Budget Forecasting and Planning in an Uncertain Economy

September 22, 2020

pfm

2020
SEEING BEYOND
THE CHALLENGES

IGFOA 2020 ANNUAL CONFERENCE WEBINAR SERIES

Introduction

Kyle Jones

Managing Director

PFM Asset Management LLC

Vieen Leung

Senior Managing Consultant

PFM Group Consulting LLC

Ryan McNeely

Senior Managing Consultant

PFM Group Consulting LLC

Agenda

I. Economy overview

II. Budget implications

III. Projecting Revenues

IV. Emerging Practices and Approaches

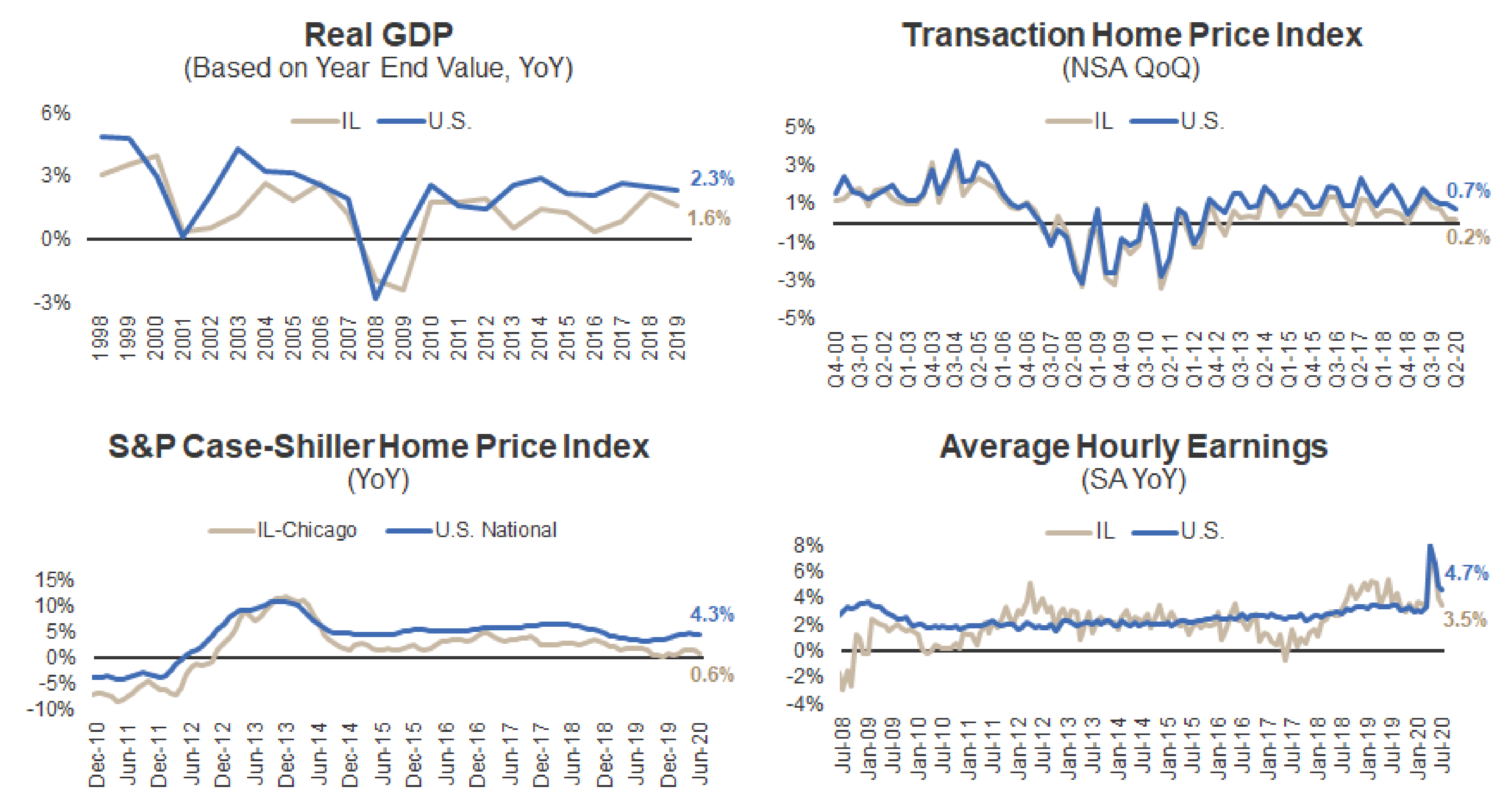
Overview

Today's economic environment is one characterized by tremendous uncertainty. This session will explore ways to address the impact of alternative economic scenarios when projecting major tax categories, non-tax revenues, and expenditures – along with perspectives on emerging best practices for budgeting within this challenging environment.

Learning Objectives:

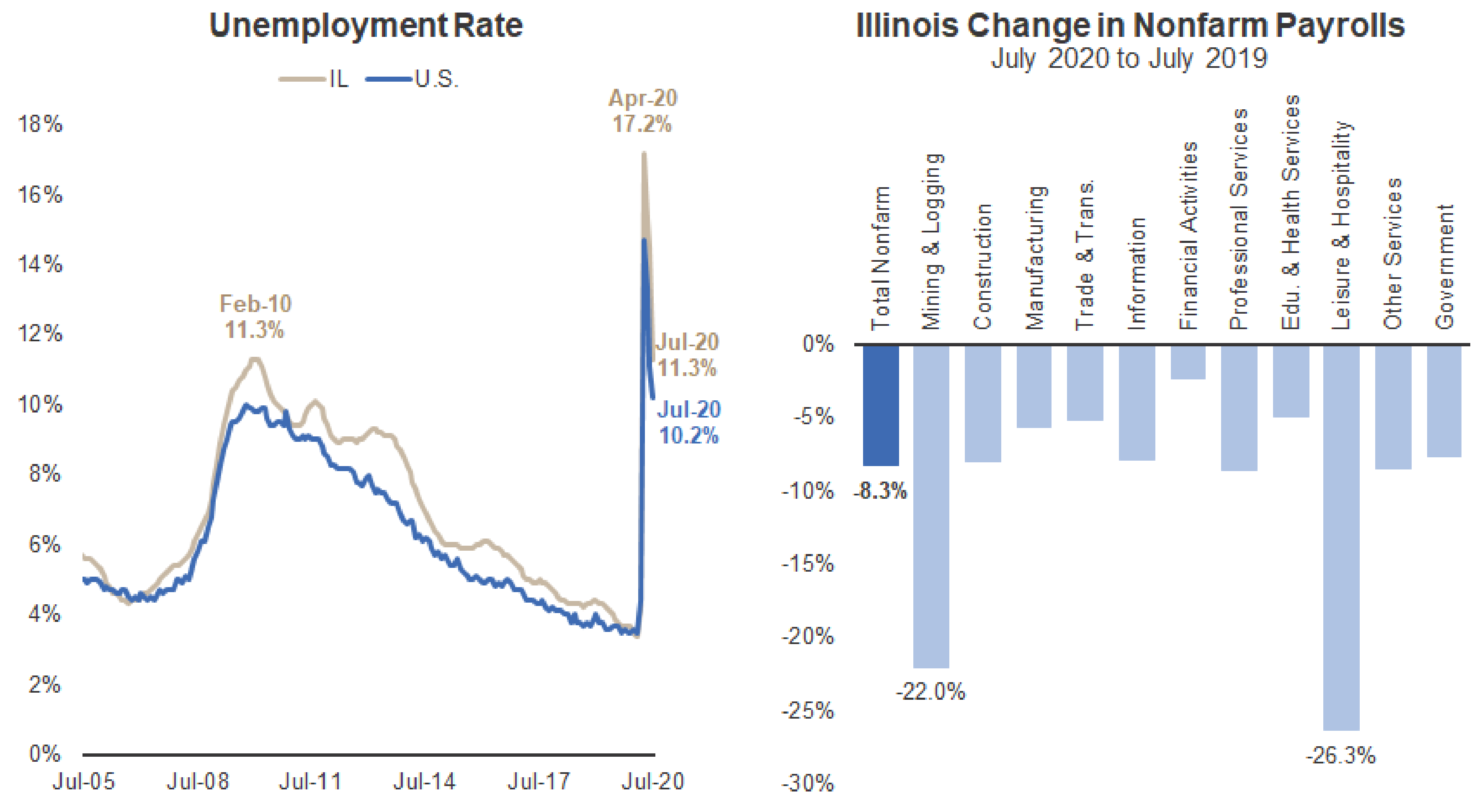
- Understand how to forecast budgets in this uncertain time;
- Understand ways to select and evaluate deficit-closing techniques; and
- Understand emerging best practices for budgeting, including innovative ways to deliver services.

An Overview of the Economic Landscape



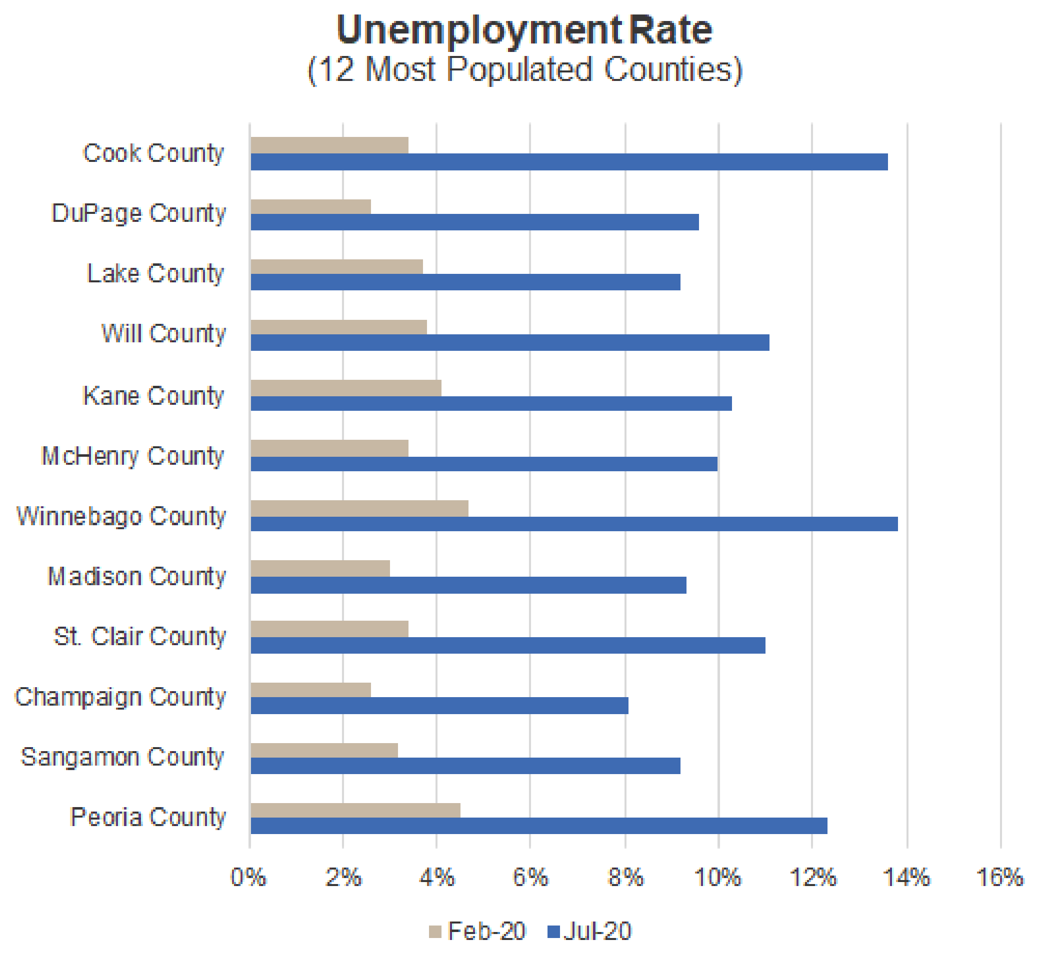
Source: Federal Reserve Bank of St. Louis FRED Database, most current data as of September 2020.

Illinois’ Labor Market Struggles



Source: Federal Reserve Bank of St. Louis FRED Database (left), U.S. Bureau of Labor Statistics (right), latest available data as of 9/14/2020.

Unemployment Rate Broken Down by County



	Feb-20	Jul-20
U.S.	3.5%	10.2%
Cook County	3.4%	13.6%
DuPage County	2.6%	9.6%
Lake County	3.7%	9.2%
Will County	3.8%	11.1%
Kane County	4.1%	10.3%
McHenry County	3.4%	10.0%
Winnebago County	4.7%	13.8%
Madison County	3.0%	9.3%
St. Clair County	3.4%	11.0%
Champaign County	2.6%	8.1%
Sangamon County	3.2%	9.2%
Peoria County	4.5%	12.3%

Source: Federal Reserve Bank of St. Louis FRED Database, latest available data as of 9/14/2020.

Budget Implications

2020 SEEING BEYOND THE CHALLENGES

Goals and Application

- Even as the COVID-19 pandemic has already generated unprecedented social and economic costs, **tremendous uncertainty** still remains about the future trajectory of new infections, rates of mortality and morbidity, the potential development timeline for a vaccine and more effective therapeutics, public policy responses – and the associated economic and fiscal impacts
- At the same time, governments must continue to provide public services and to protect the health, safety, and welfare of their communities – **and must develop budgets to do so**
- This session seeks to assist in budgetary planning during these extraordinarily uncertain times, and is grounded in conversations and work with our clients around the country
- Navigating this **ongoing** uncertainty has required, and will inevitably continue to require an **iterative process** for many more months to come
- With the experience of the first five months of this new era, some early lessons and ideas have begun to emerge
- Not all of the ideas we share today will be applicable for everyone on the call, but we hope that some of what we present may be helpful. In this same spirit, we also invite and encourage your ideas and feedback as we all continue to develop responses to the new challenges before us

The Shape of the Recovery

V… U… L… W… … or…

When the pandemic first hit, economists discussed what the "shape of the recovery would be." The most optimistic scenario had gross domestic product (GDP) dropping sharply for a short period of time and then rebounding quickly, creating a V-shaped curve. Slightly less optimistic projections had GDP rebounding a little more slowly (U-shaped curve), as was the case nationally in the last recession. There has since been discussion about a multi-year recovery ("Swoosh" shaped curve) or a double-dip recession (W-shaped curve).

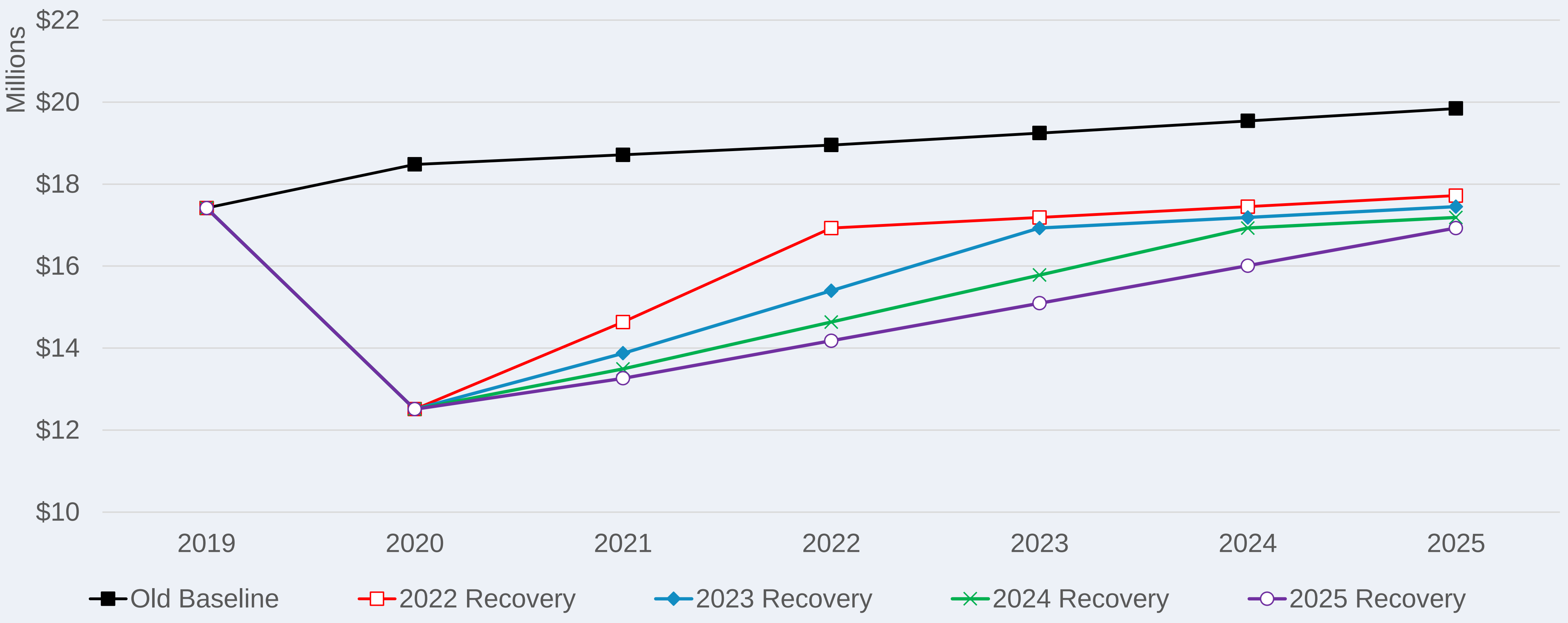
In August 2020, Moody's presented two scenarios at the National Association of State Budget Officers (NASBO) conference:

- **Baseline scenario** assumes the worst of the pandemic ends with the summer; the Q4 2020 jobless rate will be 9.5 percent higher and GDP will be 7 percent lower than in Q4 2019; and the job market doesn't fully recover until late 2023

- **Severe stress scenario** assumes second round of virus outbreaks creates a "double dip" recession; the Q4 2020 jobless rate will be 11.5 percent higher and GDP 10 percent lower than Q4 2019; and the job market doesn't fully recover until early 2026

Source: Moody's Analytics, "Stress Testing in the Age of COVID-19," presented by Dan White in August 2020

Why does the Shape of Recovery Matter?



Transparent Budget Assumptions

- Clarity for elected officials, senior policymakers, and other stakeholders regarding the underlying basis for economic projections (particularly around the path of the virus and return toward normalcy)
- Opportunity for informed buy-in around the approach and/or recalibration as warranted
- Provides a record of assumptions at key junctures, to contextualize future post-hoc reviews of forecast accuracy

Example: City and County of San Francisco (3/31/2020)

> Ultimately, the duration and depth of the downturn will correlate with both the measures required to contain the spread of the virus and the economic dislocation that occurs during this period, both of which are unknown at this time. Given this uncertainty, we have projected General Fund tax revenues under two scenarios:
>
> - More Limited Impact. A severe but more limited scenario resulting from a better-case, limited duration recession in which the economy experiences a short, six-month shock and then rapidly recovers by the end of calendar year 2020.
>
> - More Extended Impact. A more severe and extended scenario where the economy experiences a more severe six-month shock, followed by a slower period of recovery that extends through the end of calendar year 2020 and through 2021. For FY 2019-20, extended impact scenario projections represent a deeper shock than limited impact projections.

Polling Question #1

Which of the following statements most closely aligns with rating agency practice and the recommendations of this presentation?

A. Using sound economic data and analysis, you can get to the definitive, right number that will accurately predict your future revenues.

B. When forecasting revenues, it is helpful to develop two or more scenarios based on different economic assumptions, so that you can more fully assess risks, stress test your volatility, develop contingencies, and manage against uncertainty.

Correct Answer: B

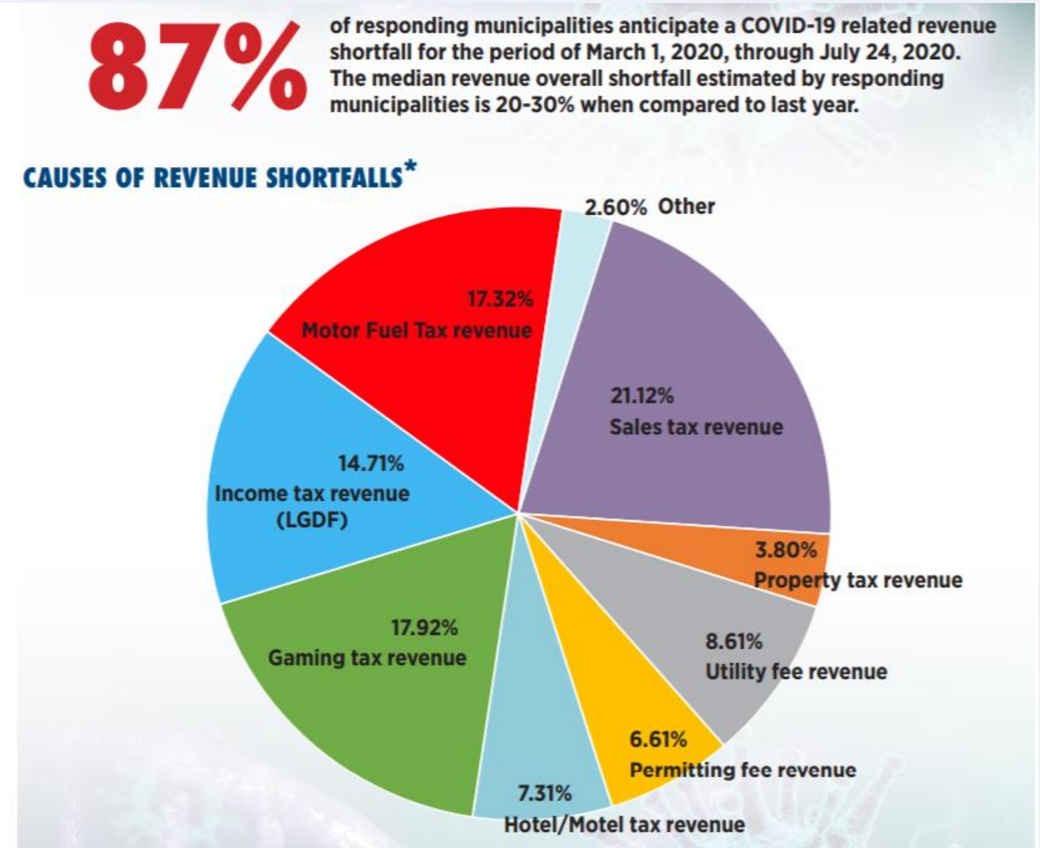
Projecting Revenues

SEEING BEYOND THE CHALLENGES

Major Tax Categories

Tax Category	Likely Impact	Local Factors
Property	• Low impact for residential; new construction can be affected (down 22.3% in March year over year, but up 9.4% year over year in July), but assessments for many in place for now and mortgage companies typically holding in escrow • Commercials may see appeals; bankruptcies to drive nonpayment?	• Frequency of reassessment • Commercial/residential mix • Collections difficulty
Real Estate Transfer	• Temporary slowdown in sales due to stay at home restrictions • Longer-term cooldown in market possible	• Local housing market composition
Sales	• Varies by sector, but near-term impact high	• Industry mix • What is covered • “Wayfair” law coverage (all but FL and, for now, MO)
Hotel, Meals, Rental Car	• Tourism and hospitality taxes hit hard • Timing, pace, and extent of recovery TBD	• Concentration of tourism and hospitality sector
Income	• Decline expected with rising unemployment, furloughs • Capital gains and other unearned income also likely to fall (partial offsets possible from liquidations)	• Nexus issues for some non-resident (commuter) taxes
Business	• Widespread impacts, concentrated on small businesses and certain sectors	• Industry mix
Excise	• Gas tax hit hard; energy and other commercially/industrially driven taxes slowed • Cable and “sin” taxes (alcohol, tobacco) likely more stable	• Industry mix

Illinois Municipal League COVID-19 Survey Results



The Illinois Municipal League provided their membership with a survey to chronicle the impact of COVID-19 on municipal governments. Survey responses were submitted from June 30, 2020, through July 24, 2020. There were 227 municipalities that completed the survey. More information and detailed survey results can be found here: https://www.iml.org/page.cfm?key=24527

User Charges, Licenses, Permits, Fines

	Examples	Has activity changed due to COVID-19? - Stay-at-home - Policy change (e.g. waivers) - Economic	How is activity likely to change after initial restrictions lifted?	Is there the potential for "catch up" post-COVID?	Impact if economic downturn continues after public health conditions improve?	Potential longer-term impacts (post-recession)?
User Charges	Parking Meters	Yes; much lower; sometimes waived	Likely slow recovery	No	Lower	More WFH?
	Recreation classes	Cancelled	Recovery	No	--	From Zumba to Zoom-ba?
	Plan review	Slowed or cancelled	Likely slow recovery	Partial	Lower	On-line?
	EMS transport	Unclear; new COVID-19 emergency calls, but other calls slowed	--	Partial	--	Telemedicine?
Licenses	Business	Varies by timing of cycle; some waivers	Return to cycle	Yes	Fewer businesses	More on-line
Permits	Building	Lower activity	Recovery	Partial	Lower	Fewer office building constructions?
Fines	Traffic fines	Lower activity	Likely slow recovery	Limited	--	Policy review of alternatives

Intergovernmental Revenues (State to Local)

- An April 14, 2020 Moody's Analytics study projects the combined fiscal shock of revenue shortfalls and Medicaid spending increases in Illinois to be **at least 15 percent of General Fund revenue by the end of FY2021.**
- These shortfalls are equivalent to the State's rainy-day funds and greater than the State's total balances

	Baseline (Moderate Stress)	Severe Stress Scenario
Tax revenue shortfall	$5,153 million or 13.1%	$6,920 million or 17.7%
Medicaid spending increase	$1,060 million or 2.7%	$1,206 million or 3.1%
Combined fiscal shock	$6,213 million or 15.9%	$8,126 million or 20.7%
Rainy-day surplus/shortfall	-15.8%	-20.7%
Total balances surplus/shortfall	-14.7%	-19.5%

State Budget Pressures

- State revenue shortfalls have already begun to emerge as sales, income, and other major tax categories have started to decline
- An April 14, 2020 Moody's Analytics study projects potential revenue losses across the 50 states through FY2021 equivalent to 14.8% to 19.5% of General Fund revenues
- Moody's Analytics also anticipates potentially significant spikes in state Medicaid costs based largely on increased unemployment
- Overall, Moody's forecasts the potential fiscal shock to reach 17.9% to 23.0% of General Fund revenues in the aggregate by the end of FY2021
- Although most states have built up strong reserves, these projected pressures exceed those of the Great Recession within a more compressed period of time
- Because state economies, tax structures, spending obligations, and reserve levels all vary, the degree of budget pressure and capacity will also vary widely across state governments

Source: *Moody's Analytics, "Stress-Testing States: COVID-19," 4/14/2020*

Other Non-Tax Revenues

- **Investment income**
  - Lower interest rates
  - Greater draw downs on reserves / weaker cash flow
- **Voluntary contributions from nonprofits / Payments In Lieu of Taxes (PILOTs)**
  - At risk due to nonprofit fiscal challenges
- **Utility transfers**
  - Where present, may see some pressure due to commercial/industrial declines and/or concentrated impacts of certain large users (e.g. universities)
- **Other miscellaneous**
  - Lease of City properties; heightened risk of nonpayment
  - Reduced property sales
  - Concessions may decline

Filing Delays & Collections Issues

- **Widespread property tax filing delays**
  - Potential longer-term collection risk, e.g. due to small business bankruptcies
- **Impact of other tax filing delays at higher levels of government, for example:**
  - Federal income tax deadline extension
- **Potential programs to waive penalties and/or interest for late payment**
- **General exposure to heightened nonpayment and collection risk**

<u>Both a fiscal year timing issue and an absolute dollar issue</u>

Polling Question #2

In most communities, which of the following tax types (where in place) saw the sharpest and fastest downturn as a result of the COVID-19 pandemic?

A. Property taxes

B. Income taxes

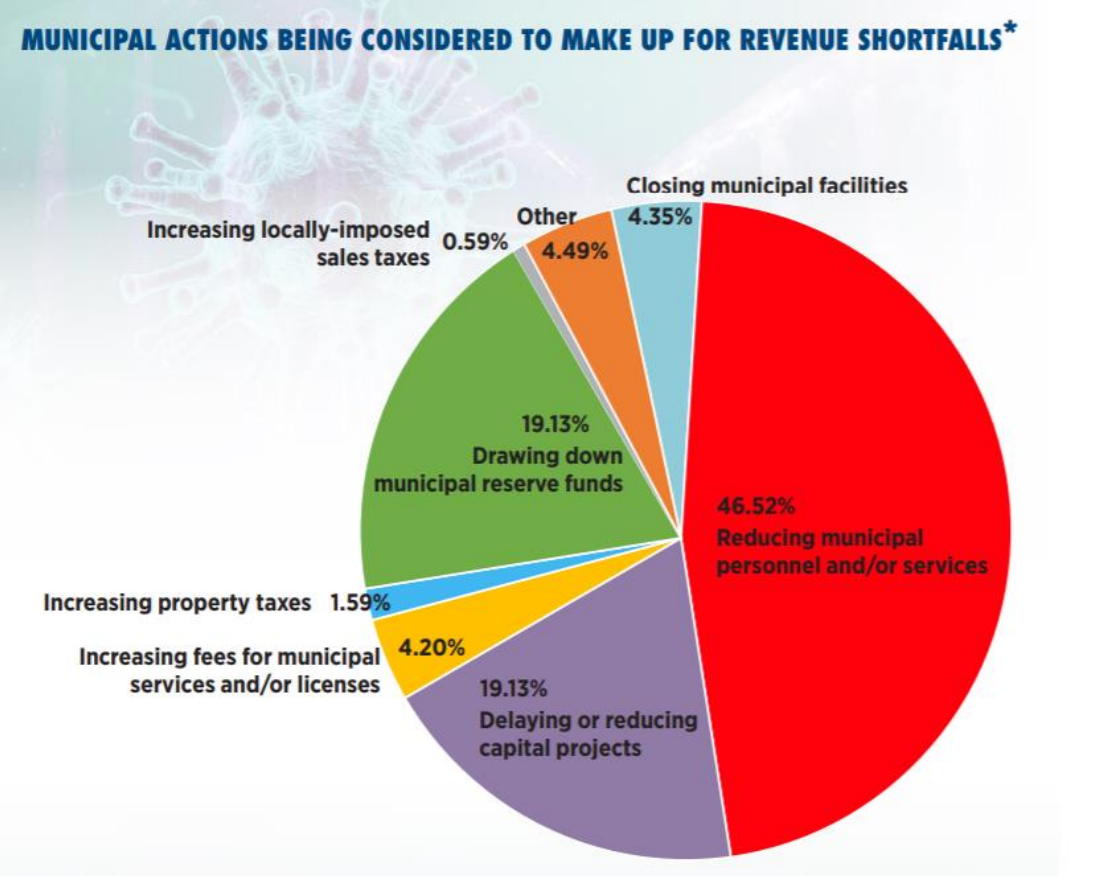
C. Hotel taxes

Correct Answer: C

Emerging Practices and Approaches

IGFOA 2020 ANNUAL CONFERENCE WEBINAR SERIES

Illinois Municipal League COVID-19 Survey Results



The Illinois Municipal League provided their membership with a survey to chronicle the impact of COVID-19 on municipal governments. Survey responses were submitted from June 30, 2020, through July 24, 2020. There were 227 municipalities that completed the survey. More information and detailed survey results can be found here: https://www.iml.org/page.cfm?key=24527

Quantifying "Organic" Savings

- Some savings will likely be achieved "organically" as a result of restrictions on social activity (and may also, in some cases, be maximized through management action):
  - Reduced costs from cancellation of special events
  - Reduced overtime in active, but non-essential or slowed functional areas (e.g. plans review and new construction permitting and inspection)
  - Lower facility and other costs for closed operations (utilities, some maintenance, some materials and supplies)
  - Lower fuel and maintenance costs for the non-essential fleet
  - Reduced travel costs (e.g. training and conference attendance)
  - Deferred pay-go capital costs with construction halted

Cost Containment & Departmental and Strategic Engagement

- As already noted, many governments have already initiated initial cost reduction efforts (e.g. hiring freezes, pay-go CIP deferrals, etc.) and, if not already launched, are commonly evaluating more severe measures (e.g. furloughs and service cuts)
- At a technical level, it is important that any such measures be fully and realistically quantified as part of a budget forecast
- At a practical level, early **department and stakeholder engagement** can help to identify smarter and more enduring opportunities than across-the-board reductions
  - Departmental engagement can also help to identify and capture the more immediate "organic" savings from social restrictions and a slowed economy, as well as (potentially reimbursable) direct COVID-19 response costs
- Many communities are also finding benefits from peer-to-peer coordination within regions and/or sectors

Useful Resource: GFOA Paper

- Part 1 of GFOA's *Balancing the Budget in Bad Times* focuses on **"primary" techniques** – sound, proven financial management best practices that can be helpful during financial distress

  https://www.gfoa.org/materials/balancing-the-budget-in-bad-times---part-1

- Part 2 will focus on **"cautionary" treatments**. These are more extensive measures with risks and potential downsides that local governments could evaluate in response to severe budget pressure, even if generally viewed by the GFOA as less advisable during good times

  https://www.gfoa.org/materials/balancing-the-budget-in-bad-times-part-2

- PFM wrote a complementary guide that offers **practical advice** on how to evaluate the effect and efficacy of gap-closing initiatives

  https://www.pfm.com/docs/default-source/default-document-library/pfm-perspectives---decision-making-in-the-covid-19-crisis.pdf?sfvrsn=cc3b4998_0

First Step: Sizing the Hole

Before we start building a strategy to fill the deficit, we need to spend some time determining how big it is and how long it'll last by working through the following questions:

- ***How big is the deficit?***
- ***How soon does it arrive? Are we at risk of running out of cash during the year?***
- ***Does the deficit grow, shrink or stay the same over time?***

With any financial crisis, especially the COVID-19 pandemic, it is impossible to answer these questions with certainty. Even so, an analysis—presented with transparency around the assumptions and commitment to update as information becomes available—is better than flying blind since it gives you a sense of magnitude. Are you trying to fill a hole the size of a lemon or a limousine?

From Triage to Stability to Sustainability

Immediate (hours, days)

- Cash flow forecasts
- Ensuring liquidity
- Budget controls
- Funding (and quantifying) emergency needs

Near-term (days, weeks)

- Reforecasts (iterative)
- Cost containment
- Workforce strategies
- Reimbursement framework
- Intergovernmental coordination
- Economic relief programs

Longer-term (weeks, months)

- Capital projects and planning
- Pension / OPEB concerns
- Sector relief and rebuilding (e.g. arts and culture)
- Intergovernmental advocacy
- Multi-year framework
- Evaluating potential lasting impacts and how to respond (e.g. new ways of working post-COVID-19)

Guiding Principle: Fiscal Stability Matters to Everyone

While there is a temptation to discuss financial performance as if it's separate from other goals – "I know you need to make the numbers work" -- financial stability is prerequisite to achieve any goal in the long term. We emphasize the importance of having stability at the lower levels in the graphic below so a community can achieve stability at the higher levels.

We assume the pandemic will push governments down the ladder. So a community that recently balanced its budget without much difficulty and was focused on multi-year issues like capital investments will have spend more time on the annual budget this year.

Service stability

The ability to deliver desired services over time at a price the community is willing to pay for them, even as the community's needs and preferences change

Structural stability

The ability to ensure that recurring revenues meet recurring expenses from year to year

Budgetary stability

The ability to balance revenues and expenditures without incurring a deficit at year's end

Cash stability

The ability to generate enough cash to pay liabilities when they are due

Multi-Year Plan Case Study: Rockford, IL

As a traditional northern manufacturing community, the City of Rockford's economy has struggled for decades but was particularly hard-hit by the broader economic declines following the September 11, 2001, terrorist attacks and the 2008 financial crisis. By 2017, Rockford faced a population decline of over three percent in five years, a poverty rate of nearly 25 percent, and an average unemployment rate of 6.6 percent. Notably, nearly 45 percent of Rockford children under age five were living in poverty.

In addition, Rockford had an urgent need to align spending with available revenues due to large and increasing pension obligation, collective bargaining constraints and rising personnel costs, and limited revenue options due to lack of home-rule status.

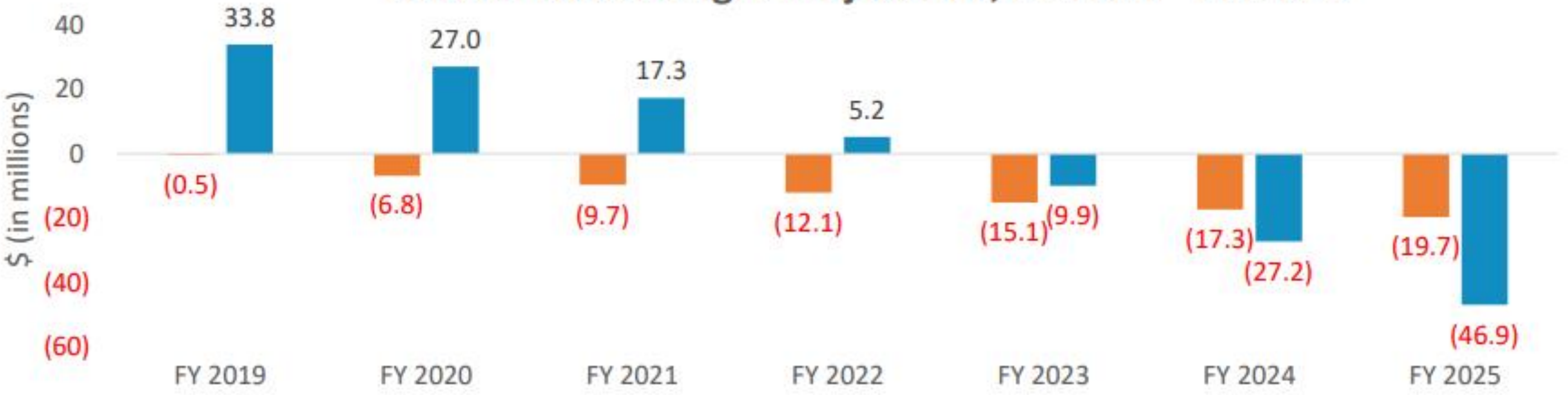
In 2017, the City of Rockford applied to the National Resource Network for assistance with multi-year financial planning. The Network recommended that the City develop a seven-year financial plan to give policy makers the tools to make sound decisions. To frame the plan, the Network focused on key priorities to address going forward:

- Fiscal Stability
- Crime Reduction
- Investing in community and economic development

Rockford's Baseline Forecast

- Under the baseline forecast, the projected cumulative deficit over the next seven years is approximately **$81.2 million**.
- By ***FY 2020***, Rockford's fund balance is projected to drop below the level required by the City's own financial policies.
- The City is projected to run out of funds during ***FY 2023***. By the end of ***FY 2025***, the City is projected to have a General Fund annual deficit of $19.7 million and a negative fund balance of $46.9 million.

General Fund Budget Projections, FY 2019 – FY 2025



Where is Rockford Now? *2020 Budget Update*

"Our budget covers a variety of services and programs that our residents expect and deserve. We continue to focus on public safety—which again represents the largest portion of our budget. Thanks to responsible fiscal management, the Police Department continues to invest in new technology, adding training resources, replacement vehicles and other technology to give the sworn staff the tools they need to address the City's public safety challenges. This investment and hard work is paying off, as we're seeing consistent decreases in violent crime and property crime.

I'm especially pleased we kept our property tax levy flat and that our property tax rate is estimated at 3.00, a 3.8 percent decrease from the previous year. Maintaining a flat levy leaves more than $1 million in revenue the City could otherwise have collected— that money stays where it belongs, in the pockets of property taxpayers."

– Mayor Tom McNamara

Polling Question #3

What kind of fiscal stability should local governments focus on?

A. Cash stability
B. Budget stability
C. Structural stability
D. Service stability
E. All of the above

2020 SEEING BEYOND THE CHALLENGES

Correct Answer: E

Opportunity in a Crisis: Operations

As the pandemic continues, there may be lasting changes in how people work and live (e.g. more working from home; potential new constituent expectations for online public services, etc.). **How can local governments learn from recent experiences and translate changes made or opportunities that arose during the pandemic to fiscal savings?**

For example:

- With the increased use of online processes during the pandemic, would it be beneficial to develop a staffing analysis and review whether the number of clerical and support staff aligns with service needs?
- Are there untapped opportunities to provide online, remote, and/or appointment-based services?
- If certain positions and/or departments were successful in working from home during the pandemic, would it be beneficial to pilot hybrid work arrangement and/or remote roll call programs that help reduce real estate footprint and utility and operating costs?
- Would establishment of an Innovation Fund help to support and accelerate change?

Examples of Potential Operational Change

- Expanded video- and teleconferencing (e.g., swearing in notaries, human services benefits assistance, probation check-ins, property assessment and appeals)
- Increased online activity (e.g., tax sales, domestic relations, plan review, licenses, payments, dispute resolution)
- Appointment hours for citizen meetings (better customer service; defined time for focused, non-customer work)
- Alternative work arrangements to retain talent and/or increase availability to the public

Note: some operational changes may require state and/or local changes in current requirements

Opportunity in a Crisis: Policy

- **In addition to operational change, are there lessons learned that can be applied to new policies?**

  For example:

  - Are there tax and revenue policy changes that could be pursued to create a more stable and diversified set of revenues?
  - Given the national conversation around criminal justice and public safety reform, are there opportunities…
    - ...to reduce costly incarceration by reducing or eliminating criminal justice fees and fines, developing alternatives to jail time, reforming probation, and rethinking cash bail?
    - …to explore expanded use of civilians in for traditionally “back-office” law enforcement agency functions and/or non-emergency response functions to achieve both cost savings and better outcomes?
  - Given the potential revenue shortfalls many local governments will experience, is this an appropriate time to revisit local governments’ mission and refocus on core services?

Questions?

Presenters

Kyle Jones
Managing Director
PFM Asset Management LLC
jonesk@pfm.com

Vieen Leung
Senior Managing Consultant
PFM Group Consulting LLC
leungv@pfm.com

Ryan McNeely
Senior Managing Consultant
PFM Group Consulting LLC
mcneelyr@pfm.com

Relationship Managers

Michelle Binns
Senior Managing Consultant
PFM Asset Management LLC
binnsm@pfm.com

Spiro Hountalas
Senior Managing Consultant
PFM Asset Management LLC
hountalass@pfm.com

Matt Hanigan
Senior Managing Consultant
PFM Asset Management LLC
haniganm@pfm.com

Jeff Schroeder
Managing Director
PFM Asset Management LLC
schroederj@pfm.com

2020
SEEING BEYOND
THE CHALLENGES

DISCLAIMERS AND COPYRIGHT NOTICE

Illinois Government Finance Officers Association 800 Roosevelt Road, Building C, Suite 312 Glen Ellyn, IL 60137 Phone: 630-942-6587 Email: info@igfoa.org Visit http://www.igfoa.org