AGENDA #9a

MEMORANDUM

TO: Roger L. Stancil, Town Manager

FROM: Kenneth C. Pennoyer, Business Management Director

SUBJECT: Impact of Economy on Town Budget

DATE: December 8, 2008

PURPOSE

The purpose of this memorandum is to provide information concerning the potential impact of the financial crisis on the Town's budget and the Town's ongoing ability to support large scale capital projects such as the Library expansion.

BACKGROUND AND DISCUSSION

The consequences of the economic crisis are still unfolding. There is a great deal of volatility in the markets and there remains the possibility of more major failures across multiple industries. In this environment it is impossible to predict with any degree of accuracy the impact of the crisis on the local economy. This is exacerbated by relatively long delays in the receipt of key revenues. This puts us in the position of having to react before we know the full extent of the impact of the crisis, because by the time our revenues show the effects it may be too late to make orderly changes to the current budget. For this reason, our analysis is limited to identifying the potential impact based on revenue performance during previous recessionary periods and making common sense assumptions concerning the potential magnitude of the current downturn. In this way we can be proactive in making changes to the budget that will lessen the impact of a major revenue shortfall. In other words, we recommend proceeding with an abundance of caution. We are in uncharted waters; the enormity of the crisis and the unprecedented nature of the events that have happened in the last three months demand immediate action on our part.

IMPACT OF THE FINANCIAL CRISIS ON THE TOWN BUDGET

The biggest impact of the financial crisis on the Town's budget will be loss of revenues from sources that are impacted by downturns in the economy. The major impacts that we foresee include:

- **Reduction in retail sales:** The acute drop in consumer confidence coupled with an increased tightening in the consumer credit markets could result in a significant impact on Sales Tax receipts for this fiscal year. A drop of 5% -10% from our budget estimates is possible.

- Recently the **consumer confidence index** hit its lowest level recorded since its inception in 1967. The index fell to 38, down from 61.4 in September and 95.2 one year ago.
- Declines in household wealth due to the sharp drop in the stock market, declines in home values, increased unemployment and tightening consumer credit have created a dismal environment for consumer spending.
- Rising unemployment rates will also negatively impact sales tax revenues. Although the triangle area may not feel the same employment impact as other parts of the country, the increased uncertainty created by rising unemployment numbers will eventually impact consumer behavior.
- Despite the factors that point to a likely drop in sales, the "Black Friday" sales surprisingly increased 3% from last year. There are a number of factors that contributed to this result, including deep discounts as retailers trade profit margin for volume.
- **Sales taxes represent 19.4% ($9,623,000) of General Fund Revenues.** A 10% decline would create a $962,000 gap that would need to be filled with reductions in spending.
- Due to the long delay in receiving sales taxes from the state, we will not know the actual impact of the financial crisis on monthly sales tax receipts until late in the third quarter of this fiscal year. In addition we will not receive the crucial holiday sales tax receipts until the fourth quarter. This will give the Town a very small window to make adjustments should the numbers be worse than expected.
- In order to limit our exposure to a major sales tax deficit for this fiscal year we will use the following strategies:
    - Immediately adjust our revenue estimates to reflect the high end of the anticipated shortfall.
    - Monitor regional and state-wide retail sales figures and make adjustments to our sales tax estimates accordingly.

- **Decline in commercial and residential construction:** The bursting of the "housing bubble" has resulted in a decline in home values and a severe restriction of credit. This combination will create barriers to new construction, as developers will have difficulty getting construction loans. Also, the glut of homes in the real estate market will stifle new construction. The primary concern is long-term rather than for the current fiscal year.
    - We do not anticipate a reduction in assessed value as a result of the upcoming revaluation, however, it is likely that we will not see the value growth that we have seen in prior revaluations. Longer term, the rate of growth in the property tax base could slow to near zero after those projects currently under constructions are completed.
    - Property taxes are the Town's largest revenue source, representing about 50% of General Fund revenues and 100% of the Debt Fund revenues ($24,620,000 and $6,400,000 respectively) and we rely on growth in the tax base to help the keep pace with increased demands for service, capital needs and general inflation on the cost of operations. Significant declines in the growth of the property tax base will increase the funding gap in future budgets.

- **Revenue shortfalls in development fees, interest income and user charges:**

- As previously noted, under current conditions development cannot continue at pre-crisis levels. This will reduce development related revenue by as much as $150,000 in the current year.
- Short-term interest rates have been driven down to near zero by demand for treasury securities. Although we have reduced the budgeted interest earning revenues significantly from previous years, there is still potential for a shortfall of as much as $50,000.
- Miscellaneous user charges could also be impacted as people adjust to the financial crisis by foregoing fee related activities. The impact in the current fiscal year could be as much as $100,000.

The Municipal Bond Market has not returned to normal – Recently rates have dropped from 10 year high levels reached in October. However, they still remain about ½ to ¾ of 1% higher than pre-crisis levels and demand in the market is still a fraction of normal. The continued absence of institutional investors in the tax exempt bond market has prevented demand and rates from returning to "normal" levels. Due to the extraordinary circumstances in other financial markets this situation could continue for an extended period of time.

- The elevated rates in the municipal bond market represent an additional interest cost of approximately $600,000 to $800,000 over the 20 year life of a $11.455 million issue.
- Originally we had planned to issue $11,455,000 of GO bonds in the 3rd quarter of this fiscal year. This would have been the first of two GO issues that would have exhausted the 2003 GO bond authority. The Town could request a three year extension of the authority to issue the 2003 GO debt from the Local Government Commission. This would allow for issues of the debt through November of 2013.
- Delaying the GO debt issuance planned for this fiscal year could be beneficial for a number of reasons. First, it will allow additional time for debt markets to return to normal. Second it would provide additional time to gauge the impact of the financial crisis on the Town's finances. Finally, a delay of 12 months would produce savings in this year's budget as well as FY2009-10 and FY2010-11.

BUDGET SAVINGS STRATEGIES FOR THIS FISCAL YEAR

Although we do not have sufficient information to accurately calculate the impact on the current year's budget, based on the preceding analysis, we believe that revenue shortfalls of as much as $1.5 million could be expected. Based on this potential shortfall the department directors have been asked to identify savings in the current budget, with the goal of achieving a 5% reduction in expenditures for the current fiscal year while minimizing the impact on service delivery. Based on prior year's budgetary savings this goal appears achievable. The 5% number includes an amount that will be needed to help fund next year's revenue gap. The following is a breakdown of how the savings will be distributed.

Potential Current Year Shortfall	$ 1,450,000	
Reserve for FY2009-10 Budget	1,030,000*	
5% Savings Target	$ 2,480,000	(5% of $49,621,000 GF Budget)

* *Based on FY09 budget projections we are anticipating a $3.3 million budget shortfall for FY10*

As additional information concerning the economy and the impact on our revenue sources becomes available this target may be adjusted.

Rather than impose across the board budget cuts and hiring freezes that tend to unevenly impact departments and could have unintended impacts on service delivery, the Manager has asked the staff to take a more measured approach to achieve these savings, including the following:

- **Manage position vacancies to maximize savings** – Rather than institute an across the board hiring freeze which arbitrarily punishes departments with high vacancy rates regardless of needs, departments have been directed to achieve a lapsed salary savings amount commensurate with the size of their workforce.
- **Reduce out of state and redundant travel and training expenses –** Although there is not a lot of money to be saved in this area, it is important symbolically to curtail these expenditures where possible. Also no transfers should be allowed into travel and training accounts.
- **Eliminate year-end "spend-down" of supplies and equipment accounts** – This is always a difficult strategy to implement, particularly if there is an implied penalty for under-spending in subsequent years budgets.
- **Delay or forgo purchase of non-essential supplies and equipment** – Purchases of non-mission critical items should have an additional approval level to filter out non-essential items.
- **Conserve energy and consumables wherever possible** – This applies mostly to fuel and utilities, but items such as paper can also yield significant savings.
- **Defer certain CIP Projects** – This strategy needs to take into consideration increased maintenance costs or project costs escalations due to delays.

DELAYING THE PLANNED FY2008-09 GO DEBT ISSUE

By delaying the planned FY2008-09 GO debt issuance to FY2009-10, and combining it with the Planned FY2009-10 issue, the Towns overall peak debt service can be reduced. This will help to relieve the budgetary pressure created by the rate of increase in debt service. In addition, this delay could help provide additional clarity with respect to the impact of the financial crisis on the Town's budget. The reduction (delay) in annual costs, including Library operating costs, would be approximately $300,000 in the current year and $1 million in FY2009-10.