goals** articulate the key policy and service priorities for Kirkland that are to be achieved over time. Goals should be reviewed and updated every two years in even-numbered years following Council elections to ensure that the Goals reflect the priorities of each new Council. The updated Goals will then form the basis for subsequent City Work Programs and budgets. **City Work Programs** are "action plans" adopted every two years by the Council following the budget process to accomplish major policy and administrative goals and demonstrate priority focus on major cross-departmental efforts with significant impacts designed to maintain the public health, safety and quality of life in Kirkland. The City Work Programs are essential to accomplishing Council Goals in a methodical and measurable manner.

The Role of Ballot Measures in Meeting Resource Needs

Kirkland has historically been judicious in its use of ballot measures. However the City has recently asked the voters to fund both "wants" through the Parks Maintenance and Enhancement Levy as well as "needs" through the Road Maintenance and Pedestrian Safety Levy.

Some critical keys to the success of both initiatives were:

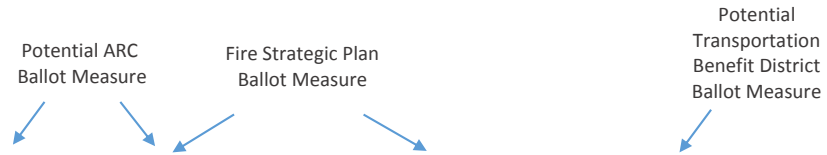
- The services desired were identified by the Kirkland Quad Chart and resident surveys and implement Council Goals
- The Price of Government was low, which signifies that residents feel they have the capacity to invest in better service
- The measures were developed as part of the City Work Program so that the programs to be provided were clear and specific, with accountability and oversight built into the measures

Using these criteria as initial guidelines, there are three potential measures on the horizon that would invest new resources in programs identified by the public as important while the Price of Government is still low:

- Aquatic, Recreation and Community Center (ARC)
- Fire Strategic Plan implementation

- Transportation Benefit District – voter-approved revenue if the Council believes revenues beyond the \$20 car tab are necessary to help implement the Transportation Master Plan

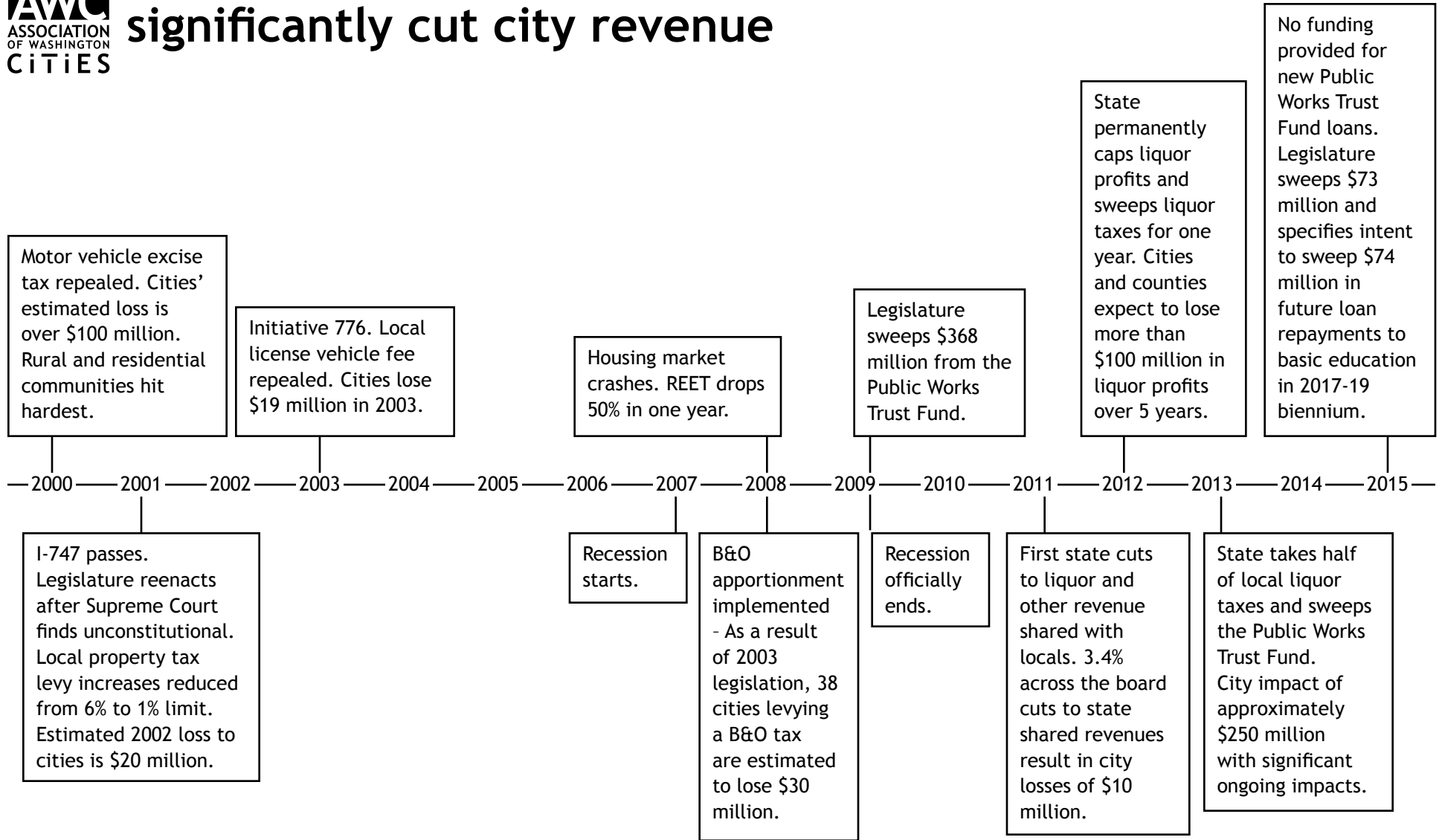
The graphic below illustrates how all of these pieces fit into the prioritization of “Wants, Needs, and Resources”. In reality, the framework is a long-term process that will evolve with changes in economic conditions, City Council direction, and citizen priorities. Each process will need to be cognizant of its impacts on the long-term picture to ensure the City’s long-term financial strength.



	2014	2015	2016	2017	2018	2019	2020	2021
Citizen Survey	✓		✓		✓		✓	
Budget	Adopt 2015-2016 Budget	Mid-biennial Adjustments	Adopt 2017-2018 Budget	Mid-biennial Adjustments	Adopt 2019-2020 Budget	Mid-biennial Adjustments	Adopt 2021-2022 Budget	Mid-biennial Adjustments
Goals & Work Program	Amended 9/27/13	Adopt 2015-2016 Goals & Work Program	Review & Update Goals	Adopt 2017-2018 Goals & Work Program	Review & Update Goals	Adopt 2019-2020 Goals & Work Program	Review & Update Goals	Adopt 2021-2022 Goals & Work Program
Capital Improvement Program	CIP Update	Adopt 2015-2021 CIP Project List (Off-cycle)	Adopt 2016-2022 CIP Project List	CIP Update	Adopt 2018-2024 CIP Project List	CIP Update	Adopt 2020-2026 CIP Project List	CIP Update



Initiatives, legislative action, and the economy significantly cut city revenue



Total Public Works Trust Fund monies diverted since 2009: \$1.2 Billion

Total state shared revenue diverted since 2011: \$169 million (with an additional \$45 million projected through state fiscal year 2017)