CITY COUNCIL REPORT

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SUBJECT: 2016-17 EARLY GENERAL FUND BUDGET STATUS

The purpose of this report is to provide an update on the 2016-17 budget development process and to discuss factors that will have significant impact on the overall budget status for the upcoming fiscal year.

THE ISSUE

The February 2015 Five-Year Forecast predicted a GF budget deficit of ($31M) to ($58M) for fiscal year 2016-17. However due to the leadership of the Mayor, City Council and the hard work of City employees the GF ended FY 2014-15 with a fund balance that was $25.0 million higher than estimated. As discussed with the Council in September, the higher than expected fund balance provides the resources needed to reduce the potential deficit down to ($6M) to ($33M). Continued work on expenditures this fall will continue to change the range until we have a final estimated number in March 2016.

Since the September 2015 report to Council, Budget and Research and Finance staff have been busy completing the work necessary to update our revenue and expenditure estimates for 2015-16 and establishing initial estimates for 2016-17. This important process will continue over the next few months; however, we wanted to provide the Council with an update on our progress and to discuss several factors that will have the most significant influence on the 2016-17 budget status.

OTHER INFORMATION

As staff develops the 2016-17 budget, we are committed to communicating with Council earlier and more frequently than in the past. This approach ensures that Council is given the time needed to adequately address the complex issues surrounding the budget development process. As such, this report provides an update on budget development activities to date and identifies critical issues impacting the upcoming budget.

While many variables ultimately influence the budget, it is our opinion that the following six items will be critical factors to evaluate in the next few months as staff develops the

Five-Year GF Forecast and the Trial Budget to be presented March. The six areas to be addressed include:

- Contingency Level
- GF Revenue Outlook
- Labor Contracts
- Allocating Vacancy Savings
- Service Levels
- Debt Service and Property Tax

Contingency Level

Every year we budget a "Contingency Fund" which provides resources as a cushion against unexpected issues during the year. Each year since 2009-10, the Contingency Level has been increased incrementally from about 2.5% to its current and highest level of 4% or approximately $46M. The goal has been to grow the Contingency Fund level to 5%. As we move forward in the budget development process how much we grow the Contingency Level will be a factor in addressing any budgetary shortfall.

GF Revenue Outlook

The second and perhaps most volatile of the issues is GF revenue. Last year at this time, we were experiencing revenue collections that were significantly below budgeted revenues; however, that is not what we are experiencing this year. The 2015-16 year-to-date (YTD) GF revenue collections at 4 months were $314.4 million or 1.2% more than 2014-15 collections of $310.8 million. As a result, revenue collections through four months are trending closely to budgeted revenue. There are still a few areas to monitor related to the GF revenue outlook for this fiscal year and next fiscal year.

The first area of concern that could adversely affect the GF revenue outlook is the future allocation of State-Shared Revenue due to the proposed census legislation. State shared sales tax is distributed to cities and towns based on relative population share as determined by the US Census (currently either decade or mid-decade). While Phoenix's population has grown over the years, our relative population share has decreased from 30.3% in 2010 to 28.8% in 2015, negatively affecting shared tax revenues. With several fast-growing cities conducting mid-decade census counts, Phoenix's share could decrease further.

The next area of concern that could adversely affect the GF revenue outlook is Transaction Privilege Tax (TPT) Reform. The Department of Revenue (DOR) has once again delayed the implementation of the single point of administration provisions of TPT Simplification until such time that the necessary system changes meet the needs and expectations of all parties. Staff will continue to monitor this issue as any change could have a material impact on City Sales Tax collections going forward.

Also impacting the GF revenue outlook is contracting and retail sales tax collections. Because of a legislative change, there has been a shift from contracting to the retail sales tax category; however, data is not available to determine the exact amount of collections that have shifted and other factors could be influencing these two categories.

The 2014-15 annual growth rate for contracting was -8.5% under 2013-14. This year, through four months, contracting is -21.3% under 2014-15 four month actuals.

Because of these concerns and because at this point in the year we only have four months of activity, GF revenue collections will be closely monitored through the remainder of the holiday season before we finalize our revenue projections.

Labor Contracts

This budget cycle we are also negotiating labor contracts. These agreements are typically two-year contracts with each of our labor unions. Current agreements are good through the end of the current fiscal year. Over the last three cycles, city employees have taken concessions, with 4.2% of concession unrestored. Our negotiations process has just begun, and agreements are usually reached by mid-April. The impact that these new contracts will have on the 2016-17 budget will be unknown until final agreements are reached.

Allocating Vacancy Savings

The fourth variable identified by staff as having a material impact on the 2016-17 budget status involves vacancies and salary savings. The number of employees leaving city employment has been on the rise, over the last five years, mostly a result of retirements. Since 2012-13, approximately 1,300 non-sworn city employees have retired. Over the next five years, nearly 2,500 additional city employees will become eligible to retire.

Turnover rates have nearly doubled from approximately 5% in 2010-11 to over 9% last fiscal year. As a result, the number of vacant positions has been higher than the historical average despite a concentrated effort to eliminate old vacant positions. It is anticipated that recent pension reform changes will have a positive impact on hiring and the retention of quality employees. We plan to analyze vacant positions and the resulting savings in more detail in the coming weeks. Staff plans to return to Council in late January with additional information about vacant positions. It is likely that this will include a recommendation to eliminate some number of vacant positions. It is important to keep in mind that many vacant positions exist in critical areas and that eliminating these positions could negatively affect service levels.

Service Levels

For more than 35 years, the city has conducted the annual Program Budget Review process. The purpose of the Program Budget Review is to evaluate services, an essential step in the city's zero-based budgeting process. Departments conduct a systematic review of programs at current service levels, identify innovative service delivery changes that enable greater efficiency, evaluate priorities and recommend any changes to services. The process is also important in determining possible changes to programs to address reduced resources, increased costs and/or other factors. This year, all departments, with the exception of Police, Fire, Office of Homeland Security & Emergency Management, Municipal Court, Prosecutor and Public Defender, will submit potential programmatic expenditure reductions equal to 7% of net General Fund

budgets. The Public Safety/Criminal Justice departments will submit potential programmatic expenditure reductions equal to 5% of their net General Fund budgets. The potential reductions should be in areas that would result in the least possible impact to the community and reflect the lowest priority programs within each department. The list of reductions is due to Budget and Research in January.

Although it is unlikely that the full range of potential reductions would be required, it is important that a full range of realistic potential options be available for discussion. Identifying more cuts than are anticipated provides flexibility for the City Council and allows us to quickly deal with any unforeseen budgetary problems. It also allows us to build a secondary budget reduction list to address any potential cuts to state-shared revenue during the regular legislative session.

Debt Service and Property Tax

The fifth and perhaps most complex of the five variables is Debt Service funded by Property Tax. In Arizona, municipalities may assess two separate property tax levies, the primary property tax levy to fund operation and maintenance expenses and the secondary property tax levy to pay debt service related to voter approved capital projects. For Phoenix, the combined property tax rate, per City Council policy, has been set at $1.82 per $100 of assessed value since 1995. The secondary tax portion of the combined $1.82 tax rate has funded voter-approved bond programs since the 2001 bond program.

Since 2010, staff has been implementing a City Council approved plan to use a surplus of funds collected in the mid-2000s to provide tax relief to Phoenix residences. As a result, $225 million less in property taxes will have been paid by residents to the City of Phoenix from 2009-10 through 2015-16. From the peak in fiscal year 2009-10 to fiscal year 2013-14, assessed values in Phoenix declined from $18.9 billion to $10.0 billion, or 47%. The annual property tax bill on a typical single-family home in Phoenix dropped from $407 in 2008-09 to a low of $217 in fiscal year 2013-14. The tax bill on a typical single-family home in Phoenix was an estimated $240 in fiscal year 2014-15.

City Council Approved Property Tax Policy

Because of substantial declines in assessed valuations, the City Council voted to adopt a property tax policy in May 2010 to provide confidence to investors and to maintain the City's excellent credit ratings. Besides agreeing to maintain the $1.82 combined primary and secondary property tax rate through the use of the G.O. Reserve Fund, the policy contains three options that would be considered in the event the reserve was inadequate to pay debt service, including the following:

(1) Allow the secondary property tax rate to float up;
(2) Allow the primary property tax rate to float down; or
(3) Use other general fund resources to pay G.O. bond debt service.

Other actions taken by Council were to delay portions of the 2006 bond program and to restructure and refinance G.O. bonds to reduce near term debt service and help maintain the $1.82 tax rate. Maintaining the G.O. Reserve Fund balance at six months of debt service was also targeted (approximately $75 million). This balance is critical to helping maintain the City's high credit ratings.

Current Market Conditions and Updated Financial Analysis

Current projections indicate that the City will reach the G.O. Reserve Fund's $75 million minimum target in 2016-17. Further the deferral of the approximately $152 million remaining in the 2006 bond program until after 2024 will be necessary. Initial forecasts predict a need for $38 million more in secondary property levy in fiscal year 2016-17 to offset the use of the G.O. Reserve Fund.

This increase could be achieved by one of the following options:

- Float the primary tax rate down; or
- Float the secondary tax rate up; or
- Increase other sources of revenue.

Cumulatively with the G.O. Reserve Fund, Phoenix property owners have paid $225 million less property taxes since 2009-10. A comparison with other jurisdictions is provided in Attachments 1 and 2. The Finance Department is preparing to refund and restructure G.O. bonds in 2017 and 2019 as long as interest rates remain near current levels. The refunding and restructuring will reduce near term debt service costs as well as future required increases to the secondary property tax rate. One of the options above will need to be implemented to maintain the G.O. Reserve Fund's $75M minimum fund balance. Future refunding and restructuring opportunities will be continuously monitored.

RECOMMENDATION

This report is for information and discussion. No action is required.

Attachment 1

Maricopa County Jurisdictions Total Property Tax Rates

	Fiscal Year 2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	Percent Change from 2010-11 to 2015-16
Phoenix	$1.8200	$1.8200	$1.8200	$1.8200	$1.8200	$1.8200	**0.0%**
Avondale	1.1058	1.3310	1.3310	1.8060	1.7500	1.7500	**58.3**
Chandler	1.1814	1.2714	1.2714	1.2714	1.1792	1.1792	**(0.2)**
Gilbert*	1.1500	1.1500	1.1500	1.1500	1.0659	1.0567	**(8.1)**
Glendale	1.5951	1.5951	1.9005	2.2889	2.1501	2.1965	**37.7**
Goodyear	1.4233	1.6000	1.7750	1.9000	1.8700	1.8700	**31.4**
Mesa*	0.3454	0.4469	0.5104	0.8636	1.1853	1.2125	**251.0**
Peoria	1.4400	1.4400	1.4400	1.4400	1.4400	1.4400	**0.0**
Scottsdale	0.8976	1.0915	1.2252	1.2946	1.2449	1.1537	**28.5**
Tempe	1.4000	1.7863	2.1414	2.4882	2.4882	2.5195	**80.0**
Maricopa County	1.0508	1.2407	1.2407	1.2807	1.3209	1.3609	**29.5**

(per $100 Net Assessed Valuation)
*The city of Mesa and town of Gilbert have only a secondary property tax rate.

Source: Maricopa County Assessor

Attachment 2

Maricopa County Jurisdictions Total Levy

	Fiscal Year						Percent Change from 2010-11 to 2015-16
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	
Phoenix	$284,142	$223,483	$196,891	$180,295	$189,852	$192,502	**-32.25%**
Avondale	5,638	5,347	4,596	5,662	5,960	5,900	**-4.65**
Chandler	36,207	31,356	28,644	27,597	27,773	28,070	**-22.47**
Gilbert*	26,418	21,404	19,267	18,340	19,500	19,500	**-26.19**
Glendale	27,746	20,938	21,836	24,024	24,429	24,799	**-10.62**
Goodyear	11,630	10,715	10,712	11,148	11,959	12,547	**7.88**
Mesa*	14,141	14,141	14,141	22,105	33,439	33,440	**136.48**
Peoria	23,026	18,366	16,372	15,216	16,560	16,963	**-26.33**
Scottsdale	64,627	62,033	62,187	62,367	63,380	59,553	**-7.42**
Tempe	34,414	34,851	36,272	37,545	38,934	40,159	**16.69**
Maricopa County	492,224	477,571	425,111	409,775	442,763	471,194	**-4.27**

(per $100 Net Assessed Valuation)
*The city of Mesa and town of Gilbert have only a secondary property tax rate.

Source: Maricopa County Assessor