

Financial Challenges - Community Advisory Group (CAG) REPORT

Majority Recommendation of the Community Advisory Group

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www.mercergov.org/FinancialChallenges

This document was produced by a Community Advisory Group (CAG) convened by the City Manager to deliver a recommendation on the City's financial challenges: 17 of 23 members supported/wrote the Majority Recommendation; 6 of 23 members supported/wrote the Minority Recommendation. Both reports are advisory only.

Recommendation of the Community Advisory Group

May 9, 2018

This report documents the consensus recommendation of the Community Advisory Group (CAG) -- with 17 members (73.9%) voting in favor of this recommendation. A minority opinion was prepared by the remaining 6 (26.1%) members of the CAG.

On April 2, 2018 the CAG voted 17-6 to make the following recommendation to City Manager Julie Underwood:

The CAG recommends that the City place on the November 2018 ballot a measure to lift the city property tax levy lid, increasing property taxes approximately \$254¹ in 2019 for a median-value \$1.2MM property, with this additional levy amount increasing by 5% each year and terminating after six years. We believe this levy lid lift is the best option for addressing the city's current financial challenges while also maintaining the current level of city services.

The CAG further recommends that the City take the following steps, which collectively reduce the proposed levy lid lift impact to island property owners from the original projection of \$331/year per median-value (\$1.2MM) property to \$254/year:

- Immediately combine the Beautification Fund with the General Fund (estimated to be \$225,000 per year beginning in 2019 – ordinance is required).
- Immediately raise the Business and Occupancy (B&O) tax from 0.10% to 0.15% while retaining the current exemption on the first \$150k of revenue, to be more in line with the level of neighboring cities and below the state average² (estimated to be \$350,000 in 2019).
- Immediately remove restrictions on use of revenue from the B&O tax.
- Retain the Utility Tax at its current level of 8%, rather than allowing the temporary increase from 5.3% to 8% to expire at the end of 2018 (estimated to be \$500,000 in 2019).
- Establish, as part of the bi-annual budget process, efficiency reviews of city departments on a rotating basis by an independent analyst.
- Encourage Economic Development opportunities (see Appendix B).

It was the opinion of 17 members of the CAG that this approach would provide the City with sufficient revenue to retain the current level of services and that voters should be given the opportunity to vote on this proposal. The CAG recognizes that the City has the opportunity every year to adjust the levy lid lift as is fiscally prudent within the limits of what the voters have approved.

Background

On November 15th, 2017 Mercer Island City Manager Julie Underwood called to order the first meeting of the CAG. Twenty-three Mercer Island residents participated in the CAG, representing broad diversity with respect to age, gender, vocation, length of residency, neighborhood, and point of view. While there is

¹ For avoidance of doubt, the \$254 is recommended as dollar amount of revenue for a median value home. Thus, we recommend that the city levy lid lift be for dollars of revenue consistent with this median-home tax increase. In particular, if homes on the island appreciate, the amount raised should not increase.

² State average B&O tax rates range from 0.16% to 0.21% depending upon type of business (Washington Association of Cities www.wacities.org)

no guarantee that the CAG members are representative of the island views, we believe the CAG represented a broad spectrum of views, and the majority of members joined the CAG without rigid preconceptions of appropriate action and with open minds.

Washington State law limits the growth of city revenue from property taxes to 1% per year, with larger revenue growth requiring a voter approved levy lid lift.³ (As a result, the City's property tax rate actually decreases when property values rise more than 1%, so that the City's property tax levy goes up only 1% annually, excluding new construction.)

At the same time, the City projects that General Fund costs will grow 4-5%⁴ per year in 2019-2024 due to inflation (the level of inflation in the Seattle metro area was 3.3% in 2017⁵), labor contracts, and a competitive labor market, and employee healthcare costs, which are expected to rise 7.5% per year⁶. As a result, the City is projecting an operating budget deficit of \$1.80 million in 2019, growing to \$6.84 million in 2024⁷, assuming the city maintains the current level of services.

The primary goal⁸ of the CAG was defined as follows in the charter:

The primary goal of the CAG will be to provide a recommendation to the City Manager regarding a proposal to place an operations levy on the November 2018 ballot, which would maintain funding for parks, recreation, and community services. The CAG will explore various solutions, including reducing service levels, increasing tax revenues, and considering alternative service delivery options.

The Meetings

Over six months and five meetings, as well as various other meetings with subsets of the CAG and with other community members, the CAG dug into the City's finances and services, spending the most time dissecting the General Fund.

The majority of the five meetings were spent looking for opportunities to identify reasonable options to contain costs without significantly reducing service levels. Previous biannual Citizens' Surveys have found that 80% of the Island's residents supported the current level of city services⁹.

City staff were highly transparent, responding to our desire to find alternate solutions with hundreds of pages of additional analysis and numerous videos. We carefully considered the impacts of cutting costs and services, potential for forecast error, impacts of delaying this request to the voters, and a potential Real Estate Excise Tax (REET – a real estate excise (sales) tax) as a revenue enhancing solution. After thorough consideration, the majority of members rejected the REET and did not identify acceptable cost-cutting options that can be implemented in the short term without cutting services. The information generated by this investigation is available to all residents through the city website¹⁰.

³ The 1% cap does not apply to "new construction," which generates another 1.3% per year on average for the City.

⁴ http://www.mercergov.org/files/CAG%20Presentation_1-6-18.pdf (p. 24).

⁵ <http://www.seattle.gov/financedepartment/cpi/historical.htm>

⁶ http://www.mercergov.org/files/CAG%20Presentation_1-6-18.pdf (p.25).

⁷ http://www.mercergov.org/files/Levy_Lid_Lift_Mailer_Mar2018.pdf

⁸ <http://www.mercergov.org/files/CAGCharter.pdf>

⁹ The question about whether the City provides the right amount of services was supported by 80-87% in the 2008-2014 surveys. The question wasn't asked in the same way in 2016.

¹⁰ <http://www.mercergov.org/Page.asp?NavID=3224>

Our Conclusions

The CAG determined that the city budget cannot be materially reduced without affecting the quality or scope of services offered to the residents of Mercer Island. Overall, the CAG found that the City is well managed and proactive about taking opportunities to reduce expenses. (See above for a recommendation to perform efficiency reviews, which originated from the staff.) Additionally, the CAG recognized that the City takes a prudent approach to financial planning.

After seeing the data, the CAG felt strongly that the City needs to act now to give the voters the opportunity to consider an operations levy lid lift. While the CAG recognizes that the McCleary decision and ST3 have increased the taxes paid to the State and County, neither of these puts any money into the city budget. Thanks to inflation and a growing economy, costs for delivering the same level of services is growing at a faster rate than the City's ability to raise revenue. That is why CAG feels that the longer the City delays dealing with the structural imbalance that exists between revenues and expenditures, the fewer options it will have.

Recognition for City Staff

The CAG would like to recognize Julie Underwood, Chip Corder, and the many members of the Mercer Island City staff who were generous and patient with the CAG as it learned how cities in Washington are funded, and the regulatory and legislative limitations to city finances. The City was transparent with the information provided – several presentations and videos were provided to explain in-depth the details in the issues that the City is facing. All of this material is available to the entire community and the CAG encourages all of our citizens to review this information. Their knowledge of the city and its financial challenges, their commitment to delivering high levels of service on a cost-effective basis, their interest in and respect for community input, and their passion for their work, was evident.

Appendix A: The second most popular recommendation

The second most popular recommendation (15/22 members) expanded upon the recommendation above to also include remodeling and expanding the existing Mercer Island Thrift Store. City staff believe that this expansion would increase revenue and potentially eliminate the need for the current level of annual support provided by the city to Mercer Island Youth and Family Services.

Appendix B: Encouraging Economic Development in the Town Center

The Mercer Island city budget is more dependent on property taxes than most other cities because Mercer Island is primarily a residential city with a limited commercial core. Changing the revenue mix for the city was seen as important, but the CAG recognizes that it cannot be changed fast enough to respond to the current revenue shortfall.

The CAG recommends that the City Council study and adopt an economic development strategy, including reconsidering ordinances in the town center. Residents and the city budget would benefit from a more diverse tax base for funding city services.

Appendix C: Changes to services debated but not supported by the majority

The following represent proposed changes to city services discussed, but not included in the majority recommendation.

- Re-negotiate with King County Library System. Members questioned whether our community was getting its fair share of value from the library taxes paid to the county. City residents currently pay the same library tax rate as other county residents, but because we are a wealthier community than others, our dollars of tax are perhaps disproportionate to the value directly derived from this community good. (18% in favor)
- Review the Marine Patrol services co-operative agreement and look for ways to reduce the cost of providing this service. (43% in favor)
- Form a Regional Fire Authority or contract to other eastside cities for police protection. While these options might reduce costs by allowing staff to float between fire stations to cover shifts, combining training costs, combining purchases, etc. it was also expected that this new taxing authority would reduce Mercer Island's independence and control. (No vote was taken on this issue.)

Appendix D: Changes to taxes debated but not supported by the majority

Currently, B&O taxes are not paid on the first \$150k of business revenue. CAG briefly discussed raising that exemption and / or providing a waiver for new businesses. There is a desire among CAG members for city policy and taxes to be friendlier to businesses, especially new ones trying to get a start. The height restrictions on town center buildings came up as an example of why the city will experience difficulties developing a strong sales tax base and continue to depend on property taxes.

The CAG looked into the possibility of raising the REET tax as a revenue source. The King County Real Estate Excise Tax¹¹ can be increased by 0.5% (50 bps) if the city also agrees to rebating 0.5% of the total 10.0% sales tax to the county. The total sales tax rate would not change with King County receiving a larger share. Chip Corder's analysis indicated that there would be a net increase in revenue from this change. Given the residential nature of Mercer Island and its relatively small sales tax base, this was an attractive option but ultimately rejected by the majority. The major concerns were the instability of the REET as a revenue source, as well as concerns over equity, as this would cause the city to be funded by people who have left the island. The REETs would also have a significant impact on long-term residents as they sell their homes on the island and would be a very painful tax that could negatively impact the real estate market. Finally, because of the required sales tax rebate to the county, a REET option would require the city to increase taxes more than other options to increase the city revenue by the same amount,

Appendix E: Capital Budget

Eighteen of twenty-two voting members (81%) of the CAG members recommended not having a capital budget levy lift on the ballot before the Fire Station levy expires in 2021. The CAG did not discuss in depth whether a capital budget levy was appropriate or not. Rather, it recognized that the political realities make asking for both the operating and capital levy increase at the same time unwise.

Appendix F: Recommendations on how to explain the issues surrounding the revenue shortfall

The following were the most helpful pieces of new information presented by the city:

1. Washington State Legislature enacted a law based on Initiative 747 that limits city *revenue* growth to 1% a year, so property tax *rates* fall as property values and inflation increases.

¹¹ <https://www.kingcounty.gov/depts/records-licensing/recorders-office/real-estate-excise-tax.aspx>

2. ST3 and McCleary both raise taxes on residents, but neither provides revenue for the city operating budget.
3. The city has benefitted from historically low inflation and high development fees in the last five years. Both of these unusual circumstances are neither reliable nor predictable sources of revenue or cost control.
4. Regional inflation rates have been consistently higher than national inflation rates.
5. Inflation at more than 3%, and benefits inflation at about 7.5% a year require the city to raise revenue by more than 1% a year to maintain services.
6. The proposed levy lift would raise the median home property tax by approximately \$0.70 a day in 2019 for the owner of the median island home.
7. Current city tax property tax rates are the lowest of any city in King County with a population over 20,000¹².
8. Current city staff head count per capita and administrative staff ratios are among the lowest in the county¹³.
9. Current staff compensation levels are near the average in the county¹⁴. While some have argued for compensation cuts, the CAG believes that delivering quality services that residents desire requires high quality staff, and high-quality staff will leave if they are underpaid.

Appendix G: Public Records and Useful References

All of the documents utilized by the CAG are archived at www.mercergov.org/CAGmaterials and the CAG encourages residents to read them.

Appendix H: The Minority Opinion

As noted above, six members of the CAG did not support the consensus recommendation. The CAG charter anticipated this possibility and includes this relevant provision:

If it is not possible to reach consensus on particular recommendations, the potential options for resolving the issue will be documented and included in the Committee's report as a minority opinion.

Unfortunately, the six members who opposed the consensus recommendation chose not to provide a minority opinion to include in this document. Nonetheless, the CAG as a whole recognizes the importance of a diversity of views, opinions, priorities, and strategies, and the CAG is fully supportive of the right of these six to produce a minority opinion document on a standalone basis, if they choose to do so, as long as it is clearly described and referenced as a minority opinion.

We offer the following responses to the minority opinion document

- The minority opinion stated that: “the deficit forecast could be eliminated if the city implements a 5% cost reduction in the city budget of \$65M. “
 - Unfortunately, neither the minority opinion authors nor the rest of the CAG could identify cuts of this magnitude that would not require material reduction in city services.

¹² http://www.mercergov.org/files/CAG%20Presentation_2-5-18.pdf

¹³ Ibid

¹⁴ http://www.mercergov.org/files/CAG%20Presentation_1-6-18.pdf

- The minority opinion referenced a 2005-2006 cost containment program and asserts that this is evidence that costs could be cut again.
 - While it is possible that potential cuts exist, past cuts are not evidence of the potential for future cuts. Logically, as “fat” is identified and removed, finding more fat to cut without impacting services is increasingly difficult.
 - The city staff provided evidence of ongoing efforts to contain or even reduce expenses.
- The minority opinion asserted that the city could utilize “the \$19 million in unrestricted reserves to balance the budget”.
 - As with any family, government, or business, the city is prudently setting aside funds to fund future long-term financial obligations such as pensions and equipment replacements. Utilizing such long-term funds, especially in a time of strong economy, to fund normal operations is equivalent to taking a home equity loan to fund a current vacation. While the CAG has recommended some utilization of reserves, relying on reserves as a solution to a long-term structural budget problem is imprudent.
- The minority opinion stated that “Mercer Islanders pay one of the highest \$ property taxes in King County”.
 - While this is true, it is also true that residents pay the lowest property tax rate among all King County cities with more than 20,000 in population. While the dollars of tax revenue are high, this is necessary because we do not have the commercial tax base of other cities, and because we have higher value properties than other cities. This was discussed extensively in multiple CAG meetings.
 - Logically, it is not fair or appropriate to, for example, compare the tax burden of a \$2 million home in Mercer Island to that of a \$1 million home elsewhere. These are not equivalent properties, and it is not surprising or inappropriate for the owner of the former to pay more than the owner of the latter.
 - Focusing on the size of the property tax bill while ignoring the differences in housing prices tells a misleading story. We pay more for our homes partly because the city provides excellent services, a safe community, and cultural gems like Summer Celebration, the Mercer Island Half Marathon, the Homecoming Parade, and mental health counselors in the schools. Homes on Mercer Island often receive multiple offers the first day they are listed for sale. Our property tax rate is lower than almost all surrounding cities, and pretending that the property taxes we pay are independent from the value of our property and the services we receive is misleading.
- The minority opinion stated that “Historical forecast modelling and accuracy has been highly variable vs. actuals”
 - To the extent that this is true, the city has provided explanation for why this is so. Largely, the positive variance in revenue is a result of a booming economy and a high level of new construction resulting in high levels of fee revenue, and this should not be expected to continue.
 - The expenditures not growing as expected are largely due to Obamacare slowing healthcare inflation, and the city being frugal. Experiencing slower than expected spending while experiencing larger than expected revenue is illustration of city financial prudence
- The minority opinion stated that “The city council has not required a formal cost containment program since the 2005-2006 budget.”

- While this may be true, the city provided many examples of cost control and reduction efforts. We believe the assertion of the city manager that “cost control is in our DNA.” Examples include
 - a 2014 Police Department shift from 8.5 hour shifts to 12 hours shifts which reduced overtime costs but increased patrol presence;
 - reducing Parks & Recreation Department maintenance costs for Aubrey Davis Park by moving work in-house from a previously contracted arrangement beginning in 2010;
 - a current project of implementing an enterprise asset management system (EAM) within the Public Works Department which will provide real time data to field personnel.

- The April 30 version of the minority opinion stated that “The levy recommendation from the city would apply an additional 30% increase in the first year, with a 5% increase every year thereafter to the existing levy rate”. This statement was corrected in the current draft, as it was inaccurate in at least two ways:
 - The proposed increase is \$254 on a \$1.2 million home, which is \$0.2117 per \$1,000 of assessed value. The 2018 rate is \$1.003 per \$1,000, which means the levy increase is approximately 21%, not 30%.
 - The proposed 5% increase does NOT apply to the existing levy. It applies only to the new levy amount. Thus, a current average home, which currently pays \$1,003 per year to the city, will not experience a 5% increase to this amount. This amount will only increase (absent further voter action) by no more than 1%. The 5% increase applies only to the \$254.

- The minority opinion frequently used the term “CAG recommendation”. The minority opinion is not a recommendation of the CAG. This document is the only CAG recommendation. The CAG charter allows for a minority opinion to be included as part of the CAG recommendation, but it does not allow for two recommendations