Early Out Look General Fund Forecast

Budget Workshop April 2, 2012

Highlights

- The Great Recession has been over for almost three years, yet the recovery continues to be slow and is expected to be slow for several more years.

- The City continues to see risk on the horizon including:
  - State legislative impacts from the State budget deficit
  - Health care costs continue to rise
  - International debt and other conflicts may impact economic recovery
  - Increase in inflation rate primarily driven by the increase in cost of fuel

- 2011 City Fiscal General Fund Performance
  - It appears by most measures that 2011 was the bottom, and we are starting to slowly climb out of the recession.
  - 2011 General Fund revenue ended the year on target with the revised mid-biennium forecast which was substantially less than the 2011 Adopted Budget revenue.
  - 2011 General Fund expenditures were approximately 1.3% lower than was projected in September.

- 2012 Projection
  - With the cost containment actions taken in 2010 and 2011, it is projected that barring further economic decline or impacts from the state budget negotiations, revenue and expenditures will be in balance. State budget negotiations may impact 2012 projected revenues, as of this printing the state has not passed budget legislation addressing the known state budget deficit.

- 2013 and beyond Outlook
  - The Early Out Look Forecast is projecting revenue to roughly equal to expenditures with no additional funding beyond the current service level. As with the 2012 projections, this is barring further decline of the economy and impacts from state budget negotiations.

The Great Recession

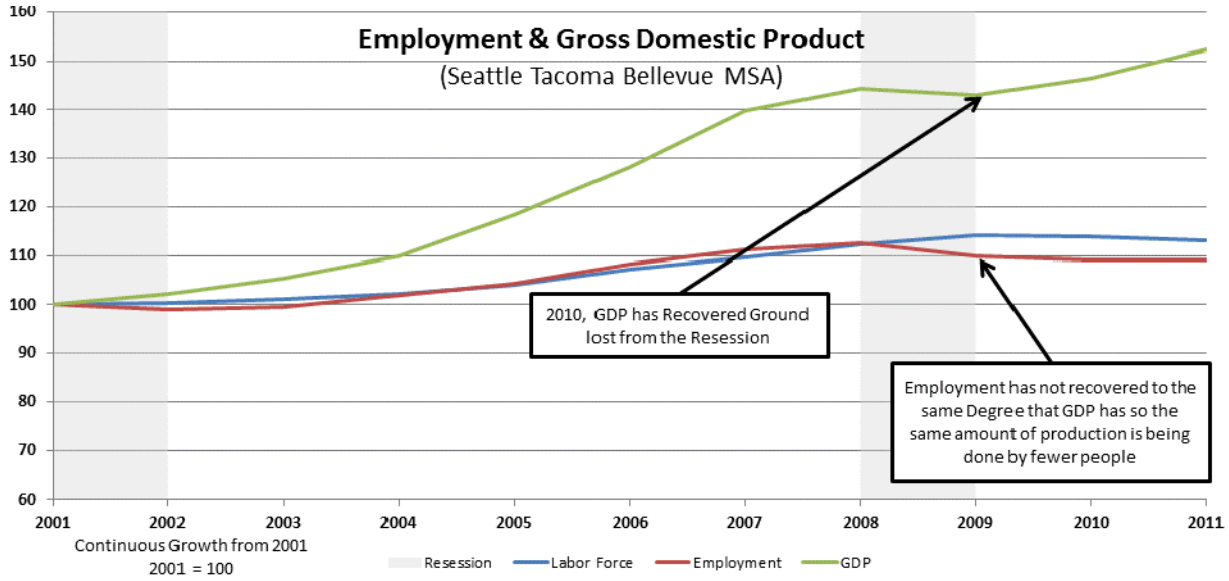
The Great Recession has now been officially over for almost three years yet the recovery has been slow. Historically, when a recession ends economic growth rebounds at a quicker pace and this recession has proved to be the exception to that rule. Most economists are projecting long slow recovery with the chance of many possible stumbling blocks along the way. Over the past three years the economy has been virtually stagnant with only a few sectors showing any substantial recovery.

Slow Recovery

When measuring the State and National economies, two of the most prominent measures are the securities markets and Gross Domestic Product (GDP), the production of products, and both have been recovering nicely. GDP and Securities markets are positively correlated because they both, basically, measure the performance of private industry. Recessions and depressions are defined by drops in Gross Domestic Product (GDP), but it is important to note that GDP only represents one aspect of the economy at large.

> *This recession, similar to recent recessions, is seeing a "jobless" recovery where GDP is returning, yet job growth is not.*

One area of the economy that has been particularly anemic is the job market. Unemployment peaked at 10.1% nationally in 2010. The last three recessions have been "jobless recoveries" where GDP recovers while employment does not. The generally accepted definition of a "jobless recovery" is when jobs are not recovered within 15 months of the end of the recession. In follow-up to this recession, as noted the graph below, GDP (or production of products) is returning, yet employment is not recovering at the same rate as the growth in GDP.



Another area of the economy that has suffered greatly is the housing market. As the recession began, defaults on high risk mortgages skyrocketed, ending in foreclosures. As the recession

continued and employment continued to drop more homes were foreclosured. Another complicating factor in the housing market was that development activity was in high gear when the recession began; single family homes and condominiums were being built at record pace and suddenly there were no buyers, leaving a glut of new homes on the market. All of this resulted in increased number of homes on the market, driving down the average home price to 2004 levels.

Economic Risks on the Horizon

2011 proved to be a difficult time for the recovery, with hit after hit threatening to derail the recovery and send us back into recession. Areas where continued downside risk exists include:

- The European Sovereign Debt Crisis has loomed over the world economy for over a year and has caused Europe to fall back into recession. European leaders have recently made progress in resolving the issues with Greece, and insist Europe is through the worst. The head of the Federal Reserve, Ben Bernanke says "European financial stresses have lessened" and that the United States exposure to the European Credit Market is minimal.

- The Middle East continues to be on the brink of chaos, with the latest problems being revolution in Syria and the potential of conflict regarding Iran's nuclear ambitions. Short of all-out war, the biggest possible concern is that Iran will follow through on their threat to close the Strait of Hormuz, the shipping lane that transports 20% of the global market for oil.

- Another unknown is legislative changes at the State and Federal levels. As the State has struggled to balance the biennial budget, various legislative changes have been proposed that could reduce revenues or increase the need for resources.

- Healthcare costs have been rising for several years at a rate greater than inflation and are projected to continue to increase as the workforce advances in ages.

- Recent increases in fuel pricing may impact rate of inflation.

2011 Performance

It appears by most measures that 2011 was the bottom, and we are starting to slowly climb out of the recession.

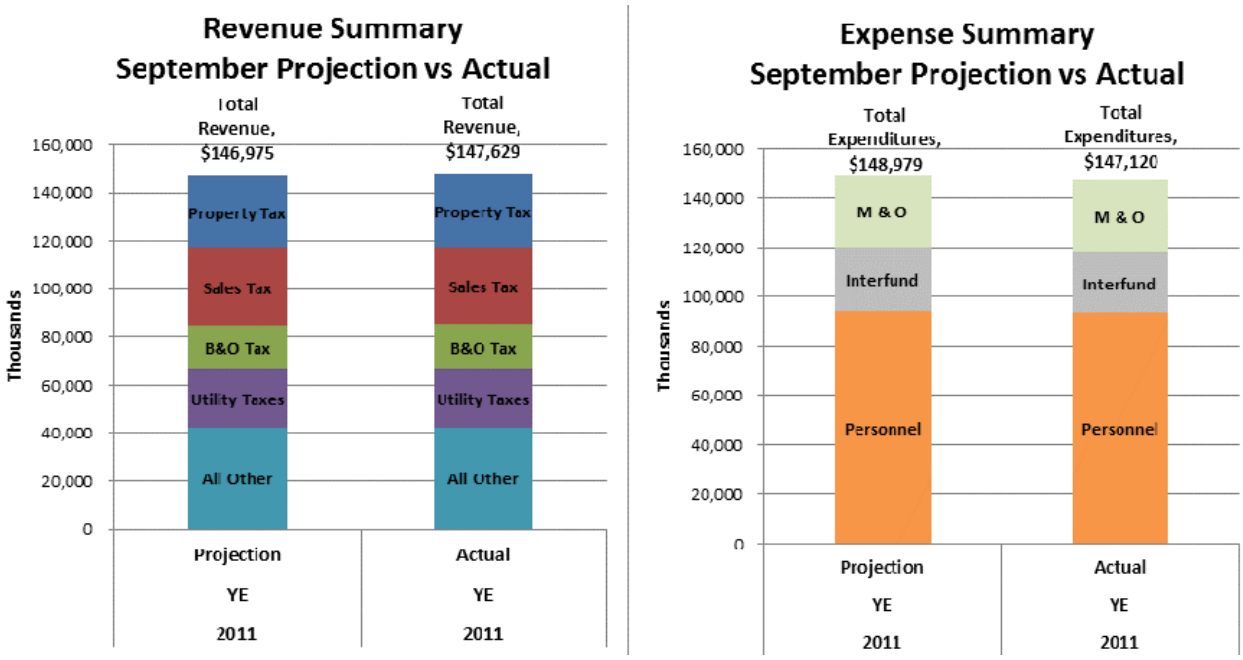
2011 revenue ended the year on target with the revised mid-biennium forecast which was substantially less than the 2011 Adopted Budget revenue. Overall, in 2011 the General Fund saw 3.2% growth in base tax revenue over 2010. Adding to the tax base were amnesty funds were approximately $700,000 in "amnesty" funds received from a taxpayer amnesty program. Adjusting for Amnesty funds, total revenue increased 3.8% over

2011 General Fund revenue ended the year on target with the mid-bi forecast.

2010. Of the City's major tax streams, Property and Utility taxes performed as originally adopted due to their stable nature, while Sales and B&O tax were more variable. 2011 Sales tax adjusted for the onetime amnesty funding had less than a 1% growth over 2010. B&O tax results were expected to be similar, however the 4th quarter returns proved to be greater than expected and total B&O tax ended the year 2.9% higher than 2010.

Expenditures were approximately 1.3% lower than was projected in September. Cost containment management actions were crucial to bringing expenses in line with reduced level revenues.

General Fund 2011 Estimated Performance compared to September Projection
(Actual data for 2011 is prior to official closing)



*2011 values provided are before yearend official closing and have been adjusted for known and measureable changes.

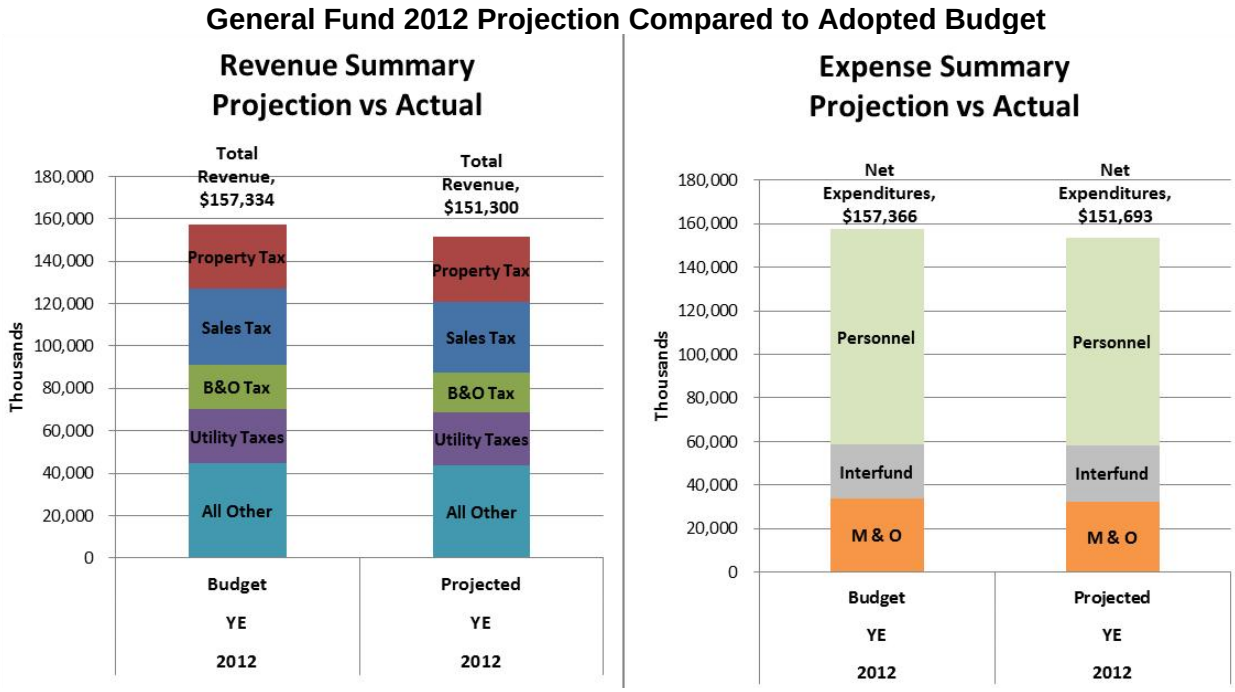
2012 Projection

2012 has begun on the right foot, with several positive economic signs such as rising personal income and employment. Despite these positive signs, we are still projecting growth in 2012 to be modest. A great deal of damage was done from this recession, and it is going to take several years before the economy fully recovers. One sector that is expected to be slow to bounce back in the next year is construction. In the past construction was the fuel that drove the City's Sales Tax into double digit growth in 2005-2007. At this time, there are no large construction projects expected in 2012, and single family home inventory is still very high and not

One sector that is expected to be slow to bounce back in the next year is construction. In the past construction was the fuel that drove the City's Sales Tax into double digit growth in 2005-2007.

likely to diminish in the short term, therefore holding back new construction.

With the cost containment actions taken in 2010 and 2011, it is projected that barring further economic decline or impacts from the state budget negotiations, revenue and expenditures will be in balance. State budget negotiations may impact 2012 projected revenues, as of this printing the state has not passed a budget legislation addressing the state budget deficit.

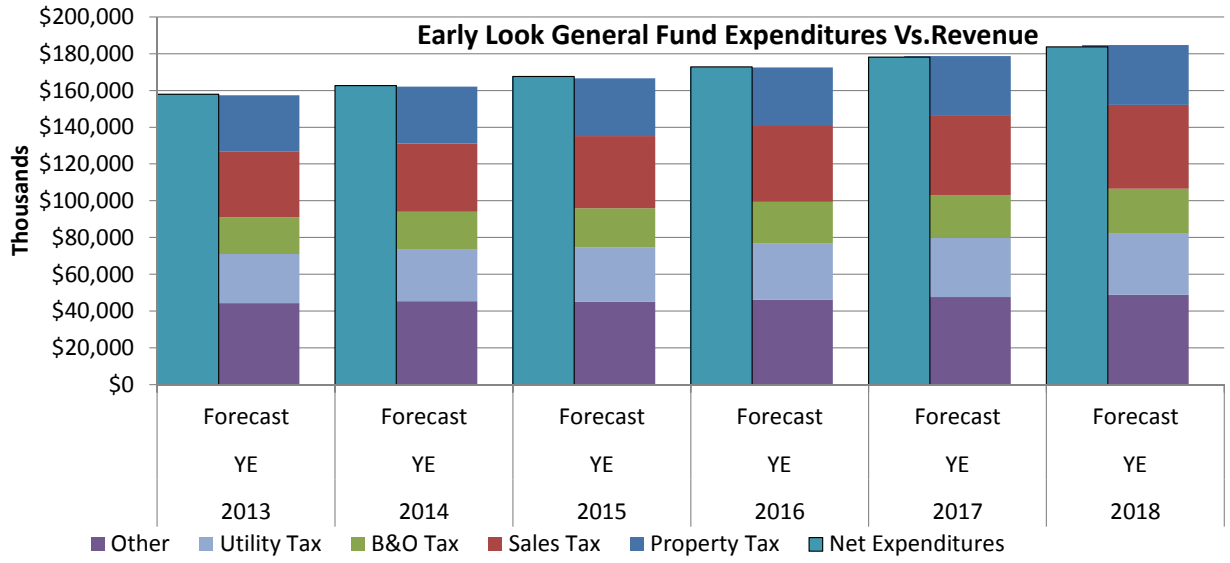


Note: 2012 Projected Revenues are not adjusted for any state impact from state budget negotiations.

2013-2014 Early Look

Washington, and particularly the Puget Sound, has traditionally outperformed the nation in most economic measures. The Early Out Look expects to see a continuation of the Puget Sound to outperform the nation, but not seeing a fast rebound and expecting to continue to be financially constrained, with revenue growth keeping up with inflationary costs. The Early Out Look Forecast is projecting revenue to roughly equal to expenditures. As with the 2012 projections, this is barring further decline of the economy and impacts from state budget negotiations.

A final Financial Forecast for 2013-2014 will be available in July.

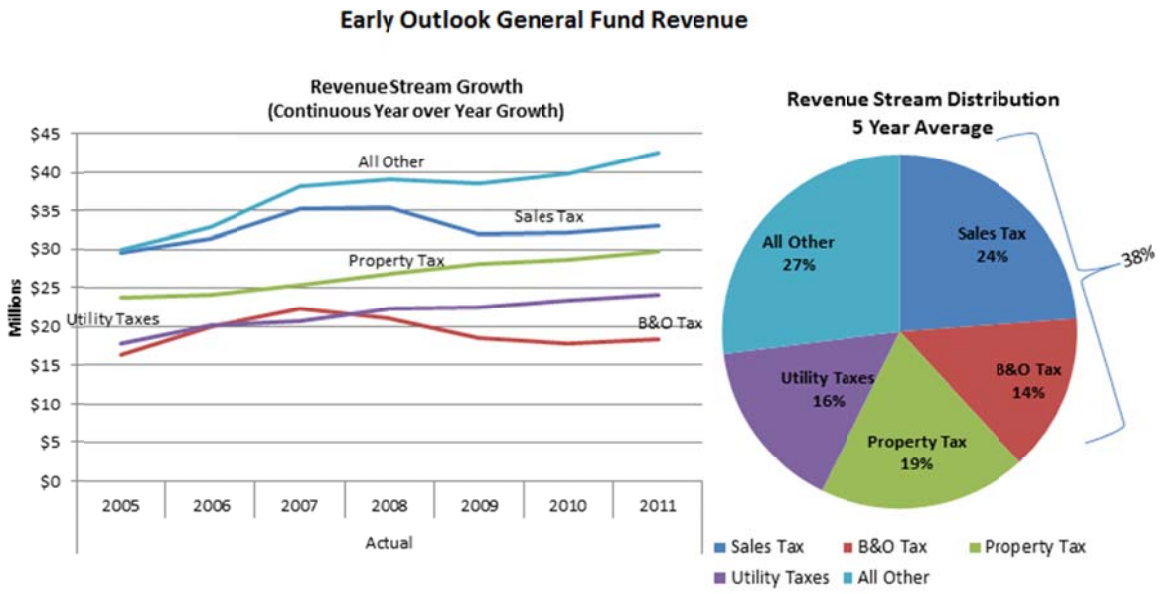


Early Financial Outlook General Fund Revenue and Expenditure Breakdown

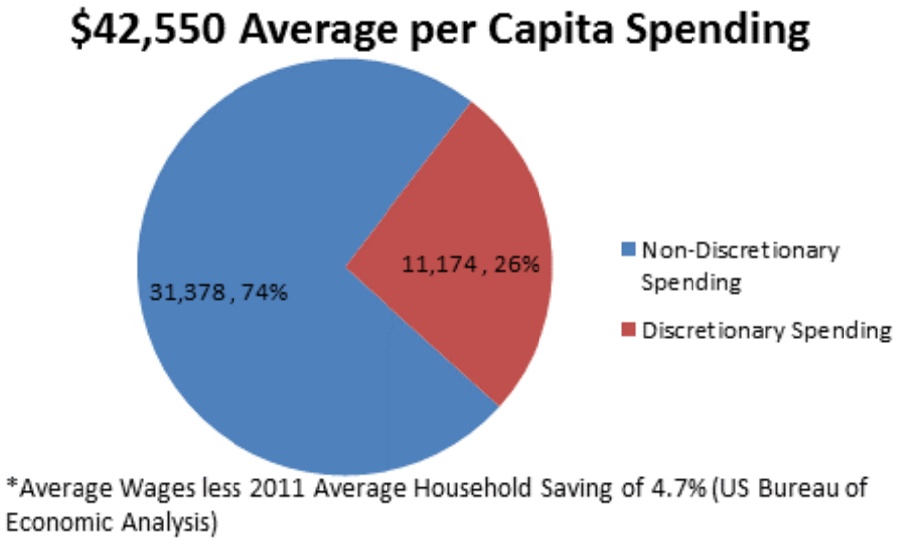
	2013	2014	2015	2016	2017	2018
Revenue						
Property Tax	$30,647	$31,007	$31,390	$31,772	$32,147	$32,504
Sales Tax	35,685	37,119	39,154	41,284	43,410	45,557
B&O Tax	19,896	20,625	21,523	22,411	23,318	24,086
Utility Tax	26,736	28,007	29,461	30,774	32,251	33,639
Other	44,342	45,392	45,026	46,237	47,552	48,840
Total General Fund Revenue	$157,306	$162,150	$166,554	$172,478	$178,678	$184,625
Expenditures						
Personnel	$100,247	$103,724	$107,443	$111,203	$115,095	$119,124
M&O	$31,721	$32,474	$33,224	$33,986	$34,815	$35,674
Interfund	$25,923	$26,404	$26,974	$27,591	$28,216	$28,888
Total General Fund Expenditures	157,892	162,601	167,641	172,781	178,126	183,686

Impact of Personal Income on Volatility of Tax Collections

The City collects a variety of revenue, but has four sources that are considered major tax revenues and which make up 81% of the City's total General Fund revenue. The City's major tax revenue streams are Sales and Use Tax (Sales Tax), Business and Occupancy Tax (B&O Tax), Property Tax and Utility Tax. Of these 4 major tax revenue streams, two are by far the most volatile and subject to economic conditions - Sales tax and B&O tax making up 38% of total revenue. Year to year fluctuations in total revenue can be traced back to these two major taxes, sales tax and B&O tax.



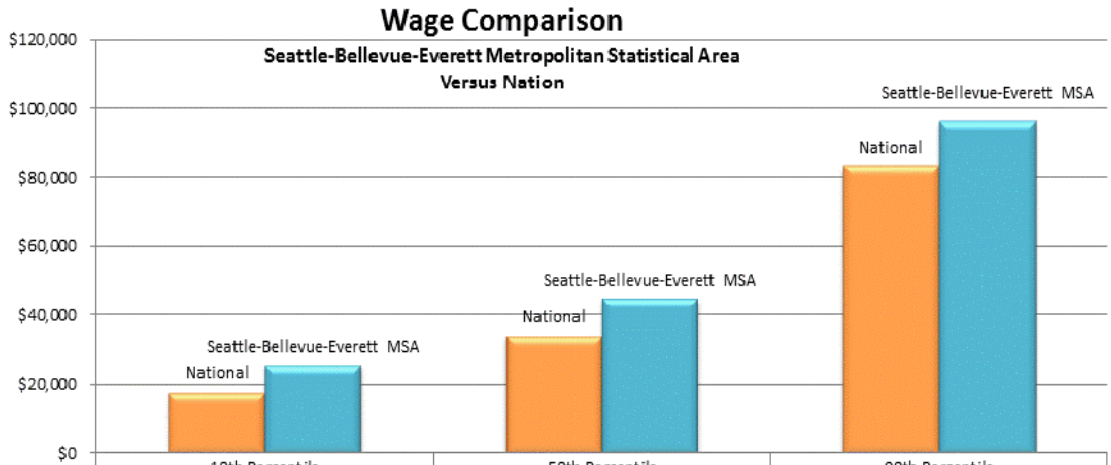
Sales tax is the City's largest single tax revenue. Sales tax is derived from retail sales of goods and services with the exception of groceries (prepared food is taxable), vehicle fuel, alcohol and tobacco. Also not subject to sales tax are rent and mortgage payments. Since the majority of personal non-discretionary spending is not taxable and most taxable items are discretionary one can assume that the amount of discretionary income will drive sales tax numbers.



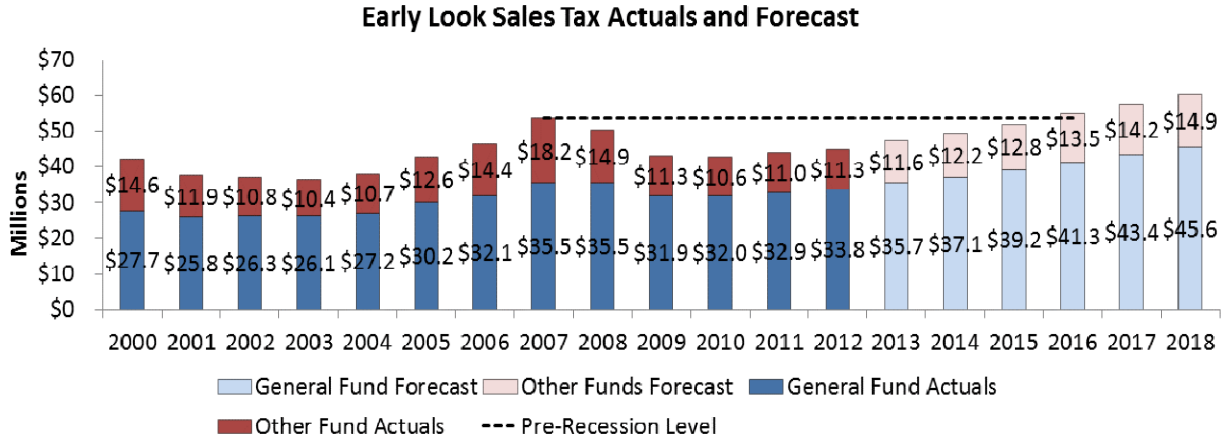
When looking at personal income, it is estimated that 26% of all spending is discretionary as the graph above shows. Discretionary spending is positively correlated with personal income, so as personal income rises people have more money to spend on luxury items that are in large part taxable, thereby increasing the City's Sales tax collections.

It is widely believed by local economists that Washington and more specifically the Puget Sound, will recover at a greater rate than the rest of the nation. This is because the Puget

Sound has several industries that pay above-average wages. A few companies leading the recovery are Boeing, Microsoft and Amazon. The chart below shows how the Puget Sound compares to the nation on wages. Low wage jobs pay 44% higher, average wage jobs pay 32% higher, and high wage jobs pay 16% higher when compared to the rest of the nation. The key to a recovery in tax collections is expansion of nominal personal income and thus discretionary spending.



	10th Percentile	50th Percentile	90th Percentile
National	$17,690	$33,840	$83,140
Seattle-Bellevue-Everett MSA	$25,400	$44,650	$96,060

Source:Bureau of Labor Statistics,
Note: Washington State Min Wage Salary = $18,803/year

As previously mentioned, sales tax is the largest single revenue stream as well as the most volatile. The Great Recession cut tax collections back significantly, and we do not expect real dollar collections approach pre-recession levels until 2016. The Chart below shows the recent impact of the Great Recession and the current forecast. When Sales tax collections are expressed in nominal dollars, or adjusted for the purchasing power of the dollar, sales tax collections are not expected to reach pre-recession levels until after 2020.