Agenda Date: 2/27/2024, **Item No.** 1

General Fund 2024-25 Preliminary Budget Status and Multi-Year Forecast

This report transmits the preliminary status for the General Fund (GF) Fiscal Year (FY) 2024-25 budget and a multi-year GF forecast through FY 2026-27 (**Attachment A**). The multi-year forecast is being presented to the Mayor and City Council as an essential tool in long-term budget discussions and decision making.

THIS ITEM IS FOR INFORMATION AND DISCUSSION.

Summary

The GF budget outlook for FY 2024-25 reflects a projected one-time surplus of $80 million. The City has experienced strong growth over the past three fiscal years with continued increases in resources. However, as the attached multi-year forecast report (**Attachment B**) demonstrates, projected deficits in FY 2025-26 and FY 2026-27 will require strategic decision making to ensure the GF budget remains balanced. Staff will update revenue and expenditure estimates in the coming weeks as part of the annual 7+5 technical review process and incorporate required changes to projections. The 2024-25 Trial Budget will be presented to City Council on March 19, and will include recommendations on how to responsibly allocate the one-time surplus.

The attached Multi-Year Forecast report includes estimates of future GF resources and expenditures for FY 2024-25 through FY 2026-27 based on several economic and budgetary assumptions. Negative numbers are shown in parenthesis. The forecast projects a range of ending balances with deficits in FY 2025-26 of $(103) million to $(66) million and for FY 2026-27 of $(53) million to a potential surplus of $19 million. The deficits are due to the State's actions to eliminate residential rental sales tax and reduce individual income tax rates, further discussed in this report. The forecast is not intended to precisely predict future GF capacity, but rather to present ranges of potential ending fund balances to be used as a framework for decision making and strategic planning to ensure a balanced budget going forward.

<u>GF 2024-25 Preliminary Budget Status</u>

The FY 2024-25 GF ending fund balance is estimated to be $80 million and is considered one-time funds representing a carry forward of prior year fund balance and savings in GF capital costs. The projected ending fund balance includes significant reductions in revenues caused by legislation passed by the State that eliminates residential rental sales taxes for cities and towns effective January 2025 (SB 1131). The estimated five-month impact to the GF for FY 2024-25 is approximately $(18.4) million and the ongoing annual impact beginning in FY 2025-26 is $(43.4) million. Additionally, SB 1828 reduced individual income tax rates beginning in tax year 2022 to the current "flat tax" rate of 2.5 percent. On June 9, 2023, the State's Joint Legislative Budget Committee (JLBC) notified the legislative membership of a significant decline in GF revenue collections, which is primarily due to underestimating the negative impact of the rate reduction. The City receives state-shared income taxes based on actual collections from two years prior. Budget and Research staff rely on projections from the JLBC to estimate this revenue stream for budget development. The estimated negative impact to FY 2024-25, FY 2025-26, and FY 2026-27 of the less than estimated income tax revenues by the JLBC is approximately $(36) million, $(43) million and $(41) million respectively, compared to projections in the GF Forecast presented to City Council on Feb. 21, 2023.

The GF preliminary estimated resources in FY 2024-25 are $2.096 billion or (1.6) percent lower than FY 2023-24 estimated resources. GF revenue for FY 2024-25 is estimated at $1.843 billion or (3.1) percent lower than the FY 2023-24 revised revenue estimate. Projections account for the reductions mentioned above to city sales tax and state shared revenue. Staff will further refine GF revenue estimates over the coming weeks in preparation for the City Manager's Trial Budget scheduled to be presented to City Council on March 19. More information on each resource category is detailed in **Attachment A.**

The GF preliminary expenditure projections may change as cost estimates are further refined in the coming weeks; however at this time the preliminary FY 2024-25 GF expenditures to continue existing levels of service are projected to be $2.016 billion, or $1.927 billion excluding contingency funds. This compares to the FY 2023-24 GF expenditure estimate of $1.890 billion. The increase accounts primarily for higher costs for employee salaries and benefits, associated with the City Council approved Classification and Compensation Study, negotiated labor increases and pension costs. These cost increases were partially offset by lower GF capital costs for vehicle replacements and pay-as-you-go projects that will instead utilize excise tax bond proceeds.

The FY 2023-24 preliminary GF budget also accounts for increasing the contingency fund from $81 million to $89 million, to reflect 4.75 percent of operating expenditures. In March 2010, the City Council agreed to gradually increase the contingency with a goal of achieving five percent of GF operating expenses. Achieving this goal will improve the City’s ability to withstand potential future economic declines.

GF Multi-Year Forecast

The attached Multi-Year Forecast and Preliminary GF Status Report includes economic, resource and expenditure assumptions (**Attachment C**) used to develop the forecast. The report also includes possible risks and unfunded needs, including costs necessary beginning in FY 2024-25 to continue efforts helping individuals experiencing homelessness. Additional GF resources will be required for the Office of Homeless Solutions (OHS) upon expiration of American Rescue Plan Act (ARPA) funds with preliminary estimates for FY 2024-25 of $6.5 million and in FY 2025-26 of $22 million. These costs have not been factored into the forecast.

The current forecast assumes no changes to existing labor contracts or service levels, and does not assume any further negative impacts to the City from the current State legislative session. The forecast accounts for anticipated cost increases for operating expenses associated with the voter approved 2023 General Obligation Bond Program in FY 2025-26 and FY 2026-27 totaling $12.8 million over the two fiscal years. Additionally, pension costs are forecasted separately based on information from the City of Phoenix Employees Retirement System (COPERS), and the Public Safety Personnel Retirement System (PSPRS) actuaries, and are anticipated to increase $109 million, or 30 percent from FY 2022-23 to FY 2026-27 (**Attachment G**).

The multi-year forecast as presented does not assume any period of recession but rather includes a baseline, optimistic and pessimistic projection, based on ranges for revenues and expenditures. As mentioned above, the FY 2024-25 GF ending fund balance is estimated to be $80 million. The outer years of the forecast project a range of ending balances with deficits in FY 2025-26 of $(103) million to $(66) million and for FY 2026-27 of $(53) million to a potential surplus of $19 million. The baseline forecast in FY 2025-26 and FY 2026-27 includes deficits estimated at $(92) million and $(31) million, respectively. The forecast assumes the one-time surplus in FY 2024-25 of $80 million is allocated for one-time purposes rather than spent on ongoing initiatives and therefore is not continued in the following year. The FY 2025-26 deficit is balanced by reducing ongoing expenditures and is not carried over to FY 2026-27. The projected deficits are due to the state's actions to diminish the ongoing tax base by prohibiting cities and towns from collecting residential rental sales tax and lowering individual income tax rates.

It is important to note the FY 2024-25 GF ending balance if adjusted for the loss of residential rental sales tax and the impact of the less than projected state shared income tax collections would have been estimated at $134 million (versus $80 million). The outer years of the forecast would also be significantly improved absent the loss in revenue with a range in FY 2025-26 of $(17) million to $20 million and projected surpluses of $33 million to $105 million in FY 2026-27 (**Attachment B**).

Additionally, to better prepare for future challenges, the attached report includes stress testing for moderate and severe recessions, which is an essential fiscal tool to evaluate how revenues respond to different levels of economic crisis. Stress test simulations can help determine if an organization can weather economic shocks or unexpected declines in revenues and is included for illustration purposes only (**Attachment D, E and F**).

As we look ahead, areas which could impact the GF include revenue volatility, economic declines or a recession, continued pension cost increases, higher costs for employee compensation, impacts from the Department of Justice inquiry, State legislative actions, and unfunded mandates. Staff will continue to monitor legislation, economic conditions and monthly revenue collections closely throughout the budget development process.

Next Steps and Community Engagement

The Phoenix City Charter requires a balanced budget each year. On March 19, a balanced City Manager's Trial Budget will be presented for City Council and community discussion along with the Preliminary Five-Year Capital Improvement Program (CIP). The CIP is a multi-year plan for capital expenditures that are needed to replace, expand, and improve infrastructure and systems.

Engaging residents in the budget process is a priority of the City Council, and this year staff plans to continue the practice of seeking community input on the proposed budget with several opportunities for residents to participate through community budget hearings to be held during the month of April. Residents are also invited to use the FundPHX tool and can contact the Budget and Research Department directly to provide input on the budget. More information is available on the Budget and Research Department's website, phoenix.gov/budget. Feedback received from residents will be provided to the City Council regularly so it may be considered ahead of final budget adoption.

Responsible Department

This item is submitted by City Manager Jeffrey Barton and the Budget and Research Department.

ATTACHMENT A

RESEARCH REPORT BUDGET AND RESEARCH DEPARTMENT	B.R. REPORT NUMBER **2024-05** DATE ISSUED February 22, 2024
TO: **JEFF BARTON** CITY MANAGER	FROM: **AMBER WILLIAMSON** BUDGET AND RESEARCH DIRECTOR

SUBJECT

MULTI-YEAR FORECAST AND FY 2024-25 PRELIMINARY GENERAL FUND BUDGET STATUS

BACKGROUND

Development and presentation of the multi-year forecast is an important step in the City's budget process. Evaluating projected available resources and identifying potential ongoing budget surpluses or funding gaps will allow City management and Council to develop strategic plans to ensure the continuation of City operations and optimize services to the community.

The multi-year forecast estimates future revenues and expenditures of the General Fund for the current fiscal year through fiscal year 2026-27. The purpose of this forecast is to identify key trends in revenues and expenditures and to provide information about the financial landscape anticipated over the next few years. The information contained in this forecast is based on data available through January 2024.

The General Fund (GF) multi-year forecast (**Attachment B**) is provided to the City Council and the community for consideration and provides City policy makers with:

- A strategic financial management best practice
- A framework for strategic decision-making to ensure a balanced budget each fiscal year
- The opportunity to make policy changes to maximize City resources and service delivery
- A roadmap to continued fiscal health and award-winning budgetary and financial reporting

The forecast is not an official policy or legal budget document and does not enact any budgetary allocations. The forecast is also not intended to set or precisely predict future revenues or expenditures. Rather, the forecast presents current estimates based on several economic and financial assumptions of the future direction and ranges of growth rates for both resources and expenditures. The economic, revenue, and expenditure assumptions are provided in **Attachment C**.

The forecast is built on several assumptions outlined in **Attachment C** regarding:

- The national, state, and local economy
- Population and job growth

- Revenue and expenditure growth
- Impacts of anticipated increasing pension liabilities
- Effects of the state's actions on residential rental sales tax and individual income tax cuts
- Estimated additional costs for the Class and Comp study
- Cost management practices

All of these factors are subject to change and are detailed further in this report.

Projecting future available resources and expenses over multiple years is complex and involves several assumptions concerning how revenue and expenditures will grow over time. To model potential future budgetary scenarios under varying economic conditions, a range is provided for resources and expenditures for the outer years of the forecast. The differences between the upper and lower ends of the ranges increase in the later years of the forecast reflecting additional economic uncertainty. The top of each range represents the "optimistic" forecast, while the bottom of the range represents the "pessimistic" forecast.

It is important to note, if any of these assumptions as described were to change or modeled differently, the ranges of amounts presented in the forecast would need to be revised. Unexpected economic shocks, recessions, legislation, unfunded mandates, or other risks to the forecast can also adversely affect projections.

Additionally, even slight variances in the revenue and expenditure growth rates in the initial years of the forecast result in substantial changes to the later years due to the compounding effect of the changes. For example, a revenue growth variance of only 1% in FY 2024-25 can result in a $19 million change to the ending balance, which would impact the ending fund balances in the subsequent forecast years. Long term forecasts become less reliable the further they are from development because of the many underlying assumptions subject to frequent fluctuations.

Projections are formulated in the first six months of the fiscal year and are based on current estimates of where staff believes resources and expenditures will be for the current fiscal year and the subsequent three years. In order to create the most reliable revenue and expenditure projections, staff relies on several economic sources, months of actual collections and extensive technical reviews before recommending estimates to City management and ultimately the City Council for final consideration.

GF Summary

Revenue growth in the previous fiscal year was strong despite the onset of geopolitical conflicts, high inflation, actions by the Federal Reserve to increase interest rates, tighter monetary policy, and volatile markets. In FY 2022-23, GF revenues were 13.2% higher than FY 2021-22, primarily due to a one-time increase in state shared income tax collections (based on actual collections from FY 2020-21), and strong city and state sales tax revenues. However, significant economic uncertainty and volatility in sales tax revenue collections in the first six months of FY 2023-24 require a cautious approach to forecasting. The baseline revenue forecast for the remainder of FY 2023-24 and looking ahead to FY 2024-25 is projected to expand but at a slower pace and is in line with trusted economic sources used to develop revenue estimates. The revised estimated revenue growth for FY 2023-24 and FY 2024-25 is 12.4% and -3.1% respectively. The negative growth in FY 2024-25 is primarily due to significantly lower state shared income tax collections caused by the state's actions to lower the individual income tax rate to the current "flat tax", and the elimination of residential rental sales tax.

The State recently enacted Senate Bill 1131, which prohibits municipalities from taxing residential rental property starting Jan. 1, 2025. The estimated 5-month impact to the GF for FY 2024-25 is approximately $(18) million and the ongoing annual impact beginning in FY 2025-26 is over $(43) million. Additionally, Senate Bill 1828 reduces individual income tax rates beginning in tax year 2022 to the current flat tax rate of 2.5%. On June 9, 2023, the State's Joint Legislative Budget Committee (JLBC) notified the legislative membership of a significant decline in GF revenue collections, which is primarily due to underestimating the negative impact of the state's decision in 2021 to enact Senate Bill 1828. The City receives state-shared income taxes based on actual collections from two years prior. Budget and Research (B&R) staff rely on projections from the JLBC to estimate this revenue stream for budget development. The estimated negative impact to FY 2024-25, FY 2025-26, and FY 2026-27 of the less than estimated income tax revenues by the JLBC is approximately $(36) million, $(43) million and $(41) million respectively compared to projections in the GF Multi-year Forecast presented to City Council on Feb. 21, 2023.

The FY 2024-25 GF ending fund balance is estimated to be $80 million and is considered one-time funds representing a carryforward of prior year fund balance and savings in capital expenditures. The outer years of the forecast project a range of ending balances with deficits in FY 2025-26 of $(103) million to $(66) million and for FY 2026-27 of $(53) million to a potential surplus of $19 million. The baseline forecast in FY 2025-26 and FY 2026-27 includes deficits estimated at $(92) million and $(31) million, respectively. The forecast assumes the one-time surplus in FY 2024-25 is allocated for one-time purposes rather than spent on ongoing initiatives. The FY 2025-26 deficit is balanced by reducing ongoing expenditures and is not carried over to FY 2026-27. The projected deficits are due to the state's actions to diminish the ongoing tax base by prohibiting cities and towns from collecting residential rental sales tax and lowering individual income tax rates. It is important to note the FY 2024-25 GF ending balance if adjusted for the loss of residential rental sales tax and the impact of the less than projected state shared income tax collections would have been estimated at $134 million (versus $80 million). The outer years of the forecast would also be significantly improved absent the loss in revenue with a range in FY 2025-26 of $(17) million to $20 million and projected surpluses of $33 million to $105 million in FY 2026-27 (**Attachment B**).

Additionally, to better prepare for future challenges, this report also includes stress testing for moderate and severe recessions, which is an essential fiscal tool to evaluate how revenues might respond to different levels of economic crisis (**Attachment D, E and F**).

OTHER INFORMATION

Staff is underway with the annual 7+5 expenditure and revenue technical review process and may update estimates if necessary. The final estimates and recommendations to the City Council on how best to allocate the one-time GF surplus in FY 2024-25 to achieve a required balanced budget will be presented in the proposed Trial Budget on March 19.

It is also worth noting the preliminary FY 2024-25 budget and forecast is based on existing state-shared revenue models and statutory obligations. Any changes to state-shared revenue formulas, or other revenue sources proposed in the Governor's budget or in legislative bills that would impact the GF forecast, are not reflected, and would need to be addressed if adopted by the State.

General Fund FY 2024-25 Preliminary Budget Status

FY 2024-25 Resources - The chart below shows the preliminary resources projection:

GF Resource Category	2024-25 Preliminary Estimate (in millions)	2024-25 Preliminary Projected Annual Growth Rate %
Local Sales & Excise Taxes [1]	$737	0.9%
State-Shared Revenue [2]	$699	-8.9%
Primary Property Tax [3]	$215	3.9%
User Fees and Other	$192	-2.9%
Beginning Balance [4]	$242	N/A
Transfers/Recoveries [4]	$11	N/A
Total GF Resources	**$ 2,096**	**-1.6%**

[1] Reflects the negative impact to Local Sales & Excise taxes because of Senate Bill 1131, which prohibits municipalities from taxing residential rental property starting January 1, 2025.

[2] Reflects the negative impact to State-Shared Income Tax Revenue because of Senate Bill 1828, which reduces the individual income tax rates to flat tax of 2.5% beginning in tax year 2022. However, it does not reflect any impact to State-Shared Revenue resulting from the FY 2024-25 State budget, nor legislative changes that have recently been proposed or discussed during the current legislative session.

[3] Assumes the continuation of the City Council adopted policy to maximize the primary levy in order to preserve GF services. Any deviation from this policy would require an ongoing reduction to GF programs.

[4] Estimates for beginning balance and transfers/recoveries are not derived from annual growth rate projections or broader economic factors.

Revenue Forecasting Model - In the fall of 2014, Budget and Research consulted with the University of Arizona’s Eller College of Management, Economic and Business Research Center (EBRC) to enhance the City’s sales tax revenue forecasting process. Dr. George Hammond, EBRC Director, and Dr. Alberta Charney, Senior Research Economist, spent several months working with City staff to develop an enhanced econometric sales tax forecasting model for all categories of city and state sales tax. In the summer of 2017, staff worked with EBRC to update the tax forecasting model. In March 2021, the EBRC revised the City’s model again by including online sales tax. The City began collecting sales tax from online marketplace retailers effective October 2019 just prior to the pandemic, which helped to offset losses experienced in the leisure and hospitality sales tax categories during the pandemic. The EBRC leads the State of Arizona Forecasting Project, which provides in-depth economic forecast analysis and databases on a subscription basis to businesses, organizations, and government via membership. The additional consulting with Dr. Hammond has provided the City with solid, independent economic and statistical expertise used to develop a statistically valid forecasting model specifically for the City of Phoenix. The projected growth rates in each category of sales tax for the FY 2024-25 estimate and the outer years of the forecast are based on projections developed with the enhanced econometric forecasting model. Revenue estimates may change as more data becomes available and will be finalized in the coming weeks.

GF Expenditures - The preliminary expenditure estimates may change as cost estimates are further refined in the coming weeks. Currently, FY 2023-24 and FY 2024-25 General Fund expenditure estimates excluding contingency are projected to be $1.890 billion and $1.927 billion, respectively. The increase includes the additional costs for the Class and Comp study, and increased costs for pension, contractual services, and commodities. The outer years of the forecast assume expenditures excluding pension grow by five percent and account for increased costs from the Class & Comp study and estimated operating cost impacts for the voter approved 2023 General Obligation Bond Program. Further detail on expenditure assumptions can be found in **Attachment C**.

Pension Costs – Expected changes in COPERS and PSPRS pension costs are as follows:

- COPERS: GF pension costs in FY 2024-25 for civilian employees are estimated at $113 million and are expected to increase to $122 million in FY 2026-27. The overall trend in COPERS pension cost has been driven by recent actuarial changes, plan earnings, payroll growth and pension reform (**Attachments B and G**).

- PSPRS: GF pension costs in FY 2024-25 for sworn Police and Fire are estimated at $330 million and are expected to increase to $352 million in FY 2026-27. The primary factors contributing to the growth are recent actuarial changes, plan earnings, and changes to the payroll base. As the multi-year forecast shows, GF public safety pension costs are estimated to increase by $31 million from the FY 2023-24 budget through FY 2026-27 (**Attachments B and G**), which adds pressure to the GF budget going forward and limits the City's ability to either expand programs and services to residents or increase employee compensation.

Contingency Fund (Rainy Day Fund) – The Contingency Fund is assumed to increase from $81 million to $89 million in FY2024-25 to reflect 4.75% of operating expenditures. The contingency rate remains at 4.75% for the entire forecast period due to the anticipated deficits in FY 2025-26 and FY 2026-27. In March 2010, the City Council agreed to gradually increase the contingency with a goal of achieving five percent of GF operating expenses to withstand potential economic declines. Contingency/rainy day funds provide one-time resources for possible emergencies and unanticipated costs that may occur after the budget is adopted. The possibility of natural disasters, public or employee safety emergencies, public health issues, economic shocks or declines, and geopolitical events that can impact the broader economy necessitates maintaining adequate contingency funds. The Government Finance Officers Association (GFOA) recommends cities maintain reserve levels as a financial best practice and according to the Pew Charitable Trust, research also shows that contingency/rainy day funds can affect a government's credit rating, which in turn has an impact on borrowing costs and operating expenses. The role of the contingency/rainy day funds is to improve a city or town's monetary stability by building up a safety net for cities and towns so that it could be used to protect itself against adversities. They offer the capability to meet a monetary crisis without hindering public services. Without a contingency fund, unforeseen emergencies or economic declines may create budget deficits requiring reductions to programs and services.

The GF preliminary FY 2024-25 budget status and multi-year forecast are provided for information purposes only.

ATTACHMENTS

Attachment B- Multi-Year General Fund Forecast

Attachment C- Forecast Assumptions

Attachment D- Background, Methodology and Assumptions for Stress Testing

Attachment E- Stress Testing for Moderate Recession Scenario

Attachment F- Stress Testing for Severe Recession Scenario

Attachment G- Pension Cost Increases

ATTACHMENT B
Multi-Year General Fund Forecast ($ Millions)

	2023-24 Adopted Budget	2024-25 Preliminary Budget Estimate	For Planning Purposes Only 2025-26 Forecast	2026-27 Forecast
Resources				
Local Taxes	$699	$737	$741 - $752	$769 - $792
State Shared Revenues	770	699	674 - 685	700 - 722
Primary Property Tax	207	215	222 - 225	228 - 235
User Fees and Other	155	192	194 - 197	196 - 202
Other (Carryover Balance, Transfers, Recoveries)	130	172	16	7
Unused Contingency from Prior Year	68	81	89	91 - 90
Total Resources	**$2,029**	**$2,096**	**$1,936 - $1,964**	**$1,991 - $2,048**
Expenditures				
Operating Expenditures	$1,360	$1,408	$1,434 - $1,426	$1,406 - $1,392
Civilian Pension	112	113	115	122
Sworn Public Safety Pension	321	330	340	352
Contingency	81	89	91 - 90	91 - 90
Pay-As-You-Go Capital	122	60	38	38
Minimum Vehicles	33	16	21	35
Total Expenditures	**$2,029**	**$2,016**	**$2,039 - $2,030**	**$2,044 - $2,029**
PROJECTED (DEFICIT)/SURPLUS:	**$ -**	**$80**	**$(103) - $(66)**	**$(53) - $19**
State's Actions to Reduce Revenue:				
AZ Individual Income Tax Cut, Effective Tax Year 2022		**$36**	**$43**	**$41**
Residential Rental Property Tax Cut, Effective 1/1/2025		**$18**	**$43**	**$45**
ADJUSTED PROJECTED (DEFICIT)/SURPLUS:		**$134**	**$(17) - $20**	**$33 - $105**

Key Resource Forecast Assumptions:

* The forecast assumes modest revenue growth with no recession from 2024-25 to 2026-27, no fee increases or decreases and no new revenue sources.
* The forecast includes tax rate reduction: Laws 2021, Chapter 412 (Tax Omnibus) reduced the number of individual income tax brackets from four in Tax Year (TY) 2021 to two brackets in TY 2022. Starting from TY 2023, the individual income tax has been reduced to 2.5%.
* Relative population share used in calculating state shared revenues in 2024-25 was based on the 2022 Census Bureau Population Estimate. It was projected to remain flat throughout the forecast period. The actual share will change annually based on Census Bureau Population Estimates. In addition, Laws 2021, Chapter 412 (Tax Omnibus) increased the Urban Revenue Sharing distribution from 15% to 18% starting in 2023-24.
* The forecast includes residential rental property tax reduction: Senate Bill 1131 prohibits municipalities from taxing residential rental property starting January 1, 2025.

Key Expenditure Forecast Assumptions:

* The contingency fund is set as 4.75% of the total General Fund operating expenditures from 2024-25 through 2026-27.
* Includes no additional future funding for program enhancements, unfunded mandates, expiring grants, etc.
* 2024-25 employee costs are based on projections under the current Council-adopted pay plan ordinance and employee contracts. No assumptions have been made concerning future labor contract negotiations. Estimated costs of the Class and Comp study are included in the forecast. Pension costs are based on required and projected contribution rates provided by the respective pension system actuaries.
* Non-personnel related expenditures for 2024-25 assume expenditure growth is in line with recent historical averages, and the out years are anticipated to align with the estimated CPI growth.

Other Forecast Notes:

* Ranges provided for revenues and expenditures. Upper & lower ends of ranges increase slightly in the outer years of the forecast reflecting additional economic uncertainty in the later years.
* Ranges include pessimistic and optimistic scenarios within assumptions provided by the primary sources of economic information mentioned in this report.
* When a baseline deficit or ongoing surplus is projected, the next year’s operating expenses are assumed to be decreased or increased by the baseline deficit/surplus amount prior to applying the assumed annual projected growth rate, as the City is required by Charter to balance the budget each year.

ATTACHMENT C

Forecast Assumptions

Economic Sources - Budget and Research staff relies on several different sources for economic data and forecasts to assist with developing revenue and expenditure projections.

The list below includes the primary sources of information:

- State of Arizona Finance Advisory Committee (FAC) which includes several economists and finance professionals from the private and public sectors
- State of Arizona Joint Legislative Budget Committee (JLBC)
- University of Arizona (UofA), Economic Business Research Center (EBRC)
- Global Insight, IHS
- Arizona State University (ASU) – WP Carey School of Business, and Western Blue Chip
- Arizona Department of Administration (ADOA) - Employment and Population Statistics Office
- JP Morgan Chase Economic Outlook Center
- Blue Chip Economic Indicators (BCEI) – National Level
- U.S. Bureau of Labor Statistics
- U.S. Census Bureau
- U.S. Bureau of Economic Analysis (BEA)
- The Conference Board
- University of Arizona (UofA) Forecasting Project – A community-sponsored research program within the Economic and Business Research Center providing project members with economic forecasts for Arizona, the Phoenix-Mesa metro area, and the Tucson metro area. City staff attends the Forecasting Project quarterly meetings and receives quarterly reports and data/projections used to assist in developing our forecasts. Forecasting Project data relies on Global Insight, IHS which is a well-known economics organization that provides comprehensive economic and financial information. The data from this project is incorporated into an econometric software program used to forecast sales tax.

Economic Outlook

The U.S. economy has demonstrated resilience over the past three years. Real Gross Domestic Product (GDP), a common economic measure, grew 2.5% in 2023. According to the U.S. Bureau of Economic Analysis (January 2024), the 2023 growth was attributed to increases in consumer spending, nonresidential fixed investment, state and local government spending, exports, and federal government spending partly offset by decreases in residential fixed investment and inventory investment. However, real GDP is expected to rise more slowly in 2024 than in 2023. The Conference Board anticipates two quarters of slightly negative GDP growth during the second and third quarters of 2024 that will be broadly felt across the economy. Estimated GDP for 2024 and 2025 is 1.2% and 1.4%, respectively. These figures represent a decline compared to the preceding three years: 5.8% in 2021, 1.9% in 2022, and 2.5% in 2023 (The Conference Board, January 2024) signaling a softening of the economy. Despite the anticipated normalization of inflation and interest rates in 2024, volatility is still expected to persist throughout the year. Several contributing factors include challenges in real disposable income growth, diminishing pandemic-related savings, rising household debt, and the impact of “buy now, pay later” plans. At a broader level, the challenges facing the U.S. economy arise from geopolitical conflicts and the risk of a surge in energy prices. It’s noteworthy that the upcoming presidential election could have an impact on the economy, and economists note concerns with the housing and commercial real estate markets as risks to the broader economy.

The U.S. economic growth established a platform for continued solid gains in Arizona in 2023. For the five-year period ending in the third quarter of 2023, the Arizona economy grew 19.6%, making it the fourth fastest-growing state during this period (Arizona Governor's Executive Budget, January 2024). Arizona was also one of the fastest states to recover its lost jobs during the pandemic. As of December 2023, Arizona's job growth was at 2%, slightly higher than the national rate of 1.9%. Overall, Arizona is well positioned to grow in 2024 but at a reduced pace. While it shares common challenges with the broader U.S. economy, the state is currently navigating potential short-term risks within the housing market. Housing permits are expected to decrease this year for both single-family and multi-family activity, driven by high interest rates and significantly reduced housing affordability. Single-family housing affordability continued to deteriorate in the third quarter of 2023, according to data from the National Association of Home Builders and Wells Fargo. In Phoenix, only 24.9% of homes sold were affordable, down from 64.9% in the last quarter of 2019 (Economic Outlook 4th Quarter 2023, UofA Economic Business Research Center).

Other significant economic assumptions from trusted sources include the following:

- Personal income growth for the Phoenix Metro area is projected to slightly decline from 6.4% in 2023 to 6.3% in 2024 and range from 6.1% to 6.4% from 2025 to 2027 (UofA Economic Business Research Center).
- Growth in population is expected to continue, but at lower rates than historical growth. Phoenix Metro population is projected to grow by 1.5% in 2024 and slightly increase to 1.6% for the remaining forecast period (UofA Economic Business Research Center).
- Non-farm employment in metro Phoenix is estimated to slow down from the growth of 2.4% in 2023 to 2.2% in 2024 and decrease to 2.1% for the remaining forecast period (UofA Economic Business Research Center).
- Arizona unemployment rate is estimated to increase from the rate of 3.7% in 2023 to 4.0% in 2024 and range from 4.4% to 4.6% for the remaining forecast horizon (UofA Economic Business Research Center).
- Arizona housing affordability declines due to home price inflation and interest rate hikes. In addition, housing permits are projected to decrease by 19% in 2024 and remain flat in 2025 (UofA Economic Business Research Center).
- Inflation is expected to decelerate from 2023. The Consumer Price Index-All Urban Consumers (CPI-U) West region is estimated to decline from 4.4% in 2023 to 2.6% in 2024 and range from 2.2% to 2.3% for the remaining forecast period (UofA Economic Research Center). In the past 50 years, CPI-U has ranged from negative 0.4% in 2009, to a high of 13.5% in 1980 (U.S. Department of Labor Bureau of Labor Statistics).

Resource Assumptions- Revenue growth rates are determined using information from our above-mentioned trusted sources, analyzing actual revenue trends and averages, and factoring in any known policy or legislative changes.

Revenue assumptions beyond the broader economic considerations are described below:

- No further period of recession with modest revenue growth for the forecast horizon.
- Annual revenue growth rates range from -3.1% to 4.2% during the forecast period. The state's actions to diminish the tax base for both city sales tax and state-shared income taxes have resulted in a negative growth rate in FY 2024-25 and will have a lasting impact on the subsequent years.
- No further impact to current revenue tax base, as provided in applicable state statutes and City ordinances.

- The forecast includes tax rate reduction: Laws 2021, Chapter 412 (Tax Omnibus) reduced the number of individual income tax brackets from four in Tax Year (TY) 2021 to two brackets in TY 2022. Starting from TY 2023, the individual income tax has been reduced to a 2.5% flat tax rate.
- Relative population share used in calculating state shared revenues in FY 2024-25 was based on the 2022 Census Bureau Population Estimate. It is projected to remain flat throughout the forecast period. The actual share will change annually based on Census Bureau Population Estimates. In addition, Laws 2021, Chapter 412 (Tax Omnibus) increases the Urban Revenue Sharing distribution from 15% to 18% starting in FY 2023-24.
- The forecast includes residential tax rate reduction starting on January 1, 2025. The state recently enacted Senate Bill 1131, which prohibits municipalities from taxing residential rental property.
- No future fee increases or decreases and no new sources of revenue.
- Potential increases to revenue resulting from economic development efforts are not included in the forecast.
- Ranges provided for revenues: upper and lower ends of ranges increase slightly in later years of the forecast reflecting additional economic uncertainty.

Expenditure Assumptions - Assumptions regarding forecasted expenditures are described below:

- Annual operating expenditure growth rates, except for pension, are based on historical growth rates, estimated CPIs and account for the impact of the City Council approved Class and Comp (C&C) study throughout the forecast period.
- Pension costs are based on historical actuals and information provided by the COPERS and PSPRS actuaries. The forecast does not attempt to predict future pension liabilities, assets or other plan assumptions, but rather to account for the anticipated costs of both pension systems.
- The forecast does not include the impact of additional potential reform measures for COPERS or PSPRS or the impact of pending litigation or proposed legislation.
- The forecast includes no additional future funding for program enhancements, unfunded mandates, expiring grants, etc.
- Pay-as-you-go capital costs are based on the preliminary estimates in the five-year Capital Improvement Program and include costs for facility major maintenance, replacement of critical IT infrastructure, and money earmarked for future expenses, including one-time funds for costs of grant matching requirements for the Bipartisan Infrastructure Bill.
- The contingency fund is set at 4.75% of the total GF operating expenditures from FY 2024-25 through FY 2026-27.
- The FY 2024-25 total compensation costs are based on projections under the current Council adopted pay plan ordinance and existing employee contracts.
- The C&C study requires significant increases to employee salaries that will have an ongoing impact to the budget beginning in the current fiscal year. The study also provides for higher starting salaries to attract qualified candidates to fill vacancies throughout the City. Costs are estimated at $99 million in FY 2024-25, $143 million in FY 2025-26, and $170 million in FY 2026-27 and have been accounted for in the forecast.
- No other financial impact from changes to labor unit contracts resulting from current or future negotiations is assumed.

- In forecast years with a projected baseline deficit or ongoing surplus, the next year's operating expenses are assumed to decrease or increase by the baseline deficit/surplus amount prior to applying the assumed annual growth projection, as the City is required by Charter to balance the budget each year.

- Ranges provided for operating expenditures: upper and lower ends of ranges increase slightly in later years of the forecast reflecting additional economic uncertainty.

Other Considerations to the Multi-Year Forecast - The items below will likely require additional funding or could adversely impact the multi-year forecast as it's currently presented.

- The forecast incorporates the estimated annual ongoing operating costs in FY 2025-26 and FY 2026-27 for the voter approved 2023 General Obligation Bond Program totaling $12.8 million over the two fiscal years. These costs have been factored into the forecast, but additional resources could be needed.
- The forecast reflects the continued funding of approximately $16 million per year earmarked to address aging City infrastructure and critical equipment. Examples of these projects include upgrades and replacements of fire life safety, electrical, and cooling systems in City facilities. Also, under the direction of the City Manager, staff continues to identify critical needs in all City facilities and works with several external firms that specialize in facility assessments. Staff has also taken active steps to enhance facility maintenance oversight by centralizing GF facility maintenance funding and creating a review committee. This change has significantly enhanced the prioritization of GF facility projects. However, additional resources may be required to adequately maintain city infrastructure.
- GF vehicle funding is estimated at $16.2 million for FY 2024-25 and increases to $20.7 million in FY 2025-26, and $35 million in FY 2026-27 to replace units in the fleet. The cost to replace vehicles and Fire apparatus has grown significantly due to inflation over the past three fiscal years per the Public Works Department. It should be noted the current GF backlog of vehicles is estimated by Public Works at 1,193 units with a total backlog value of $122 million, and more vehicle replacement funding may be needed during the forecast horizon.
- Additional costs to the GF are anticipated to further the City's effort to help individuals experiencing homelessness upon the expiration of American Rescue Plan Act funds. Preliminary estimates include a funding need in FY 2024-25 of $6.5 million and in FY 2025-26 of $22 million. These costs have not been factored into the forecast.
- The current state legislative session could result in further negative revenue impacts that if passed would require adjustments to revenue projections used in the forecast.

ATTACHMENT D

Stress Testing

Background – According to the National Bureau of Economic Research, the longest economic expansion on record was ended by COVID-19 in February 2020. The COVID-19 recession is one of the deepest but shortest in U.S. history. With federal stimulus packages and more than anticipated revenue collections, the City was not forced to cut the budget. The City exhibited remarkable economic resilience during the pandemic. However, several risks currently threaten national and local economies, potentially triggering a recession or economic slowdown. Thus, stress testing is crucial, as it helps estimate potential financial shortfalls resulting from adverse events. To help the City plan ahead, avert or limit a fiscal emergency and keep long-term priorities on track, staff conducted stress testing for the General Fund.

Methodology/Assumptions - "Stress test" in financial terminology, is an analysis or simulation designed to determine the ability of a given entity to deal with an economic crisis. Instead of doing a financial projection on a "best estimate" basis, a company or its regulators may do stress testing to estimate how robust an entity performs in certain negative circumstances, a form of scenario analysis. There are two scenarios for this stress testing: moderate and severe recession scenarios.

Attachment E shows a hypothetical moderate recession estimated to start in FY 2024-25. This scenario assumes that General Fund revenue, except state-shared income tax, will decline by 1% for two consecutive years. According to Moody’s Analytics, a recession typically affects budgets for at least two years (except for the COVID-19 recession, which was interfered with the federal stimulus packages). Although a moderate recession may impact revenue by more than 1%, the model is simulated with a 1% decrease. State-shared income tax distributed to cities and towns is based on the collections from 2 years prior, so the state-shared income tax decrease due to a moderate recession will not affect revenues until FY 2026-27.

Attachment F shows a hypothetical severe recession that is estimated to start in FY 2024-25. This scenario assumes that General Fund revenue, except state-shared income tax, will decline by 3% for three consecutive years. Although a severe recession may impact revenues by more than 3%, for simulation purposes, this stress test used a 3% decrease. Similar to the moderate scenario, the state-shared income tax decrease caused by the economic recession will not affect revenues until FY 2026-27.

Assumptions for recoveries, fund transfers and expenditures remain the same as the model shown in **Attachment B**. However, the expenditures for the forecast period will be different due to the methodology applied in the model. When a deficit or surplus is projected, the next year’s operating expenses are assumed to be decreased or increased by the deficit/surplus amount prior to applying the assumed annual projected growth rate, as the City is required by Charter to balance the budget each year.

ATTACHMENT E

Multi-Year General Fund Forecast – Moderate Recession Scenario ($ Millions)

	2023-24 Adopted Budget	2024-25 Preliminary Budget Estimate	For Planning Purposes Only 2025-26 Forecast	2026-27 Forecast
Resources				
Local Taxes	$699	$696	$666 - $676	$690 - $712
State Shared Revenues	770	680	638 - 648	645 - 665
Primary Property Tax	207	205	201 - 204	207 - 214
User Fees and Other	155	187	183 - 186	185 - 191
Other (Carryover Balance, Transfers, Recoveries)	130	168	16	7
Unused Contingency from Prior Year	68	81	89	91 - 90
Total Resources	**$2,029**	**$2,017**	**$1,793 - $1,819**	**$1,825 - $1,879**
Expenditures				
Operating Expenditures	$1,360	$1,408	$1,434 - $1,425	$1,255 - $1,242
Civilian Pension	112	113	115	122
Sworn Public Safety Pension	321	330	340	352
Contingency	81	89	91 - 90	84 - 83
Pay-As-You-Go Capital (Includes Technology Plan)	122	60	38	38
Minimum Vehicles	33	16	21	35
Total Expenditures	**$2,029**	**$2,016**	**$2,039 - $2,029**	**$1,886 - $1,872**
PROJECTED (DEFICIT)/SURPLUS:	**$ -**	**$1**	**$(246) - $(210)**	**$(61) - $7**

Key Resource Forecast Assumptions:

* The forecast assumes moderate recession in 2024-25 and 2025-26, no fee increases or decreases and no new revenue sources.
* The forecast includes tax rate reduction: Laws 2021, Chapter 412 (Tax Omnibus) reduced the number of individual income tax brackets from four in Tax Year (TY) 2021 to two brackets in TY 2022. Starting from TY 2023, the individual income tax has been reduced to 2.5%.
* Relative population share used in calculating state shared revenues in 2024-25 was based on the 2022 Census Bureau Population Estimate. It is projected to remain flat throughout the forecast period. The actual share will change annually based on Census Bureau Population Estimates. In addition, Laws 2021, Chapter 412 (Tax Omnibus) increased the Urban Revenue Sharing distribution from 15% to 18% starting in 2023-24.
* The forecast includes residential rental property tax reduction: Senate Bill 1131 prohibits municipalities from taxing residential rental property starting January 1, 2025.

Key Expenditure Forecast Assumptions:

* The contingency fund is set at 4.75% of the total General Fund operating expenditures from 2024-25 through 2026-27.
* Includes no additional future funding for program enhancements, unfunded mandates, expiring grants, etc.
* 2024-25 employee costs are based on projections under the current Council-adopted pay plan ordinance and employee contracts. No assumptions have been made concerning future labor contract negotiations. Estimated costs of the Class and Comp study are included in the forecast. Pension costs are based on required and projected contribution rates provided by the respective pension system actuaries.
* Non-personnel related expenditures for 2024-25 assume expenditure growth is in line with recent historical averages, and the out years are anticipated to align with the estimated CPI growth.

Other Forecast Notes:

* Ranges provided for revenues and expenditures. Upper & lower ends of ranges increase slightly in the outer years of the forecast reflecting additional economic uncertainty in the later years.
* Ranges include pessimistic and optimistic scenarios within assumptions provided by the primary sources of economic information mentioned in this report.
* When a baseline deficit or surplus is projected, the next year's operating expenses are assumed to be decreased or increased by the baseline deficit/surplus amount prior to applying the assumed annual projected growth rate, as the City is required by Charter to balance the budget each year.

ATTACHMENT F

Multi-Year General Fund Forecast – Severe Recession Scenario ($ Millions)

	2023-24 Adopted Budget	2024-25 Preliminary Budget Estimate	For Planning Purposes Only 2025-26 Forecast	2026-27 Forecast
Resources				
Local Taxes	$699	$681	$635 - $645	$615 - $635
State Shared Revenues	770	673	623 - 634	601 - 621
Primary Property Tax	207	201	193 - 196	186 - 192
User Fees and Other	155	183	176 - 179	169 - 174
Other (Carryover Balance, Transfers, Recoveries)	130	167	16	7
Unused Contingency from Prior Year	68	81	89	89
Total Resources	**$2,029**	**$1,986**	**$1,732 - $1,759**	**$1,667 - $1,718**
Expenditures				
Operating Expenditures	$1,360	$1,408	$1,403 - $1,394	$1,193 - $1,180
Civilian Pension	112	113	115	122
Sworn Public Safety Pension	321	330	340	352
Contingency	81	89	89	81 - 80
Pay-As-You-Go Capital (Includes Technology Plan)	122	60	38	38
Minimum Vehicles	33	16	21	35
Total Expenditures	**$2,029**	**$2,016**	**$2,006 - $1,997**	**$1,821 - $1,807**
PROJECTED (DEFICIT)/SURPLUS:	**$ -**	**$(30)**	**$(274) - $(238)**	**$(154) - $(89)**

Key Resource Forecast Assumptions:
* The forecast assumes severe recession from 2024-25 to 2026-27, no fee increases or decreases and no new revenue sources.
* The forecast includes tax rate reduction: Laws 2021, Chapter 412 (Tax Omnibus) reduced the number of individual income tax brackets from four in Tax Year (TY) 2021 to two brackets in TY 2022. Starting from TY 2023, the individual income tax has been reduced to 2.5%.
* Relative population share used in calculating state shared revenues in 2024-25 was based on the 2022 Census Bureau Population Estimate. It is projected to remain flat throughout the forecast period. The actual share will change annually based on Census Bureau Population Estimates. In addition, Laws 2021, Chapter 412 (Tax Omnibus) increased the Urban Revenue Sharing distribution from 15% to 18% starting in 2023-24.
* The forecast includes residential rental property tax reduction: Senate Bill 1131 prohibits municipalities from taxing residential rental property starting January 1, 2025.

Key Expenditure Forecast Assumptions:
* The contingency fund is set at 4.75% of the total General Fund operating expenditures from 2024-25 through 2026-27.
* Includes no additional future funding for program enhancements, unfunded mandates, expiring grants, etc.
* 2024-25 employee costs are based on projections under the current Council-adopted pay plan ordinance and employee contracts. No assumptions have been made concerning future labor contract negotiations. Estimated costs of the Class and Comp study are included in the forecast. Pension costs are based on required and projected contribution rates provided by the respective pension system actuaries.
* Non-personnel related expenditures for 2024-25 assume expenditure growth is in line with recent historical averages, and the out years are anticipated to align with the estimated CPI growth.

Other Forecast Notes:
* Ranges provided for revenues and expenditures. Upper & lower ends of ranges increase slightly in the outer years of the forecast reflecting additional economic uncertainty in the later years.
* Ranges include pessimistic and optimistic scenarios within assumptions provided by the primary sources of economic information mentioned in this report.
* When a baseline deficit or surplus is projected, the next year's operating expenses are assumed to be decreased or increased by the baseline deficit/surplus amount prior to applying the assumed annual projected growth rate, as the City is required by Charter to balance the budget each year.

ATTACHMENT G
Pension Cost Increases

The below chart illustrates the rise in General Fund (GF) pension costs for PSPRS and COPERS. The forecast for fiscal years 2024-25 through 2026-27 is based on information from plan actuaries and on the valuations dated June 30, 2023. Projected amounts account for changes made by the PSPRS Board, which updated the salary, inflation, and demographic assumptions. The PSPRS Board also lowered the payroll growth assumption to 2.0%, resulting in an increase to the employer contribution rate.