

Financial Challenges - Community Advisory Group (CAG) REPORT

Minority Recommendation of the Community Advisory Group

Lisa Anderl, Heather Cartwright, Doris Cassan, Bob Harper, El Jahncke, Elaine Kavalok

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.

Mercer Island Community Advisory Group

CAG Recommendation for No Levy in 2018

May 9, 2018

Authored by a Sub-set of the CAG:

Lisa Anderl, Heather Jordan Cartwright, Doris Cassan, Robert Harper,
El Jahncke, Elaine Kavalok

Executive Summary

The goal of the CAG was to provide a recommendation to the City Manager regarding a proposal to place an operations levy on the November 2018 ballot. In order to better understand the metrics and financial forecasts presented to the CAG, a group of CAG members dedicated 60+ additional hours during the CAG process to complete a data-driven analysis of the current situation.

Based on deeper study of city budget history and forecasting models, several alternative approaches were identified for the city to successfully manage the current budget that do not require Mercer Island citizens to pay more taxes.

The financial forecasts presented to the CAG indicated a potential deficit in the 2019-2020 budget of \$4.3M. While a levy is one way to address this projection, **this study confirmed that the deficit forecast could be eliminated if the city implements a 5% cost reduction in the city budget of \$65M.**

- Many members across the 23 member CAG expressed throughout the process that cost containment should be a key part of any city proposals. The last formal cost containment program implemented by the city council took place with the 2005-2006 budget. At that time, the Mercer Island city staff successfully implemented this process with little to no negative impact to valued citizen services. Given the strength of experience and skills in our city staff (many of whom participated in the cost effort 13 years ago); we believe our city staff would be successful in replicating this process.
- The CAG was asked to review a proposal for a six-year levy, however there was limited discussion in the CAG regarding the city budget beyond year six when the proposed levy is scheduled to end. While a short-term levy would address the imbalance between spending and revenue, long-term forecasting would suggest the city would either need to extend or make permanent any levy put in place now, or address expenditures at a future point.
- In addition to the immediate 5% cost containment, the CAG was proactive in generating a list of longer term ideas to increase revenue over the course of the next 6 year budget forecast. Investigation and implementation of these ideas could serve to meet future budget needs at the latter part of the 6-year forecast.
- The financial stability of Mercer Island was a key consideration in this study. Fortunately, Mercer Island carries almost no debt and has ~ \$40M in reserves. Reserves are a positive indicator of the city's financial health and represent available funds the city government can utilize to meet its obligations to citizens and creditors. While it is prudent for the city to continue holding some reserves for financial stability, even if the city took no action on a tax levy and leveraged the \$19 million in unrestricted reserves to balance the budget the city could maintain a positive operating position for the city budget into 2021.

Given the opportunity to identify cost efficiencies in the current budget and the strong reserve position to ensure financial stability, this study recommends the city should not place a proposal for an operations levy on the November 2018 ballot.

CAG recommendation for the Mercer Island City Council and City

Staff:

- 1.** Implement a cost containment program following the 2005-06 format or similar program.
- 2.** Recast 2019-2020 biennial budget using the final 2017 actuals, leveraging existing reserves: moving unused funds such as \$500k-\$1M in the Beautification and Criminal justice funds to the General Fund and \$3M in REET funds to be used for maintenance of capital projects and defer short term forecasted deficits.
- 3.** City staff should send a recommendation to the City Council to create formal committees for study of long-term projects that could generate large revenue recapture, including: reduction of under-utilized Marine Patrol vehicles, study/ negotiation with KCLS to capture the annual \$5M+ in fees paid to KCLS to support the MI library (vs. estimated \$1.2M to operate), and enlist the help of an economic development expert to provide guidance on increasing revenues.
- 4.** Do not place an operational levy lift on the November 2018 ballot.
- 5.** Consider placing the levy on the November 2020 ballot if expenditures cannot be controlled to match revenues.

CAG Recommendation for No Levy in 2018

CORE ISSUES AND CONCLUSIONS:

This analytical study of the city financials looked at 4 core issues:

1. *What is the relative tax burden for Mercer Island residents?*
2. *Since we were asked to make a decision based on a six year forecast, what has been the accuracy of prior city forecasts?*
3. *What has the City done to contain costs in past years? What were the results? Can it be done again?*
4. *Resident satisfaction level as a method to measure of the number of employees or FTEs (Full time Equivalents) the City should employ. IE: Do we have enough FTEs to deliver the services at a level that satisfies the recipients of those services, the residents?*
5. *Do we have enough money to fund the City through the 2019-20 biennial budgets if the City cannot save any money through a cost containment program and the income and expense issues are as forecast?*

The summary of the findings:

1. Mercer Islanders pay one of the highest \$ property taxes in King County

Mercer Island residents pay the 3rd highest city property taxes and the highest total property tax vs. comparable King County cities. Adding a levy lid lift would place an even higher burden on Mercer Island (calculated using \$'s paid on 2017 City Property Tax for Median Residential Value; comparable cities were selected by the MI City Staff).

2. Historical forecast modelling and accuracy has been highly variable vs. actuals:

The most recent previous six-year forecast projected for Mercer Island projected an accumulated \$5M deficit. Actuals after 6 years delivered a \$9M surplus. The variance was due to under forecasting revenue and over forecasting expenses. The current forecast 2019-24 seems to follow the same pattern.

3. The City Council has not required a formal cost containment program since the 2005-2006 budget.

City staff advised the CAG that the Mercer Island budget is created based on a needs basis using year-over-year increases to maintain existing operations (vs. matching annual budget spend up

or down based on city priorities). Single department reviews have occasionally been conducted (one department, every two years), however no formal program has been put in place for 13 years.

The city budget was reduced in 2011 through a headcount reduction of 6 employees (in reaction to the Great Recession), but has since added 22.5 employees (12.1% vs. population growth of 4%) and the city budget has grown 20% to \$65M in 2017 from \$54M in 2011. The city advised the CAG the main driver of cost over runs is the cost of employees and benefits.

4. City service levels of satisfaction relative to expenditures on a higher number of employees are not positively correlated.

How happy are the residents with the City's performance? In general, the residents are very happy and give the City high marks over many years. The city advised the CAG that the increasing number of employees hired has been required to maintain city service levels and resident satisfaction.

In 2011, the City had 185 FTEs and the satisfaction level was 70.5%. By 2014, the city added 9 employees and satisfaction rose to 74%. However, since 2014 the city has continued to add 4-5 employees a year. In the 2016 survey, the city had grown to 205 FTEs, but resident satisfaction levels declined to 66%. This indicates a lack of positive correlation between the number of FTE's and resident satisfaction level, meaning the city could likely reduce FTEs without a reduction in service levels satisfaction.

5. Mercer Island holds over \$40M in reserves.

The CAG was asked to only look at the General Fund, which reflects less than half of the full \$65M city budget. The City Council can and has historically moved funds from the main budget to the General Fund to adjust the budget. In the city budget, several funds are held and designated for various purposes. Many of the current reserve accounts were identified as ones that could be adjusted at the discretion of the City Council to support operational costs (this excludes reserve funds constrained in their use by laws). The balances in these funds have grown from \$25 million in 2010 to \$40 million in 2016. The 2016 Washington State Audit for Mercer Island stated that over \$19M of the \$40M was discretionary. Based on this data, it was concluded the 2019-20 the City Financial biennial budget can be funded thru unused reserves even if there are no cost saving in a cost containment program and the deficit forecast turns out to be accurate. Chip Corder, Director of Finance confirmed the ability to apply city reserves to the budget situation, and has subsequently included some of the reserve funds into a revised budget.

STUDY PARTICIPATION AND PRINCIPLES:

Citizens in the study group have deep fiscal backgrounds, including: a corporate lawyer, a management consultant, an entrepreneur in real estate and business, a business unit manager for Amazon and Microsoft, a prior City Council member and Deputy Mayor, an institutional real-estate advisor, and a mutual fund executive. All participating members have lived on the Island between 10-50 years. The

group was focused on financial analytics, but shared a common viewpoint on a number of important principles:

1. We love Mercer Island, and all it represents. We value and respect the quality of life on the Island and want to preserve that.
2. We are sensitive to the tax burden Islanders already face, and especially the recent 18% hit in property taxes, coupled with increases from several recent tax changes (Sound Transit, McCleary, etc.). We believe that a tax increase paid to the City that raises taxes between 21-27.3%%, in addition to current taxes hitting citizen budgets, could negatively impact residents and diversity on the Island. *
3. When asking for more money, particularly taxpayer money, we support implementation of cost review first to identify potential efficiencies, before moving to collect additional taxes.
4. We believe asking questions about our city budget should be a positive process, and approached this study with full respect that the city staff is dedicated to the preservation of a solid city government. We recognize asking questions might feel uncomfortable, but also recognized it takes leadership. This study was completed solely to help identify opportunities and efficiencies for the long-term financial strength of Mercer Island.
5. We believe review and measurement of data is important. Studying historical financial forecasts vs. actuals for accuracy and accountability will help us more accurately forecast future scenarios, manage today, and improve for the future.

*Reference Pages 8 & 9: Mercer Islanders pay one of the highest \$ property taxes in King County

KEY FINDINGS:

The 1% property tax cap resulting from the WA State Legislature does not reflect the whole tax revenue picture:

Mercer Island city revenues from property taxes, which represent 40% of General Fund revenues, are capped by state law at 1% annual growth. The city's position is that the 1% property tax limitation resulting from state legislation prevents the City from keeping pace with inflation of goods and services, which the City purchases to deliver services, and leads to a deficit in city budgets. The 1% limitation is in place, but represents only a portion of the larger tax picture for the city. Mercer Island also collects property taxes on new construction, and over the last 8 years, the increase in property taxes collected by Mercer Island has never been just 1%, in fact, it has averaged 2.4%.

When looking at the broader collection of taxes, 60% of the Mercer Island General Fund collects revenue from the following:

- Sales taxes
- Utility taxes
- License, permit & zoning fees
- Park, recreation & rental fees
- EMS levy & charges for services
- Intergovernmental revenues
- Business & occupation tax
- Utility overhead
- Court fines
- CIP overhead
- General government
- Interest

Taxes listed above have been growing at a rate of 7% over the last 8 years, resulting in a net 5% growth for the Mercer Island General Fund over the last 7 years.

Mercer Islanders pay one of the highest \$ property taxes in King County:

The city advised the CAG that Mercer Island has a low assessment rate per \$1,000 vs. comparable cities (per the chart below taken from the city presentation materials to the CAG).

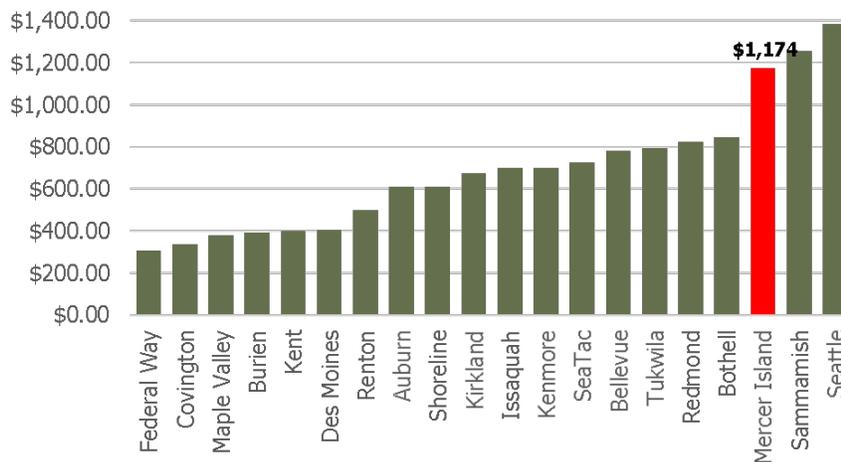
Key Facts
2017 Property Tax Levy Rate

| King County Cities (>20K population) | 2017 Levy Rate (City Portion Only) | King County Cities (>20K population) | 2017 Levy Rate (City Portion Only) |
|--------------------------------------|------------------------------------|--------------------------------------|------------------------------------|
| 1. Mercer Island | \$1.07739 | 10. Des Moines | \$1.51076 |
| 2. Issaquah | \$1.12329 | 11. Kenmore | \$1.53841 |
| 3. Maple Valley | \$1.12921 | 12. Shoreline | \$1.58415 |
| 4. Federal Way | \$1.13118 | 13. Renton | \$1.60954 |
| 5. Bellevue | \$1.14121 | 14. Bothell | \$1.89209 |
| 6. Kirkland | \$1.31279 | 15. Sammamish | \$1.92616 |
| 7. Redmond | \$1.35057 | 16. Auburn | \$2.19668 |
| 8. Burien | \$1.36228 | 17. Seattle | \$2.62327 |
| 9. Kent | \$1.41136 | 18. SeaTac | \$2.89429 |

What does this mean? Given the same AV, a Mercer Island homeowner will pay less property tax to the City than any other homeowner in King County will pay to his/her city.

Evaluating the city tax rate by itself does not convey the entire tax equation. Tax rates should be viewed in context with the median property values (which vary greatly from city to city) to understand the full tax that residents are paying. Per the chart below, when multiplying the tax rate times the assessed value, Mercer Island residents actually pay the most in city property tax excluding Sammamish and Seattle.

2017 City Property Tax for Median Residential Value



In the January 6th CAG meeting, the Finance Director presented and recommended a levy lid lift of \$331 in 2019 based on a median home value of \$1.2M, which results in a 30.7% increase in the first year of taxation. The levy lift amount will subsequently increase 5% each year thereafter, with the annual amount raising from \$331 in the first year to \$422 in 2024.

ORIGINAL LEVY LID LIFT PROPOSAL PRESENTED TO THE CAG on January 6:

Levy lift lid (6 years), reflecting smoothed annual funding for a \$1.2M AV home

| 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|-------|-------|-------|-------|-------|-------|
| \$331 | \$348 | \$365 | \$383 | \$402 | \$422 |

In the April 2nd CAG meeting, the Finance Director presented a few different options, but focused on two.

1. Option 1: LEVY LID LIFT ONLY.

This is the same as the option presented in January 6th CAG, however calculation adjustments were made and presented to the CAG, resulting in **27.3%** increase in the first year of taxation. The Levy Lid Lift will subsequently increase 5% each year thereafter, with the annual amount raising from \$331 in the first year to \$422 in 2024. This is based upon a median home value of \$1.2M.

OPTION 1: LEVY LID LIFT ONLY PROPOSAL PRESENTED TO THE CAG on April 6:

Levy lift lid (6 years), reflecting smoothed annual funding for a \$1.2M AV home

| 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|-------|-------|-------|-------|-------|-------|
| \$331 | \$348 | \$365 | \$383 | \$402 | \$422 |

2. Option 2: SMALLER LEVY + OTHER REVENUES.

The CAG was also asked to review an alternative levy lid lift proposal that included a **21%** increase in the first year. Based upon a median home value of \$1.2M, this levy lid lift is \$254 in 2019, plus an increase in the B&O tax rate from .10% to .15% and a permanent increase in the household utility tax from 5.3% to 8% effective January 2019. This option also has subsequent 5% levy lid lift increase of 5% each year thereafter, with the annual amount raising from \$254 in the first year to \$324 in 2024.

OPTION 2: SMALLER LEVY + OTHER REVENUES PRESENT TO THE CAG on April 6:

Levy lift lid (6 years), reflecting smoothed annual funding for a \$1.2M AV home

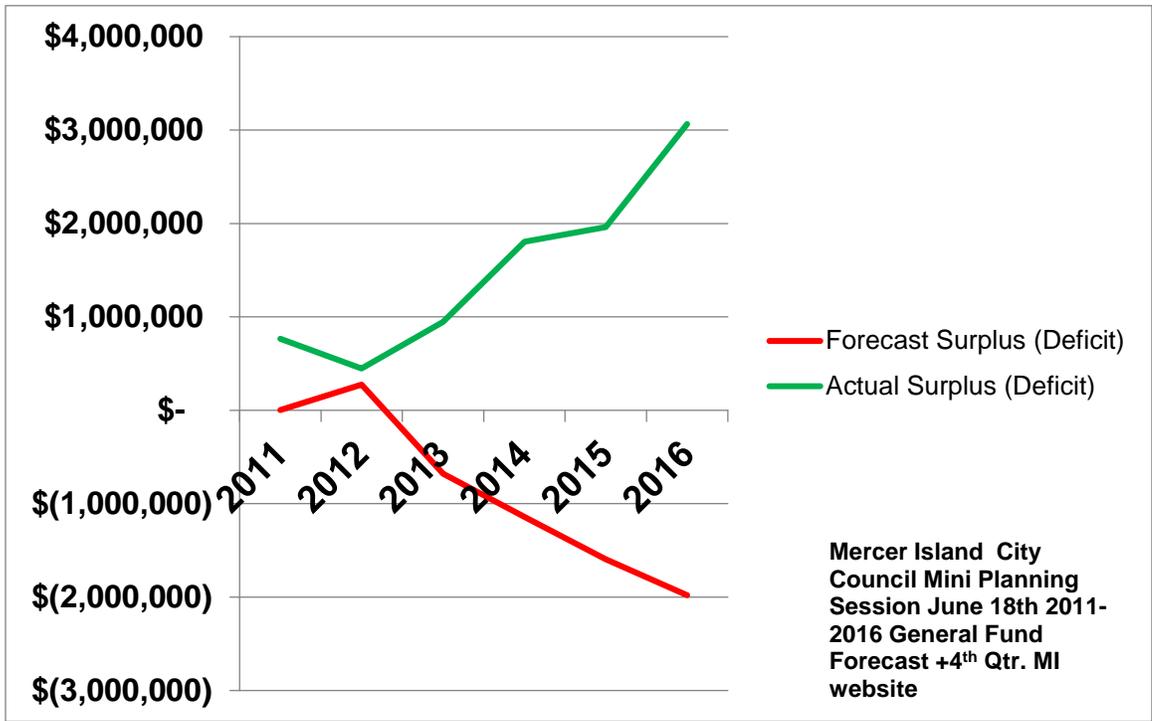
| 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|-------|-------|-------|-------|-------|-------|
| \$254 | \$267 | \$280 | \$294 | \$309 | \$324 |

Given the high value of Mercer Island homes, any increase of this size – whether 21% or 27.3%, would likely push Mercer Island to the highest city property tax paid among comparable cities as Mercer Island home values.

Historical forecast modelling and accuracy has been highly variable vs. actuals:

The City is asking for a tax increase based on a 6-year forecast for 2019-2024. Forecasting is inherently challenging, but because it is such an important component in the levy request, it is important to study historical forecasts vs. actual data to evaluate relative reliability of the current forecast.

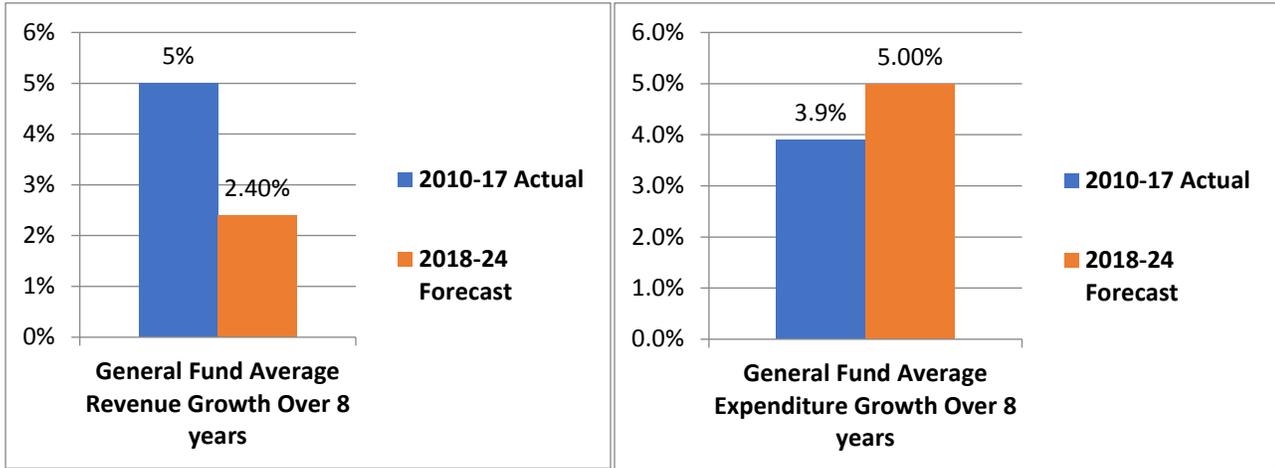
The last 6-year city forecast (which applied a similar modelling approach) completed for the 2011 to 2016 forecast and is shown in the below chart. The red line reflects the city budget forecast and the green line reflects actual budget performance. By 2016 there was a \$5 million positive variance in the actual data (\$3 million in positive net revenue vs a \$2 million dollar forecasted deficit).



The Mercer Island Director of Finance explained the reasoning is that he did not expect a robust recovery in real estate coming out of the 2008/2009 recession and on the revenue side that the City raised other taxes and fees.

According to El Jahncke, who served on the City Council for 11 years with some of the service during this time as Deputy Mayor, **forecasts of expenses exceeding revenues has been an ongoing theme since 2001 when the 1% limitation was first legislated.**

The 2018-2024 forecast reflects a similar profile. As an example, growth in revenue in the General Fund has averaged 5% over the past eight years, but the growth forecasts for years 2018-2024 used to support the need for a levy are 2.4%. Expenditure growth over the last eight years has averaged 3.9%, but forecasts used to support the levy are averaged at 5%.



Formal cost containment programs have not been directed by the City Council since the 2005-2006 budget:

Several members of the CAG suggested cost containment suggestions throughout the process, including administrative efficiencies, sustainability, cost out incentive programs, study of Marine Patrol, Library, Fire Department, etc. The City leadership and department heads know their departments well and are best to identify those areas where efficiencies could be gained.

In 2005, the City ran a cost containment program that reduced expenses by ~5% of the General Fund (\$1M). The first thing the city did was to prioritize the city's goals, with an emphasis on safety and reliable service. The second step was to create a budget that tied to the goals. Having created an exhaustive inventory of the City's services and organized them according to City Council approved priorities; City staff approached the 2005-2006 biennial budgets with a clearer understanding of how to develop expenditure and revenue proposals.

Examples of the cost containment measures that were implemented included:

- Outsourcing and Insourcing
- Alternative Suppliers
- Reduced Supplies / Equipment
- Reduced / Eliminated Services
- Reduced Travel and Training
- Reduced Overtime

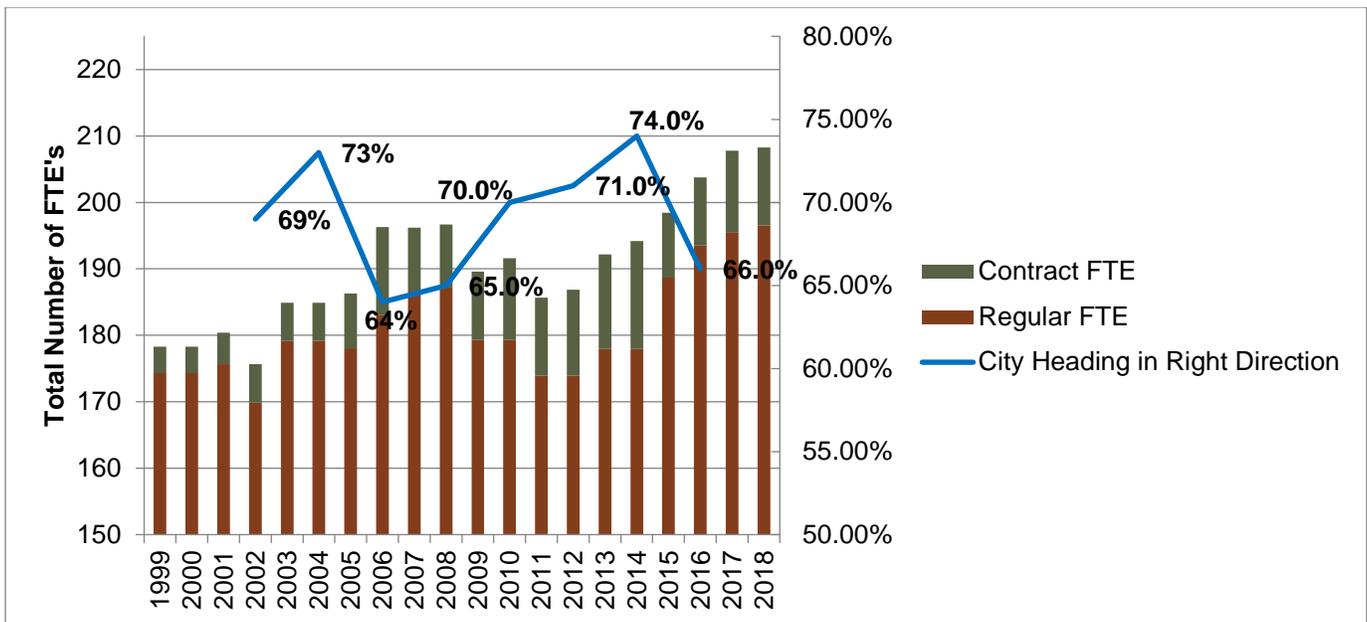
Formal cost containment programs help to create a focus on items that might sometimes be overlooked. Given there has been no formal program for 13 years, there is an opportunity for a deeper study. As an example: in the 2019-2020 budget, the city the biggest driver of costs are wages and benefits. Two labor contracts were recently approved by the Mercer Island City Council. The contracts extended for 2 years; however, they included no cost concessions for the city. If the city is facing a legitimate deficit position, and labor related expenses are the biggest driver, it would be prudent to engage in deeper contract negotiations and be proactive on cost containment within labor contracts.

Further, without a formal cost containment program, costs will continue to increase, and there will be no alternative but to renew and possibly increase the levy after 6 years. The levy lid lift does not solve the problem.

City service levels satisfaction expenditures on a higher number of employees are not positively correlated.

One of the concerns presented to citizens was that any cut in headcount would translate to a reduction of citizen satisfaction in city services. This study sought to understand staffing levels related to city service levels and whether there was a positive correlation.

When looking at the number of full time employees (FTE's) vs. city surveys on resident satisfaction, there is no positive correlation. This indicates opportunity to study the current staffing framework used by the city to potentially identify efficiencies and cost reduction opportunities through elimination of roles, which may not be as high a value to citizens.



Mercer Island holds over \$40M in reserves, some of which are over-funded:

The CAG discussions were directed to the City’s operational issues within the General Budget, which is approximately \$30 million dollars. The total budget for Mercer Island actually runs about \$65 million dollars and includes operational budgets. Within both the General Fund and the total budget, there are several reserve accounts that have been set up (some discretionary, some required by state law) to hold funds that might be needed in the future. The following balances were held in reserve accounts at the end of 2016 (the most current data available to the CAG):

| | | |
|----------------------|----|-----------|
| General Fund | \$ | 5,796,629 |
| Self-Insurance | \$ | 109,750 |
| Youth services Endow | \$ | 310,700 |
| Street | \$ | 3,874,030 |
| Criminal Justice | \$ | 1,100,614 |
| Beautification | \$ | 1,108,708 |
| Contingency | \$ | 2,629,429 |
| Muni arts/1% | \$ | 178,927 |
| YFS | \$ | 173,020 |
| Bond Red Non Voted | \$ | 18,943 |
| Bond Red Voted | \$ | 5,038 |
| Capital Improvement | \$ | 4,143,042 |
| Tech and Equipment | \$ | 656,890 |
| Capital Reserve | \$ | 169,999 |
| Equipment Rental | \$ | 3,092,248 |
| Computer Equip | \$ | 397,184 |
| Fireman’s Pension | \$ | 901,717 |
| Water Fund | \$ | 7,857,529 |
| Sewer fund | \$ | 4,204,431 |
| Storm water Fund | \$ | 3,971,292 |
| Fire Station Reserve | \$ | 36,195 |

to identify potential reduction of under-utilized reserves. This approach would help mitigate current challenges in the budget.

Reference: 2016 Washington State Audit – Mercer Island

For the City of Mercer Island, assets and deferred outflows of resources exceeded liabilities and deferred inflows of resources by \$217,843,956 at the close of 2016. The largest component of the City's total net position at \$189,390,423, or 86.9%, is net investment in capital assets (e.g. land, buildings, machinery, equipment, vehicles, and infrastructure), which subtracts out any related outstanding debt that was used to acquire those assets. The City uses these capital assets to provide a variety of services to its citizens. Accordingly, these assets are not available for future spending. Although the City's investment in capital assets is reported net of related debt, it should be noted that the resources used to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to pay these liabilities.

Approximately 4.0%, or \$8,685,492, of the City's total net position represents resources that are subject to external restrictions on how they may be used. The increase in restricted net position in 2016, as compared to 2015, is primarily the result of an increase in real estate excise tax revenues, which are

City of Mercer Island, Washington

restricted for capital projects related to streets, pedestrian/bicycle facilities, parks, and public buildings. The remaining 9.1%, or \$19,768,041, of the City's total net position is unrestricted and may be used to meet the government's ongoing obligations to its citizens and creditors.

At the end of the 2016 fiscal year, the City of Mercer Island had positive balances in all reported categories of net position, both for the government as a whole, as well as for its separate governmental and business-type activities. The same situation was true for the prior fiscal year.

www.mercergov.org/files/2016_Audit_Report.pdf