

Economic Update

Update on economic issues affecting Seattle's tax revenue performance

MARCH 2003

SPECIAL TOPIC:

Slow economy has surprising benefit to businesses – lower property taxes

The news about the economy hasn't been rosy for some time. Its lackluster performance has taken a toll on business owners. Flagging consumer confidence, slumping sales and high vacancy rates have conspired to reduce business profits and income. This is nothing different during a soft economy, but what is different this time around is a surprising twist to the housing market. Record low interest rates, meant to jumpstart the lagging economy, has propelled the housing market and kept housing prices growing at a respectable rate despite business turndown. This uneven reaction to the current economy has interesting implications for the commercial and residential sectors in terms of property taxes - a shift of the property tax burden from the commercial property owner to the homeowner.

In 2003, approximately 66% of Seattle's property tax revenue came from residential properties and 34% from commercial properties. As a whole, total property values in Seattle increased by 6.2% in 2003, which was due entirely to the increase by residential properties. The residential component of the total base increased by 9.3% compared to a 0.7% increase by the commercial component.

Reasons for property tax increases

It's true that property taxes, on average, increases when taxing jurisdictions increase their levies or voters approve additional property taxes for special purposes. But to determine how an individual property tax bill will change in any given year is more complicated than looking at these two factors alone.

Since the passage of Initiative 747, taxing jurisdictions cannot increase their levies by more than 1% without voter approval and there was only one new voter-approved levy passed in Seattle. With the addition of revenue from newly constructed properties, Seattle's 2003 property tax revenue will increase by 2.6% from 2002; however, the average homeowner in Seattle will pay approximately 7.9% more in property taxes. This discrepancy can be explained by the fact that property taxes can disproportionately affect property owners depending on the relative increase in their property values. In order to understand why this occurs, it is helpful to look at some of the underlying laws and principles governing our property tax system.

Uniformity and fair market value system

Our property tax system is based upon uniformity and "fair market value" standard. Uniformity requires that all property owners in Seattle face the same property tax rate, and "fair market value" means that property owners pay taxes according to the market value of their properties. Every year, the property tax burden is shifted among property owners according to their relative increases in property values. Thus, rapidly appreciating properties pay disproportionately to those gaining value more slowly.

1% growth limitation

As stated earlier, Initiative 747 reduced the annual growth limit in which taxing jurisdictions can increase their levies without voter approval. This law can be confusing because it applies to the amount of revenue a taxing district can collect from property taxes, and not to increases in the assessed value of individual properties. In short, the law restricts taxing jurisdictions, such as Seattle, from increasing its non-voted property tax levy by more than 1% from the previous year; however, it does not restrict the growth of an

individual's property value or tax liability. Therefore, an individual's property tax bill could increase by more than 1% in any given year.

Sensitivity to market conditions

Another component to this puzzle is how commercial and residential property values react to market conditions.

King County assessors follow standard appraisal practices in assessing property values. Appraising residential property is more straightforward simply because there are many more residential market sales than commercial sales (see figure 1), and they can rely on market sales alone to appraise residential property.

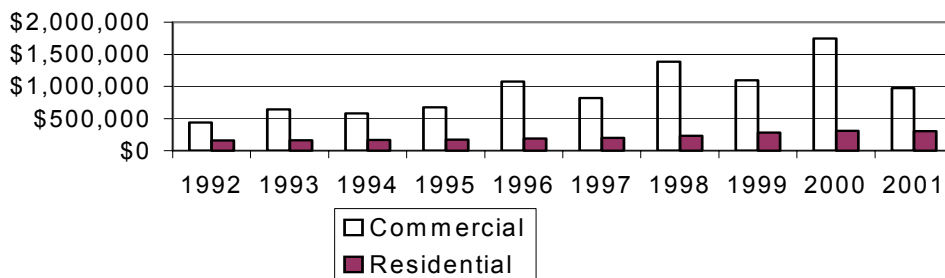
**Figure 1
Number of Sales by Type in Seattle**

| Number of Sales | | |
|-----------------|------------|-------------|
| Year | Commercial | Residential |
| 1992 | 567 | 9,052 |
| 1993 | 501 | 8,409 |
| 1994 | 575 | 8,444 |
| 1995 | 642 | 8,668 |
| 1996 | 744 | 9,822 |
| 1997 | 777 | 11,533 |
| 1998 | 895 | 12,490 |
| 1999 | 887 | 11,698 |
| 2000 | 767 | 11,211 |
| 2001 | 724 | 11,101 |

For commercial property, the relatively paucity of sales means that assessors must rely on other factors, such as vacancy rates and income generation of the property. Because these factors are very sensitive to market conditions, commercial values quickly adjust during a slow economy.

Housing values are also affected by the economy; however, since homeowners are better able to cope with short-term conditions than commercial owners, housing prices are relatively more stable. The financial risk is generally lower on a house than a commercial property and homebuyers are in a better position to take advantage of low interest rates. Figure 2 shows the volatility of the commercial side and also shows the magnitude of commercial to residential. The average commercial sale is about four times the size of an average residential sale. The range of commercial properties is broader and includes a variety of properties such as apartment buildings, downtown skyscrapers, parking lots, manufacturing plants, small retail shops, etc.

**Figure 2
Average Sale Price Comparison**



Summary

Commercial property values have stagnated with the economy. Conversely, the residential market, spurred by low interest rates, increased despite the weak economy. Given our property tax system based on uniformity and fair market standard, the significant increase of housing values relative to commercial values have shifted the property tax burden from the commercial owner to the residential owner. In 2003, the average residential property owner will pay 7.9% more while the average commercial owner will pay 4.8% less than last year

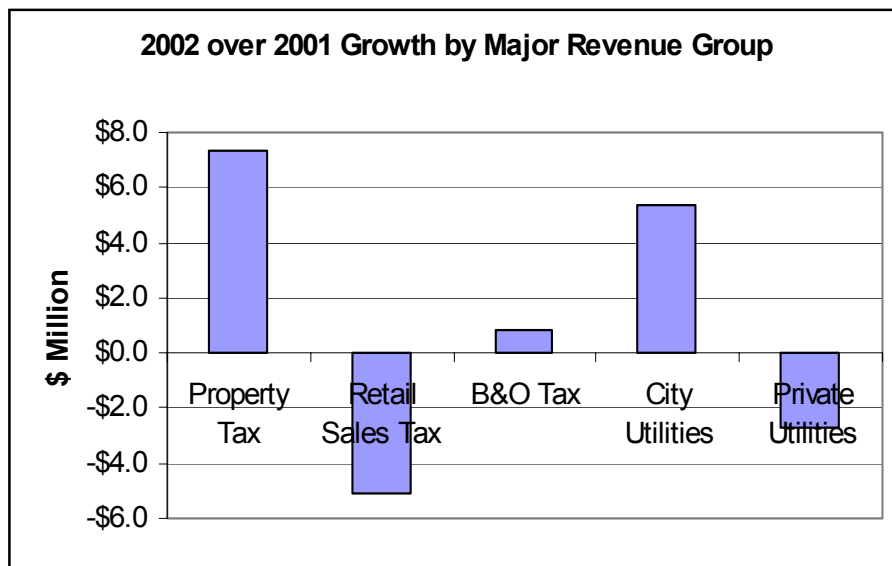
2002 Yearend Report

Comparing year-over-year revenues for general fund taxes and other major revenues

For the national economy 2002 was a year of modest recovery from the 2001 recession. There were clear signs of improvement during the first half of the year, but the recovery faltered during the second half. Gross domestic product (GDP) increased by 2.4% during 2002, but that was not enough to lift the labor market. Employment was generally flat and the unemployment rate drifted gradually upward during the year.

Unlike the U.S., the Puget Sound Region remained mired in recession during 2002. Employment in the 4-county region fell by 2.7% from 2001 levels, and total personal income was lower in 2002 than in 2001 - after adjusting for inflation. Employment in the region declined for 8 consecutive quarters in 2001 and 2002. During that period the region lost 82,000 jobs, a 4.7% decline. On a positive note, the magnitude of decline has been diminishing after reaching a peak in 4th quarter 2001. Job loss in 4th quarter 2002 was a relatively modest 2,400.

As the table below shows, City tax revenues in 2002 exceeded 2001 by \$6.9 million, despite large declines from sales, telephone, admission and natural gas taxes. Offsetting these losses were gains from property tax and the public utility taxes, most notably, City Light. Looking at the total tally, general subfund revenues in 2002 were approximately \$3.2 million above the November forecast of \$634.1 million. However, approximately \$5.0 million of 2002 revenues were associated with grants for specific projects from other jurisdictions. Anticipation of these grants was not included in revenue forecasts. As a result, adjusting for grants receipts indicates that general subfund revenue in 2002 was \$1.8 million below forecast. Greater detail on significant revenue changes follow on the next page.

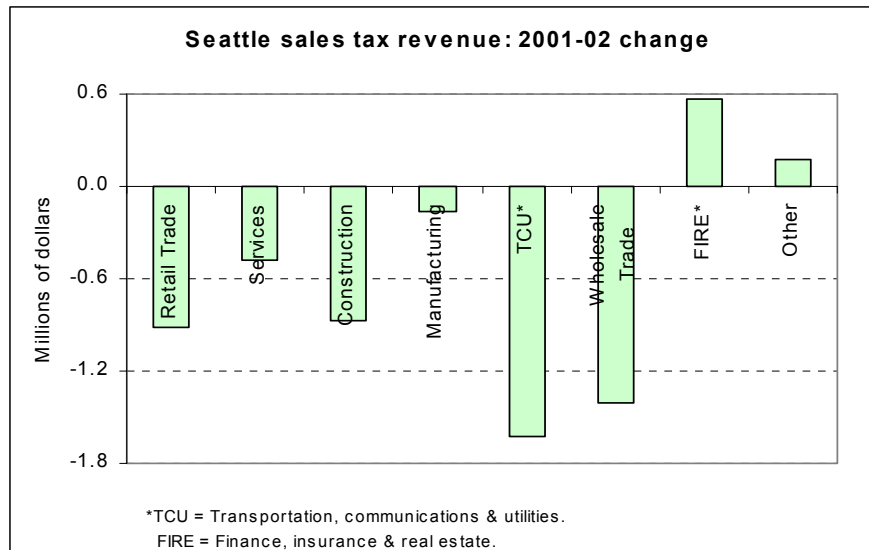


2002 Major General Fund Revenues

| | Nov 2002 F'cast for 2002 | Actuals 2002 | \$ Difference | Percent | Actuals 2001 | Yr/Yr \$ Difference | Yr/Yr percent |
|---|-----------------------------|--------------------|--------------------|--------------|--------------------|------------------------|------------------|
| TAXES | | | | | | | |
| General Property Tax | 154,637,000 | 154,585,764 | (51,236) | 0.0% | 147,212,604 | 7,373,160 | 5.0% |
| Property Tax - EMS Levy | 18,551,000 | 18,516,980 | (34,020) | -0.2% | 15,871,290 | 2,645,690 | 16.7% |
| Retail Sales Tax | 115,091,000 | 115,334,274 | 243,274 | 0.2% | 120,053,388 | (4,719,115) | -3.9% |
| Retail Sales Tax - Criminal Justice Levy | 10,769,000 | 10,874,436 | 105,436 | 1.0% | 11,233,272 | (358,837) | -3.2% |
| B&O Tax (90%) | 112,135,000 | 113,442,248 | 1,307,248 | 1.2% | 112,596,867 | 845,381 | 0.8% |
| Utilities Business Tax - Telephone (90%) | 32,483,000 | 30,464,897 | (2,018,103) | -6.2% | 32,225,542 | (1,760,645) | -5.5% |
| Utilities Business Tax - City Light (90%) | 30,662,000 | 30,594,392 | (67,608) | -0.2% | 26,428,198 | 4,166,194 | 15.8% |
| Utilities Business Tax - SWU & priv.garb. (90%) | 7,888,000 | 7,509,790 | (378,210) | -4.8% | 7,894,753 | (384,963) | -4.9% |
| Utilities Business Tax - City Water (90%) | 7,209,000 | 7,077,704 | (131,296) | -1.8% | 6,441,841 | 635,863 | 9.9% |
| Utilities Business Tax - DWU (90%) | 12,678,000 | 12,741,699 | 63,699 | 0.5% | 11,793,323 | 948,376 | 8.0% |
| Utilities Business Tax - Natural Gas (90%) | 8,953,000 | 8,704,591 | (248,409) | -2.8% | 9,829,527 | (1,124,936) | -11.4% |
| Utilities Business Tax - Other Private (90%) | 8,683,000 | 8,559,922 | (123,078) | -1.4% | 8,414,596 | 145,325 | 1.7% |
| Admission Tax | 5,198,000 | 5,251,220 | 53,220 | 1.0% | 6,710,859 | (1,459,639) | -21.8% |
| Other Tax | 5,092,000 | 4,706,292 | (385,708) | -7.6% | 4,745,052 | (38,759) | -0.8% |
| Subtotal, Taxes | 530,029,000 | 528,364,209 | (1,664,791) | -0.3% | 521,451,113 | 6,913,096 | 1.3% |
| OTHER REVENUE | | | | | | | |
| Licenses and Permits | 9,985,000 | 10,212,453 | 227,453 | 2.3% | 9,756,498 | 455,954 | 4.7% |
| Parking Meters & Meter Hoods | 10,300,000 | 10,674,005 | 374,005 | 3.6% | 10,679,477 | (5,472) | -0.1% |
| Court Fines | 14,567,500 | 14,178,091 | (389,409) | -2.7% | 15,307,194 | (1,129,103) | -7.4% |
| Interest Income | 3,597,000 | 3,053,278 | (543,722) | -15.1% | 4,374,826 | (1,321,548) | -30.2% |
| Revenue from Other Public Entities ¹ | 11,476,082 | 16,674,163 | 5,198,081 | 45.3% | 16,271,421 | 402,742 | 2.5% |
| Service Charges & Reimbursements ² | 42,231,001 | 41,134,246 | (1,096,755) | -2.6% | 16,280,534 | 24,853,712 | 152.7% |
| All Else | 845,133 | 1,724,481 | 879,348 | 104.0% | 1,022,015 | 702,466 | 68.7% |
| Use of Fund Balances ³ | 11,089,770 | 11,303,894 | 214,124 | 1.9% | 3,354,210 | 7,949,684 | 237.0% |
| Subtotal, Other | 104,091,486 | 108,954,613 | 4,863,126 | 4.7% | 77,046,176 | 31,908,436 | 41.4% |
| Total, General Subfund Revenue | 634,120,486 | 637,318,821 | 3,198,335 | 0.5% | 598,497,289 | 38,821,532 | 6.5% |

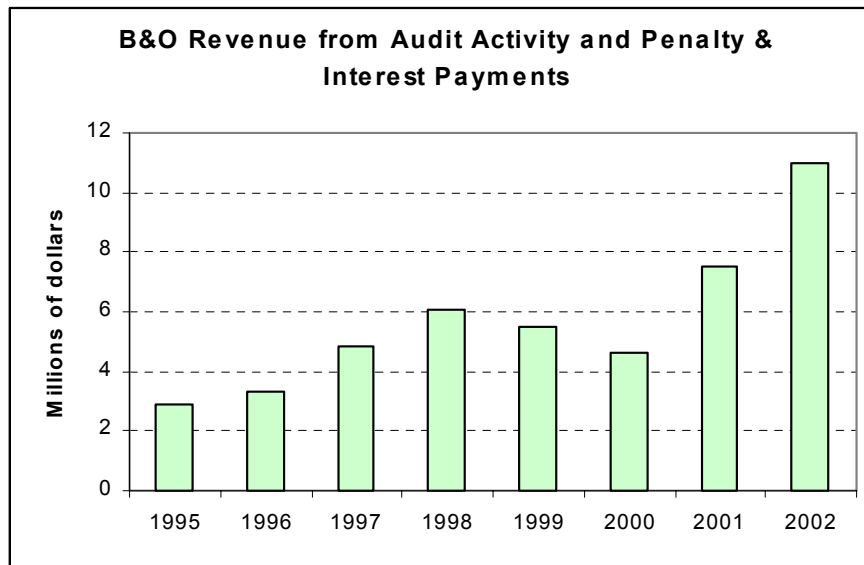
Property tax: 2002 was notable for the huge increment provided to property tax revenue from newly constructed property. Over \$5.2 million of the year-over-year property tax revenue increase in 2002 was due to new construction built the previous year. Additionally, the increase approved by City Council and the levy to recapture refunds resulted in another 1.8% to the overall revenue increase for 2002.

Sales tax: Reflecting the impact of the 2001-02 recession, sales tax revenue declined for the second consecutive year in 2002. Revenue dropped by 3.9% (\$4.7 million) in 2002 after falling by 2.9% in 2001. Sectors registering the largest declines were transportation, communications, and utilities (TCU), which declined by \$1.6 million in 2002, and wholesale trade, which dropped by \$1.4 million. Revenue declines in TCU were concentrated in the telecommunications industry. The only sectors with increased revenue in 2002 were finance, insurance, and real estate (FIRE) and other. The growth in FIRE reflects the fact that most of the FIRE sales tax base is in real estate related industries, which benefited from the strong housing market.



Telephone: Although wireless activity remained positive, the telecom industry showed severe contraction in 2002. The lackluster economy continued to harm telecom revenues amid restructuring in the industry as carriers shift positions in providing service to the end user. The long distance market has been in a slow declining mode for several years as substitution to cellular use has grown; however, the demand for long distance fell at an increasing rate in 2002. All large long-distance carriers have posted revenue declines by over 30% from the previous year.

B&O Tax: Despite the recession, B&O revenue managed a modest gain of \$845,000, or 0.8%, in 2002. However, B&O revenue would have declined had it not been for exceptionally strong growth in revenue from audit activity and B&O penalty and interest payments (see figure below). This growth was due in large part to the resolution in the City's favor of a long-standing legal dispute over the taxation of wholesale transactions in a major industry.



Utility Tax: Electricity: Utility tax revenue from electricity businesses (i.e., Seattle City Light) increased by \$4.2 million (15.8%) from 2001 to 2002. This increase was due to a series of electricity rate increases that went into effect during 2001 and 2002.

Admission Tax: The 2002 revenue posted 22%, or \$1.4 million, less revenue than 2001, but most of the reduction stemmed from the permanent loss of all tax revenue from Seattle Seahawks games due to their move to the newly constructed football stadium in 2002. State law that established the financing mechanism on the new facility prevents the City from levying its admission tax on professional sports in the new football stadium.

Interest Earnings: Relatively large changes in interest rates and the City's residual General Fund associated cash balances caused interest earnings to decline approximately 30% between 2001 and 2002. The City's 2002 rate of return on its General Fund cash balances was approximately 1% below 2001. At the same time, General Fund associated average daily cash balances declined approximately 20%. The majority of this change was due to a mid-year redesignation of a \$19 million fund as an independent interest earning fund. Additionally, due to economic effects on interest rates and Sales tax receipts, the City experienced a 35% decline in its State-shared interest earnings.