August 9, 2023

MEMORANDUM

To: Finance and Housing Committee
From: Tom Mikesell, Analyst
Subject: General Fund Deficit Historical Analysis

The City's General Fund (GF) has a projected annual operating deficit (recurring expenditures exceeding recurring revenues) of approximately $224 million beginning in 2025.[1] Further, the 2023 and 2024 budgets would not be balanced except for the temporary support from one-time fund balances and transfers from other funds, primarily the JumpStart Payroll Expense Tax Fund (JS Fund).

The City has an ongoing GF deficit because, after nearly a decade of rapid economic growth and service expansion by the City, the Covid-19 pandemic abruptly reduced GF revenues, while at the same time new ongoing GF expenditures were approved. To meet the statutory balanced budget requirement, this imbalance between base GF revenues and expenditures has required the infusion of temporary, one-time revenues and expenditure reductions. Beginning in 2025, these one-time measures will either expire or be diverted back to their originally intended purpose, and revenue growth will lag expenditure growth, resulting in a projected deficit.

This memorandum describes the sequential history of how this deficit developed, and offers insights to avoid similar imbalances in the future, focusing on four key factors:

- **I.** The years preceding the pandemic, rapid growth in revenues and a low inflation environment, enabled the city to significantly expand city services in response to community needs (2012-2019) **(pg. 2)**;
- **II.** The Covid-19 pandemic reduced ongoing GF revenue while the service needs increased, requiring the use of one-time revenues to balance the GF budget (2020-2024) **(pg. 5)**;
- **III.** In the current post-pandemic period, portions of the City's tax base[2] are still below pre-pandemic levels, resulting in use of one-time funds to pay for ongoing spending. This transition to a low-growth, high-inflation economy, leads to structural deficit projection **(pg. 8)**; and
- **IV.** Lessons learned to avoid future unsustainability **(pg.10)**.

[1] Please see the General Fund (GF) Financial Planning memorandum, presented to the Finance & Housing Committee on May 17, 2023, for details on this analysis.
[2] Tax base = all economic activity that is taxable by the City.

I. The years preceding the pandemic exhibited rapid growth in service need and revenues (2012-2019), in the context of low inflation.

A. Since the end of the 'Great Recession', there was rapid growth in service demand, in a low-inflation economy.

In the period from 2012 through 2019, Seattle's population grew from 616,500 to 747,300,[3] a 21 percent increase (3.5 percent per year, on average), leading to both an increased demand for City services and housing. During that period inflation, as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) grew by 16 percent[4] (2.3 percent per year, on average).

Taken together, these statistics suggest that the demand for City services was rapidly increasing, but the projected future cost of supporting each incremental addition of new City service capacity was growing relatively slowly. Put another way, in this low-inflation environment during a period of rapid economic growth meant that the city could pay for new capital projects and expanded services at a relatively low cost.

B. Budgets grew due to population growth and emerging service needs.

To respond to the rapid growth in service demand, City GF budgets, which provide core City services, increased from $926 million to $1.4 billion, a 52 percent increase (7 percent annually).[5] With that came an increase in City employment; the salary and benefits for new positions was a major factor driving GF expenditure growth.

During this period, budgeted non-utility/transportation full time equivalent (FTE) staffing grew from 6,900 to 8,313, a 26 percent total increase (3.7 percent per year, on average).[6] The City's personnel and budgeting systems do not track positions by fund, so it is not possible with available data to specifically determine how many of the new positions are in the GF. That said, the resident population was growing rapidly, and that growth in City personnel budgets mirrored growth in the service need.

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[3] City of Seattle Annual Comprehensive Financial Reports, citing the Washington State Office of Financial Management, "2022 Population Cities, Towns and Counties" estimates only.
[4] Office of Economic and Revenue Forecasts - Seattle MD (King & Snohomish Counties) Economic Forecast – March 2023
[5] Seattle City Budgets -Revised Budget for applicable years (https://www.seattle.gov/city-budget-office/budget-archives)
[6] City of Seattle Annual Comprehensive Reports.

Furthermore, budgeting during this growth period was made more complex due to several existing and emerging policy issues, including:

i. A 2012 Settlement Agreement between the United States Department of Justice and the City, resolving a lawsuit that alleged that the Seattle Police Department had engaged in a pattern of practice of constitutional violations, and requiring significant budgetary support for implementation;

ii. A homelessness emergency, declared in 2015 in tandem by the King County Executive and the Seattle Mayor;

iii. A shortage of affordable housing, exacerbated by the City's rapid growth; and,

iv. The emergence and growth of the gig economy and the impacts on income inequality and labor standards for workers.

Community concerns have a compounding effect, which cannot be captured through a simple comparison with growth in population and inflation, and generally help explain why spending growth outpaced population and inflation.

C. <u>During the same period, there was rapid growth in the local economy during the longest economic expansion since World War II.</u>

From 2012 through 2019, Real Personal Income in the Seattle Metro Area grew by 46 percent, or 6.5 percent per year,[7] housing permits grew by 56 percent, or 7.9 percent per year, and private employment grew by 21 percent, or three percent per year.

Assessed value (AV), the basis for property taxes, grew even more rapidly, increasing from $117.5 billion to $244.9 billion, a 108 percent increase. This growth was so rapid that in 2016 the Mayor and Council approved Resolution 31717 which disconnected the sizing of the City's Emergency Fund from growth in AV in favor of CPI, which was growing more slowly. The rapid growth in AV would have required larger contributions to the fund at a time when other service needs were growing, particularly with regards to the homelessness emergency as stated in the resolution, however, would have resulted in larger reserves. In retrospect, this decision to save less in the good times was premature.

The Seattle economy grew rapidly in the years preceding the pandemic, which perhaps created a false sense that fiscal risks were minimal, and that growth in reserves could be safely limited.

[7] Ibid.

D. GF revenue growth outpaced inflation and population

This growth in the economic base supported rapid GF revenue growth. From 2012 through 2019 actual GF revenue collections grew from $964 million to $1.44 billion, a 50 percent increase (seven percent annual average). This rapid revenue growth supported the similarly sized increase in GF Budget during this time.

In addition, these revenue results consistently outperformed the annual revenue forecast used to adopt each year's budget, which provided additional resources to increase spending mid-year to meet service demands and generate healthy starting fund balances. Based on data from an Office of Economic and Revenue Forecasts (OERF) study of forecast accuracy for major revenue categories[8], during the period from 2012 to 2019 the median budget to actual revenue variance for these categories was 1.7 percent and ranged from a high of two percent to a low of one percent.

A robust economy fostered rapid revenue growth to support spending, and consistently conservative forecasts provided some measure of additional revenues to be programmed in supplemental budgets.

E. Pre-pandemic financial plans demonstrated a structural deficit.

In the fall of 2019, near the end of the economic growth cycle immediately preceding the pandemic, the GF financial plan included with the 2020 Adopted Budget showed an approximately $39 million deficit beginning in 2021. This calculation did not include the impacts of Seattle Municipal Code (SMC) § 3.20.060, which requires that contracts with Human Services providers be adjusted annually for inflation. If this had been provided for in the 2020 plan, it is likely that the projected future deficit would have been as much as $18 million larger by 2023, as described in an August 17, 2022, Central Staff memorandum. Given the regular under forecast of revenues, and persistent expenditure underspend, it is possible that this deficit would have been largely reduced in successive budget and revenue updates.

It is unknown what detailed assumptions about growth were used for the financial plan, as they were not disclosed by the Executive to the Council or the public. This is particularly relevant for growth in labor costs, which traditionally comprise the bulk of the GF budget and are the most susceptible to changes in inflation. Better transparency about increases in labor budgets, including assumptions about how those contracts could grow into the future, would have provided insight into assumptions about the affordability dynamics of the GF financial program.

Immediately prior to the pandemic a future deficit was forecasted, though the assumptions used in that analysis were not publicly known, nor did the projection include all statutory elements of growth, which would have made the projected deficit worse.

[8] Page 8: "Forecasts Quite Accurate and Accuracy Increases Through the Budget Process"

II. Covid-19 pandemic reduced ongoing GF revenue while the service needs increased, requiring the use of one-time revenues to balance the GF budget (2020-2024):

A. Beginning of the Covid- 19 Pandemic

In February 2020, the Washington State Governor proclaimed a state of emergency in response to the emergence of local Covid-19 cases. Soon thereafter, responding to increasing hospitalizations and deaths from the virus, the governor amended the original proclamation to include a 'Stay Home-Stay Healthy' order, which essentially shut down non-critical public movements of residents and visitors around the state and city.

The response to a novel public health emergency that was jeopardizing the lives of residents had detrimental effects on key sectors of the economy that had been growing rapidly in prior years, and in several cases the lasting impacts persist to this day.

B. Due to pandemic shocks GF revenues decreased, followed by moderate growth.

In 2020, the first year of what turned out to be a three-year pandemic, ongoing actual GF revenues[9] decreased from $1.41 billion in 2019 to $1.22 billion in 2020, a $186 million (13 percent) decrease. From this lower base, revenues began to grow again, albeit at a slower rate than in the preceding years. In 2022, actual ongoing GF revenues were $1.52 billion, which means over the three-year period from 2019 to 2022 ongoing revenues grew 8 percent, or 2.7 percent annually, less than half the pre-pandemic growth rate.

Overall, from 2019 to 2022, actual ongoing revenue grew from $1.41 billion to $1.52 billion, approximately 2.7 percent per year on average, less than half of the growth rate in the years preceding the pandemic.

C. GF expenditures increased due to pandemic and national racial reckoning.

Responding to the Covid-19 pandemic, the effects of which were compounded by the affordable housing crisis, homelessness emergency, and local impacts of the national racial reckoning sparked by the murder of George Floyd by a Minneapolis police officer, from 2019 to 2022, adopted GF budget expenditures[10] grew from $1.4 billion to $1.65 billion, a $246 million (18 percent) increase, representing 6 percent per year[11].

From 2019 through 2022, new adopted spending increased 18 percent, or 6 percent annually due to myriad of emerging and pre-existing needs, which added to the operating deficit.

[9] For the purposes of revenue calculations in this memorandum, 'ongoing' revenues are defined as total revenues less transfers, grants, land sales proceeds, carryforwards, and revenues from current year legislated ordinances.
[10] Includes planning reserves, which are amounts held for unbudgeted expenditures that are anticipated.
[11]Seattle City Budgets – GF Adopted Budget for applicable years (https://www.seattle.gov/city-budget-office/budget-archives)

D. Since GF expenditure growth outpaced revenues, GF ongoing expenditure growth was supported by one-time revenues and temporary spending reductions.

As explained above, GF revenues were reduced by the pandemic, and began growing more slowly than in pre-pandemic years, and new and existing expenditure commitments continued to grow. Due to those factors, an assortment of one-time (temporary) revenue and expenditure strategies were deployed to balance the GF budgets during the pandemic, including:

i. **One-time prior year fund balances**: In most years, due to revenues coming in higher than adopted forecasts, and actual spending below budget levels, a starting balance higher than original projections is available in the following year. For example, the 2023 Adopted /2024 Endorsed Budget relies on $193.6 million of starting balance, which is a one-time resource generated by prior year activity, to support spending over the two-year budget plan.

ii. **Fiscal reserves**: The 2020 budget relied on transfers from the Revenue Stabilization Fund, which is designed to provide backfill when revenues do not meet budgeted targets, and the Emergency Fund, which is designed to support spending in specific emergencies.

iii. **Federal grants:** Two novel federal grants programs were offered during the pandemic, including:
   a. Coronavirus Relief funds from the Coronavirus Aid, Relief, and Economic Security Act of 2020, which helped fund the response to the pandemic's public health effects, and included support for existing GF services that were substantially redirected from their normal purposes to work on Covid-19 response; and,
   b. Coronavirus Local Fiscal Recovery (CLFR) funds from the American Rescue Plan Act of 2021, a portion of which was used for direct GF revenue replacement. It is worth noting that a key federal requirement of using the CLFR Funds for revenue replacement was demonstrating that the City incurred a revenue loss from the pandemic; the City's calculations[12] indicated that, compared to the allowable federal benchmark, pandemic-related revenue losses across City funds were $311 million.

iv. **One-time spending reductions combined with ongoing spending increases:** As described in the GF Financial Planning Analysis & Related Fund Policies memorandum presented to the Select Budget Committee, the 2024 proposed budget included $52 million of new ongoing spending increases that were 'paid for' through $21 million of temporary spending reductions, a $10 million temporary underspend assumption and the use of one-time balances. While the budget showed as balanced for 2024, these practices of supporting new ongoing spending with temporary reductions added to the ongoing deficit projection in 2025 and beyond.

[12] City Budget Office internal calculations.

v. **JumpStart Fund Payroll Expense Tax:** Approved by the City Council in July 2020, the JumpStart Payroll Expense Tax is a progressively tiered tax on high levels of compensation expense at large private businesses. Revenues from the tax were primarily intended to support investments in affordable housing, with the remainder going to green new deal investments, equitable development, economic revitalization, and administration expenses. Given the GF revenue loss and increased public needs from the pandemic, the first year's (2021) payroll expense tax collections were directed towards temporary GF support, including specific investments intended to help mitigate the impacts of the pandemic. Though at a lower level than in 2021, continued weakness in GF revenues has required a continuation of the temporary support through 2024, provided through Ordinance 126719 the Funds Flexibility ordinance, resulting in a lower amount being appropriated towards the tax's original purposes, noted above, which are in a spending plan codified in SMC 5.38.055.

The sources of funding are temporary, and most cannot be relied on to balance the GF budget in the future, absent policy changes. One obvious policy change would be to revise the level of support from the JumpStart fund, which would reduce the dedicated funding for affordable housing, an acute community need as documented in a recent Washington Department of Commerce analysis. In addition, JumpStart funds are supporting key investments to support small businesses and workers throughout the City that continue to feel the impacts of the pandemic. Adopted to support housing investments, relying on JumpStart Fund transfers in the future would mean the JumpStart tax would instead be supporting other city services.

To continue to support City services an assortment of temporary measures have been used to balance recent GF budgets. These sources are either one-time in nature or are temporary diversions of resources from other community priorities.

III. In the current post-pandemic period, portions of the City's tax base are still below pre-pandemic levels, resulting in use of one-time funds to pay for ongoing spending. This transition to a low-growth, high-inflation economy, leads to structural deficit projection.

A. Important parts of the economy remain below 2019 levels, including:

1. **Tourism:** 2022 Seattle-Tacoma Airport passenger volumes were 11.9 percent below 2019 levels, with forecasted volumes reaching 2019 levels by 2024[13]. This means fewer travelers to the area than what was experienced three years prior, which impacts sales tax revenues and B&O tax revenues. Based on an Office of Economic and Revenue Forecasts (OERF) analysis of Washington State Department of Revenue (DOR) Sales Tax distributions, inflation adjusted sales activity from downtown leisure and hospitality sales are approximately 20 percent below 2019 levels. This represents loss of tax base.

2. Recent reports indicate that Seattle office vacancies are 19.3 percent as of the end of June 2023. Further, OERF's April Regional Economic forecast indicates 2023 housing permits will be 25 percent below 2019 levels, and will not reach the 2019 level of permitting until 2026. Based on the OERF analysis of DOR Sales Tax distributions, inflation adjusted sales activity from the construction sector are approximately 20 percent below 2019 levels. This represents loss of tax base.

Economic indicators, and revenue collections data, indicate that inflation adjusted economic base activity is below 2019 levels for key sectors, including construction and hospitality.

B. Select revenues are lagging pre-pandemic projections:

The following revenues are projected to come in lower in 2023 than what was projected for this year in 2019, including:

- Court Fines and Forfeitures: $15 million below the 2019 projection.
- Parking Meters: $10 million below the 2019 projection
- Utility Taxes: $8.5 million below the 2019 projection
- Other Taxes: $12.7 million below the 2019 projection

If these revenues were performing at the levels projected in 2019, an additional $46.2 million would be available to the GF budget.

Growth in some revenue categories is lagging projections made in 2019, despite growth in inflation and resident population.

[13] https://www.portseattle.org/page/sea-airport-basics

C. Ongoing base service demand (measured by population) did not decrease, and in some ways is more acute, and potential inflation impacts on labor contracts are much higher based on service needs, including a homelessness emergency exacerbated by a shortage of affordable housing.

1. **Higher service needs**: Concurrent with the revenue disruption described above, service needs for affordable housing, homelessness, and community safety have led to ongoing budgeted spending increases in recent years. In the 2024 Proposed Budget, a total of $52 million of new ongoing spending was added, across several departments supported by one-time resources.

2. **Affordable Housing:** As detailed in an April 2023 presentation to the Select Committee on the 2023 Housing Levy, affordable housing is an ongoing and urgent community need.

3. **Inflation and Growth in Labor Contracts:** Most City labor contracts are under negotiation in 2023. Labor contract growth rate projections are undisclosed during negotiations, so it is not yet clear what impact inflation is having on current and future City expenditures. However, personnel costs represent over half of the GF budget, and inflation has seen rapid growth, indicating that this category represents the bulk of future cost increases.

IV. Tools to Avoid Future Unsustainability.

A. Focus on the one-time/ongoing nature of decisions: Budget additions that are expected to continue in future budgets should receive enhanced scrutiny, particularly new positions and funding, as future decisions to decrease this funding due to lack of revenue might require a layoff. Further, clarifying the growth expectations for ongoing adds (e.g., is the first year's funding full year or partial year cost, and what role does future inflation play?) can enhance the understanding of potential budget pressures that could develop.

B. Endorse transparency and alternative formats for communication: The Legislative branch makes decisions based on data that the Executive provides, and data limitations can lead to a less-than-optimal decision-making framework.

   1. A different format of financial plan to better demonstrate operating margin (ongoing expenses compared to ongoing revenues) would make it easier to see emerging trends.
   2. Show assumptions, and the sensitivity of projections to those assumptions in regular financial plan updates.

C. Pay attention to how actual data relates to original assumptions: Effective current year monitoring of real time information can provide early insights into developing risks and opportunities. When original assumptions prove to be way off the mark, focus on what measures are being taken to bring projections close to reality.

D. Consider reserve policies in the context of saving more when economic times are good: As mentioned earlier in this memorandum, in 2016 the Emergency Reserve policy was changed from higher reserves to buffer impact, coupled with freeze on growth, revenue strategies to bridge the difference. Risk-based reserves strategies (GFOA).

Transparency of planning assumptions, clear communication of the annual operating margin, and periodic reporting on revenue and expenditure performance against budget assumptions, can help identify future challenges before they develop. Ultimately, with greater transparency the City may have made the same decisions given the significant policy issues the increased spending responds to but may have been better prepared to respond to the changing economic conditions.

cc: Esther Handy, Director