MEMORANDUM

105 Municipal Way
Juneau, AK 99801
Phone: (907) 586-5215
Fax: (907) 586-0358

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TO: Assembly Finance Committee

FROM: Jeff Rogers, Finance Director

SUBJECT: **Looking Ahead to FY2024**

This memo is far shorter than in previous years. After several years of extraordinary uncertainty, FY24 likely marks the return to a more historically typical budget. The pandemic has evolved into an endemic contagious disease that generally does not affect the health of our economy and does not trigger government intervention. So, as we begin to work on FY24, we are not so much reeling with uncertainty, but instead we confront the reality of a post-pandemic budget that must responsibly carry CBJ into its next economic cycle. FY21, FY22, and FY23 were marked by extraordinary one-time revenues that begot extraordinary one-time expenditures. Such extraordinary one-item revenues are unlikely in FY24, so we can finally focus on what a balanced budget will look like.

The major themes for the fiscal circumstances of FY24 return to considerations prior to the pandemic:

- Forecasting Summer Visitation
- One-Time Revenues
- Inflationary Pressure on Expenditures
- Inflation of Sales Tax
- Continued Growth in Property Value
- State Budget and State Employment
- Big Fund Balance and Big Needs

<u>Forecasting Summer Visitation</u>

Cruise industry expectations for visitation in the summer of 2023 vary, but generally, the cruise industry remains highly optimistic. According to the current ship schedule, there will be capacity for approximately 1.57 million passengers. That would significantly exceed pre-pandemic capacity. However, the industry is still recovering from the hang-over of COVID fears, especially as it relates to travel in close quarters. Cruise lines are reluctant to divulge specific information about current bookings; however, all lines consistently report that demand for Alaska cruises remains very high and that many passengers who had cancelled bookings in 2020 and 2021 still plan to use those bookings in 2023. In the past, cruise lines have aggressively discounted prices to fill berths rather than sail with them empty, but with rising input costs and staffing challenges, that may not be the preferred strategy in 2023.

Given that combination of factors, Management recommends discounting total capacity by about 10%. This would result in a passenger forecast of 1.4 million passengers as a planning number for 2023. That would be record visitation for Juneau. For forecasting sales tax and passenger fees, we will assume growth from summer 2022 revenues. Aside from the specific revenues from sales tax and passenger fees, 1.4 million passengers will continue to push Juneau's economy into even higher gear. The summer of 2023 will likely feel much larger than any pre-pandemic season.

<u>One-Time Revenues</u>

CBJ received an unprecedented amount of one-time revenue over the past several fiscal years. A portion of those one-time revenues were invested in business and community grants to stabilize Juneau's pandemic economy. But the substantial remainder was generally unrestricted and benefited the general fund. We have every reason to believe that those unrestricted one-time revenues are behind us. Going forward, state and federal funds will most likely be narrowly available for specific infrastructure investments. Several federal bills have been signed into law to bring many billions of dollars to the state of Alaska. These projects are likely to play out over the next 5 to 10 years, and CBJ should start to see the impact in FY24. Early indications are that many of these projects will require local matching funds. Unless those funds come from state sources, Juneau will need to commit local revenues as match to many federal grants. For example, if Juneau were to receive $100 million in projects with a required 20% match, then Juneau would need to provide $20 million of local funds to see the projects advance.

So, in summary, additional operating/stabilization grants are unlikely. And while federal/state infrastructure spending will certainly spur the economy and benefit Juneau, it is very likely that those grants will also induce the expenditure of considerable local general funds.

Inflationary Pressure on Expenditures

Inflation is clearly upon us. CPI, PPI, and CPE (all different measures of inflation) all point to real cost inflation of 5% to 8% over this time last year. Locally, fuel prices are significantly more inflated. Several geopolitical factors continue to underpin global inflation—most notably Russia's ongoing war with Ukraine and China's *zero COVID* policy. In its effort to combat domestic inflation, the Federal Reserve has dramatically raised interest rates, with the intention to cool off the overheated US economy. Economists note that this round of inflation has been particularly "sticky" meaning that it did not abate as certain conditions improved. For example, gas prices fell, but overall inflation remained high. Housing prices are starting to break, but overall inflation remains high. In short, the Federal Reserve will continue to raise interest rates until it sees inflation falling to acceptable levels (around 2%). Most economists now believe that the Federal Reserve will inevitably overshoot the mark, and will drive the United States into an economic recession in order to curb runaway inflation.

CBJ should expect to see costs rise across the board through the end of FY23 and into FY24. Higher costs for supplies, higher costs for fuel and utilities, higher costs for services, and higher costs for construction activities. In short, almost everything will likely be more expensive, and potentially by a wide margin. Vast federal infrastructure spending is likely to pile-on to the cost increases for construction activities. And the current labor shortage may severely increase the cost of professional services (architects, engineers, etc.) and non-professional services (custodial, shipping/freight, transit/logistics, etc.).

It is probably too early to predict exactly how inflationary pressure will impact the FY24 budget, but higher costs will require additional general funds or service reductions. And the impact on the Capital Improvement Plan is likely to be even more pronounced.

Forecasting Sales Tax

For many years, the Finance Department has under-forecast Sales Tax receipts. Some have viewed this as a measure of conservative fiscal planning, and it certainly is. But, the consistent outperformance of Sales Tax is part of what has driven the phenomenon of CBJ finishing the year with surpluses when the Assembly was told to expect deficits. The goal should be to identify a realistic forecast that is neither too high nor too low; as in, we should have as much chance to miss on the down-side as on the up-side.

Per the separate memo on FY23, sales tax forecasts have been increased in response to a very strong July-Sept quarter. As of this writing, total FY24 sales tax collections are forecast at $65.0 million, which is $7.6 million higher than was forecast as part of the FY23/24 biennial budget. However, the FY24 forecast represents just 3% growth from the FY23 forecast. 3% growth is definitely conservative, but it recognizes that the most recent FY23 forecast already feels quite aggressive. FY24 sales tax collections could be higher if cruise visitation grows rapidly beyond pre-pandemic levels or if inflation marches higher. On the flip side, FY24 sales tax collections could be muted by economic contraction/recession in the United States, the strong US dollar (which could dampen international visitation), a new surge of COVID infections/deaths, rapid decline in state employment, deflation, and countless other factors.

Continued Growth in Property Value

Finance does not forecast property tax in the same way as sales tax. The amount of property tax CBJ receives is simply the mill rate established by the Assembly multiplied by the taxable assessed value of property determined by the Assessor. Residential home prices are certainly higher than they were a year ago, but there have definitely been strong signals (longer days on market, and price reductions) that the housing market has cooled. Growth of commercial values is harder to determine. This year, the Assessor conducted a voluntary market survey of commercial property owners to attempt to obtain income/expense information that would help the assessor more equitably assess all commercial properties. The recent surge in economic activity and the robust return of cruise tourism will make investors more confident with commercial real estate purchases, which may reinforce or increase market values. Given all of the various factors affecting commercial property values, it is challenging to forecast how commercial values may change in 2023.

The Finance Department will use 2.5% property tax growth overall as a starting point for FY24 budget planning, but that number will be trued up once the Assessor finalizes assessed property values in March.

<u>State Budget and State Employment</u>

The State of Alaska continues to face a fiscal cliff. As with CBJ, one-time federal revenues related to the pandemic buttressed the FY23 state budget and prevented cuts and reductions. However, over the long-term, the State of Alaska budget remains in deficit—annual recurring expenditures outpace annual recurring revenues. As of this memo, it appears that both chambers of the Legislature may organize in moderate bipartisan coalitions. Likewise, Governor Dunleavy appears poised to win reelection, and he has made moderate bipartisan overtures to the public. This could signal two years of moderate collaboration on spending reductions and revenue increases. Or, the Legislature and Governor could remain locked in a dogfight of political dogma. Either way, Alaska cannot long continue on its current track.

CBJ is less exposed to school bond debt reimbursement and state revenue sharing than it used to be. So, in some ways, we are more in control of our own destiny, but we have less-and-less state support for municipal operations and infrastructure. With news across the state of school closures and increasing class sizes, the Legislature and Governor are very likely to spend a considerable amount of time talking about school funding. If state funding for education goes up, then CBJ funding for education could also go up (the local funding cap rises as state funding rises). If the state continues to refuse to fund school construction and major maintenance, then CBJ will have to continue spending significantly to maintain schools without state assistance. Or, perhaps reinstitution of school bond debt reimbursement could give the Assembly confidence to invest more in school facilities in recognition of the state's cost sharing.

State employment in Juneau continues to decline. The move to remote work opened the floodgates for positions to leave Juneau. Governor Dunleavy has done less than his predecessors to have his cabinet members home-based in Juneau. In my opinion, the outward flow of positions starts in the top ranks and flows down from there. Commissioners in Anchorage yields Directors in Anchorage, which yields Program Managers in Anchorage, which yields front-line staff in Anchorage. These two factors have resulted in a significant shift of positions out of Juneau during the pandemic, which means fewer working state employees living here. As I have noted before, some of these losses have been offset economically by Juneau's gain of state and federal retirees. This is definitely worthy of further analysis in the spring. That analysis should consider whether the shift of state employees also results in a shift in federal and NGO employees.

<u>Big Fund Balance and Big Needs</u>

The FY23 year-end fund balance is projected to be $30.1 million. That level of fund balance is far higher (~$25 million higher) than is necessary as a "cushion" for unforeseen needs. Remember, the Restricted Budget Reserve is the primary source of funds for economic emergencies and other catastrophic events. Unrestricted fund balance may be wisely invested in community priorities without endangering CBJ's fiscal position.

This level of fund balance will likely cause the community and the Assembly to consider another round of major investments in infrastructure, as it did in FY22. The Manager has consistently recommended that fund balance be invested in infrastructure that can reduce future municipal costs—as insulation against future revenue downturns. For example, if the Assembly still believes in the long-term cost savings that results from a New City Hall, perhaps it is time to consider funding the project with cash rather than debt. Aside from New City Hall, the Assembly has a long list of priority projects, and they are all meritorious in their own right. Deciding how to carve up this pie will not likely be easy.

Summary

After consideration of all of the factors above, the FY24 budget likely starts with a surplus of $3.6 million, not accounting for the lapse, which has historically been between $1.5 and $2.0 million. That surplus already accounts for the negotiated wage/benefit costs, but it does not account for what are likely to be very substantial increases for non-personnel services and commodity costs. Over the course of a few years, CBJ has moved from what appeared to be "structural deficits" (current revenue less current expenditure) to what could be a balanced FY24 budget. This happened for the simple reason that tax revenues have grown faster in FY23 and FY24 than CBJ expenditures for operations. The 5.5% wage increase in FY23 now appears to be far less than the growth of sales/property taxes. And the 2.0% wage increase in FY24 will almost certainly be far less than tax growth in that year.

Of the many things that the Manager may propose as part of his budget, the Assembly is very likely to see one or more proposals related to employee recruitment and retention. CBJ faces considerable staffing shortages and a high level of employee turnover. Hence, CBJ must take steps to be as competitive as possible. With wages/benefits now successfully negotiated for the next three years, the Manager may make proposals that increase or expand non-wage benefits in an effort to attract and retain high quality employees. Additionally, CBJ has not had a durable mechanism for increasing the balance of the Restricted Budget Reserve to keep it consistent with the Resolution that established it. The Assembly should expect to see a proposal in the Manager's budget to bring the Restricted Budget Reserve in line with two-months of annual operating expenditures. This proposal will likely require several million dollars, either from fund balance or from the FY24 operating surplus.

All in all, FY24 should start to look like a "normal" year. Tax revenues appear to be robust, but costs are rising. The state is less-and-less of a fiscal dance partner. Fund balance is high, and so is the demand for new or improved infrastructure. The Assembly is charged with striking the balance among these competing themes. But, no matter how you slice it, Juneau appears to be in a very enviable fiscal position heading into the FY24 budget process.