City of Bellevue

Attachment C

10/16/2023

Introduction

In preparation for considering the 2023-2024 mid-biennium budget, staff has prepared a revised General Fund forecast that outlines recent investments, the structural revenue deficit, as well as the risks, pressures and financial strategies concerning the Fund. This forecast serves as a snapshot in time and as the economic conditions evolve staff will continue to monitor their impact on the city and will update City Council and staff as needed.

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General Fund Financial Forecast: Recapping 2023-2024 & Looking Ahead to 2025-2028

Pandemic Challenges, Solutions, and Investing in 2023-2024

In 2022, Council adopted the 2023-2024 Operating Budget for the City and responded to feedback from residents and businesses by investing in urbanization and growth as well as several Council Priorities. These investments outlined in the graphic below, detail the issues addressed and the initiatives therein.

Building off the 2021-2022 Amended Budget, the 2023-2024 Adopted Budget maintains the cost containment measures adopted to weather the economic impacts of the COVID-19 pandemic, These include reducing discretionary spending on professional services, travel and training, surge capacity and, non-safety-related maintenance to transportation and park facilities. While these ongoing measures help the City's long-term revenue and expenditure imbalance, it does not fully offset the needs to address the growth and urbanization of the city. To fund the priorities above, a 0.1 percent increase in the Business and Occupation (B&O) gross receipts tax was implemented on January 1, 2023, as well as a 2 percent property tax adjustment that utilized 1 percent of the City's banked capacity as well as the 1 percent councilmanic increase allowable by State law.

Structural Deficit: Challenge Remains but Manageable

The City continues to face challenges to long-term financial sustainability due to the tax structures in Washington state which do not keep pace with the spending needs of the City as well as increased costs due to inflation and personnel. As a result, the City continues to become more reliant on economically sensitive revenue sources such as sales and business and occupation taxes.

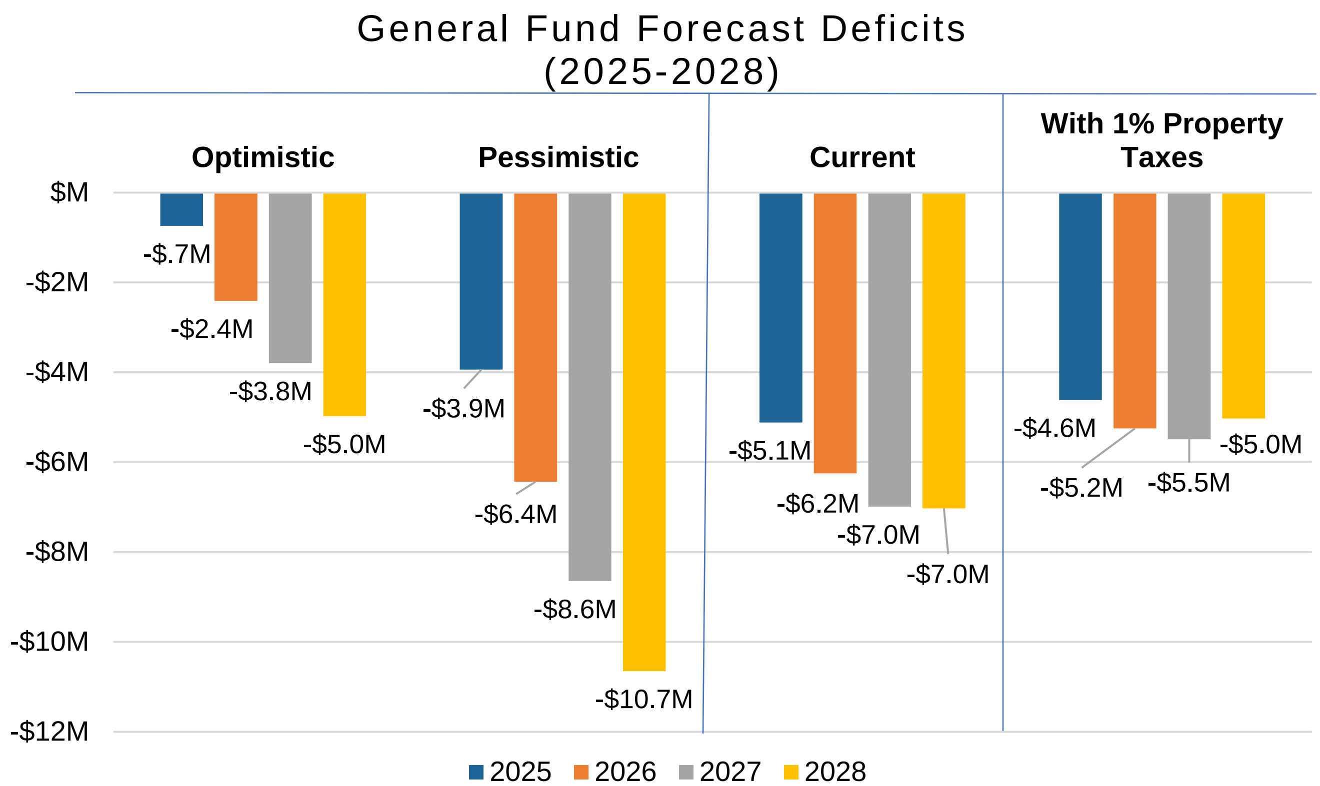
During the overview of the 2023-2024 Preliminary Budget, staff presented a General Fund forecast for 2025-2028 highlighting two potential scenarios, one optimistic and one pessimistic. The optimistic scenario assumed continued robust growth in Bellevue's various economic hubs, most notably Downtown, BelRed and the Spring District. Conversely, the pessimistic scenario, while assuming growth, was more tepid about the long-term impacts of continued hybrid working environments which could lead to more vacant office space, diminished demand for new construction and therefore less economic growth.

Tonight, staff outlines a revised General Fund forecast showing that the economic circumstances lean more towards the pessimistic scenario while acknowledging that the deficits anticipated are manageable and do not require a change in course during the fall 2023-2024 mid-biennium update.

The chart below shows the anticipated deficits for the out-years of the forecast looking at 2025 through 2028 for each scenario and the current forecast. The current forecast anticipates a slightly more pessimistic picture in the near-term but a notable positive revision in 2027 and 2028. This revision reflects development and construction returning to more robust levels in the latter half of the decade as interest rate and inflationary pressures ease.

The deficits are notable dollar amounts. However, the deficits in relation to the total General Fund budget are limited. As a percentage of the forecasted General Fund expenditure budget in 2025, the deficit represents approximately 1.6 percent. Similarly in 2028, the deficit would represent slightly less than 2 percent of anticipated General Fund spending. Operating deficits around 5 percent or less are considered manageable.

Importantly, these scenarios do not assume any adjustments to revenues and, specifically do not assume Council using its 1 percent councilmanic authority on property taxes during the period. The Should the Council decide to take the 1 percent allowable increase, approximately $500K in additional revenue would be generated each year in addition to the compounding effect from implementing the 1 percent adjustment across multiple years. For example, should the Council continue their recent practice of taking the 1 percent property tax allowable in each of the four years, the General Fund would see an additional 2 million dollars in 2028, reducing the deficit to approximately $4.4 million or 1.4 percent of the anticipated General Fund spending. To illustrate this effect on the City's deficit, this example has been included in the chart below for context.



<u>Economic Outlook & Pressures</u>

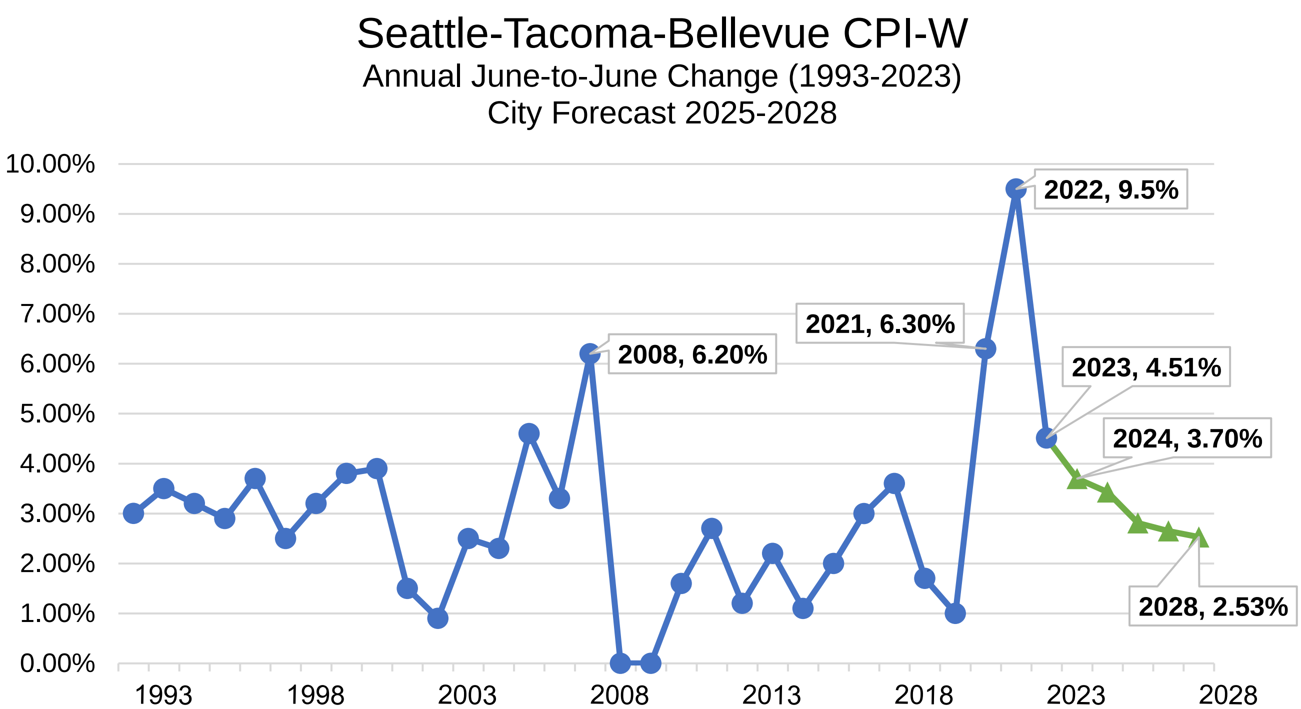
In the near-term, the City remains to be in a secure financial position for the 2023-2024 biennium. Revenues are anticipated to be approximately 3.5 percent above budget in 2023. The growth is due to an increase in investment interest, right-of-way leases, a modest increase in sales and B&O taxes as well as increased utility tax and amusement revenues. Expenditures are projected to be below budget for 2023 due to personnel savings from vacancies throughout the City due to turnover, the tight labor market and, inability to hire for technical and specialized professions.

In 2023, all sectors of the Bellevue economy, including those sectors hardest hit during the COVID-19 pandemic, will have met or will meet their pre-pandemic 2019 levels. Economic activity related to consumer spending, in-person services, as well as food and accommodation are expected to see continued growth during the biennium. It is expected that auto sales within the city will diminish slightly during 2023 due to higher lending costs but, should return to a growth pattern in 2024. Similarly, the services industry which includes the city's finance and information technology firms is due to stay nearly flat in 2023 as companies refocus towards leaner and more profitable parts of their businesses. Critically, unlike most sectors of the economy, the services sector did not experience the same decline during the pandemic. Rather, services continued to grow in part due to the increased reliance on digital and hybrid services during the last 3 years.

In 2024 through 2028, there are notable economic factors that make the picture less clear. The persistence of inflation is leading to knock-on effects throughout the economy from higher prices on consumer goods, increased wages and labor costs, driving the Federal Reserve to increase interest rates, among others.

The City is heavily impacted by the cost of inflation. The City's inflation is benchmarked against the Bureau of Labor Statistics (BLS) June-to-June CPI-W for the Seattle metropolitan area which is released annually in mid-July. At a minimum, inflation impacts all funds with personnel, and many contracted services, which in turn impacts the expenditure growth. The release of CPI-W on July 13 shows that inflation grew by 4.51% over the last year compared to 9.5 percent growth from the year prior. This number is included in the General Fund forecast presented by staff tonight and assumes that inflation will moderate further in 2024 before returning to more historical norms of between 2 and 3 percent in 2025 and beyond.

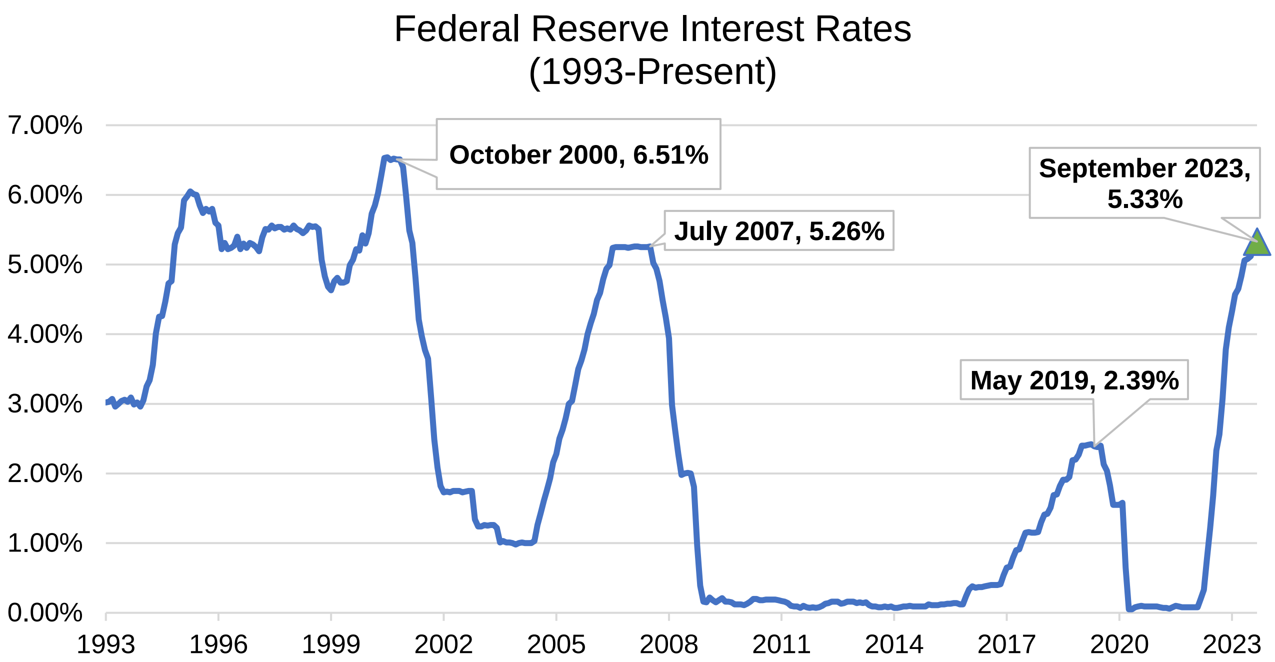
The chart below plots the historical Seattle-Tacoma-Bellevue CPI-W for years and includes the City's forecast for inflation for the outyears of the forecast.



Source: Bureau of Labor Statistics (BLS)

Inflationary pressures also influence the U.S. Federal Reserve Board's (Fed) Federal Funds Rate commonly known to most consumer lenders as the Fed's interest rate. The Fed is charged with a dual mandate to maintain price stability (i.e., inflation) at approximately 2 percent annual growth while also maintaining full sustainable employment in the economy which is estimated to be at approximately 4.1 percent unemployment (Source: Chicago Federal Reserve Bank).

Currently, national unemployment sits below this target at 3.8 percent. With low unemployment, the competition for labor is driving wage growth in the economy and therefore increasing the costs of goods. This coupled with global instability, supply chain issues among other factors are sustaining the high inflation figures seen in recent years. As a result of this more persistent inflationary environment, the Fed has increased interest rates more than a dozen times since March 2022 where interest rates were hovering around a historical low of 0.8 percent. Currently, interest rates are now more than 5 percent. The chart below details the Fed's interest rate going back to 1993.



The Fed is increasing interest rates and effectively the cost of lending to limit the amount of money coursing through the economy. Moderating the economy through interest rates hikes has the potential to unintentionally cause economic damage or even a recession. Currently, the risk of recession is still present but has dissipated as various economic factors continue to show a robust economy.

For Bellevue, interest rate pressures remain a topic of concern due to its direct impacts on potential development throughout the city. The General Fund forecast assumes construction growth in the near and long terms but will likely not reach the historic highs of the previous years due to higher vacancy rates and costs of lending. Staff will continue to monitor the development pipeline, interest rates and other factors to determine the economic impact of any development slow down.

<u>Risks</u>

The following are a list of the more notable potential risks to the General Fund forecast:

- Interest rates:
  - Fed interest rate strategy and the timing of lower rates; its impact on the broader economy.
- Development & Construction:
  - Higher lending costs impact on the development pipeline in the near and long term.
  - Continued impact of hybrid work environments on development demand and office vacancy rates.
- Inflationary Pressures:
  - Persist inflation and the impact on City expenses.
- Personnel Costs
  - Responding to a competitive labor market and notable wage growth, the City’s approach to remaining an employer of choice may have ongoing financial implications.

Financial Strategies

The City has continued to execute sustainable financial strategies and practices to ensure that it meets the challenges of the city and still provides exceptional public services. In doing so, staff has initiated cost containment measures to bend the cost curve downward, the City has refinanced its debt in advance of rising interest rates and limited the use of reserves to one-time expenditures. To meet the revenue needs of the City, Council has provided for greater compliance with Bellevue's B&O tax code, taken the allowable councilmanic 1 percent property tax increase in 8 of the last 9 years going back to 2015, as well as adjusted the B&O gross receipts tax rate by 0.1 percent.

Notably, staff and the Council have examined the impacts of these financial strategies to various stakeholders and engaged in public dialogue to weigh the revenue options best suited to meet the City's needs in the context of who benefits most from those investments. Beyond the revenue strategies above, the City also advanced the most recent Park's and Open Space Levy Lid Lift to Bellevue voters in 2022 to address the capital and maintenance needs facing the City's park system. Staff will continue to catalog the allowable revenue options available to Council as permitted by State statute.

A conversation about the long-term financial strategies facing the City during 2025 and beyond will be brought back to Council as part of the broader 2025-2026 operating budget and the 2025-2031 CIP Plan discussions occurring in 2024.