INTRODUCTION

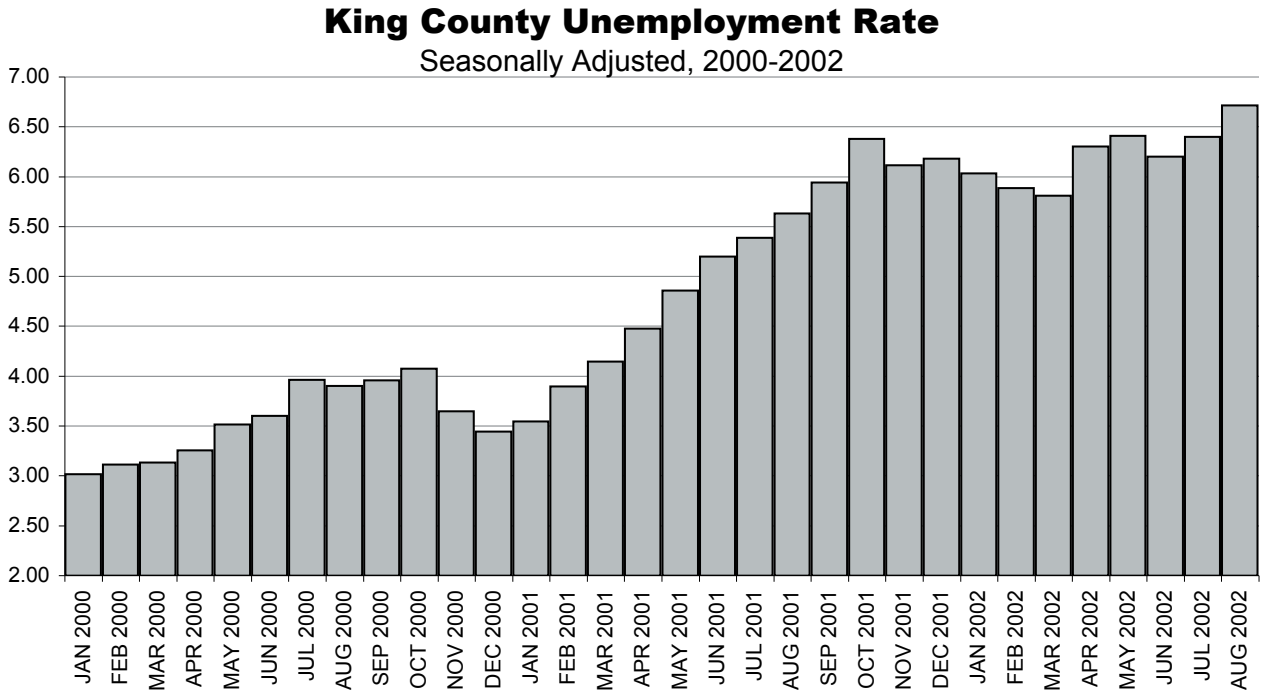
Four years of rapid growth in King County gave way to recession in 2001. Instead of rebounding, 2002 has seen continued deterioration across the economy. Although recovery has been elusive, it will eventually materialize as the local economy adjusts to structural changes over the last business cycle (largely the decline in aerospace employment). Without an expanding national economy to stabilize local business activity, this adjustment process – and tepid economic conditions – will continue for the foreseeable future.

For six months forecasters have anticipated a recovery in the national economy, and for six months the economy has largely stagnated, sparking discussion of double-dip recessions and jobless recoveries. A brief recovery in business investment at the start of the year has reversed, despite unprecedented low interest rates. The Dow Jones Industrial Average fell 17.9 percent in the third quarter of 2002 – the worst performance since 1987 and the worst two-quarter period for mutual funds since 1974.[1] In an environment of increasing uncertainty, the consensus of economists that a recovery would occur in the second half of 2002 has been pushed back to early 2003 or later.

In the absence of compelling positive indicators at the national level, the King County Budget Office is assuming no recovery in 2003 from the county's 18-month old recession. Developed by surveying local economists, published state and national forecasts, and a county forecast prepared by Conway Pedersen Economics, the forecast is the basis for 2003 revenue and expenditure projections. Initial estimates of 2004 and 2005 revenues and expenditures are also prepared from this forecast for the out-year current expense subfund financial plan.

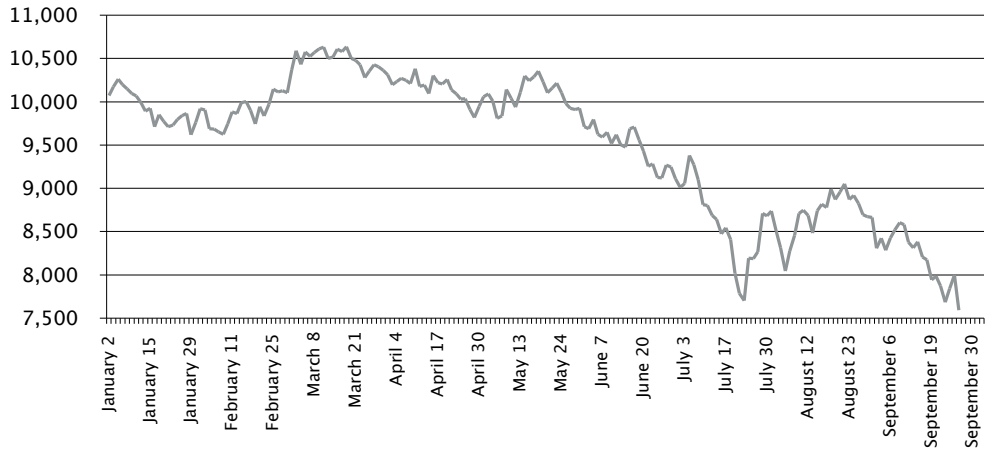
REVIEW OF ECONOMIC CONDITIONS

The national economy entered a recession well before September 11, 2001. A sharp slowing in the U.S. economy and significant declines in the aerospace and technology sectors pushed the Puget Sound region into recession several months before the terrorist attacks on the World Trade Center and Pentagon buildings. A large drop in stock market values curbed growth in personal income, ending almost a decade of extraordinary expansion.



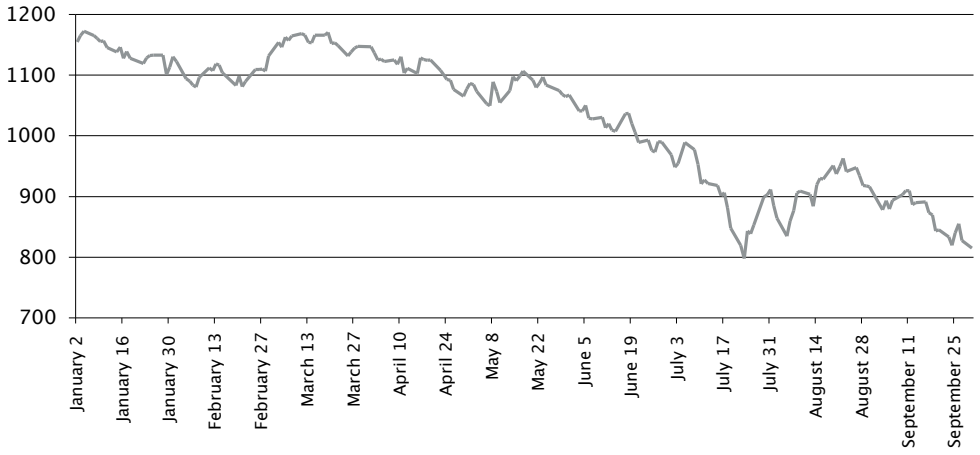
Dow Jones Industrial Average

Closing Values, 2002 Year-to-date



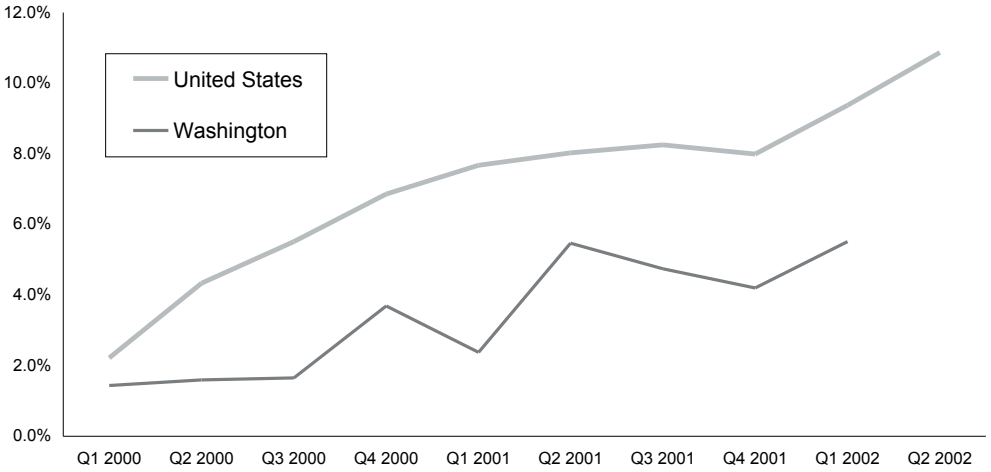
Standard and Poor's 500 Index

Closing Values, 2002 Year-to-date



Personal Income Growth

Cumulative Quarterly Percentage Change Since January 1, 2000

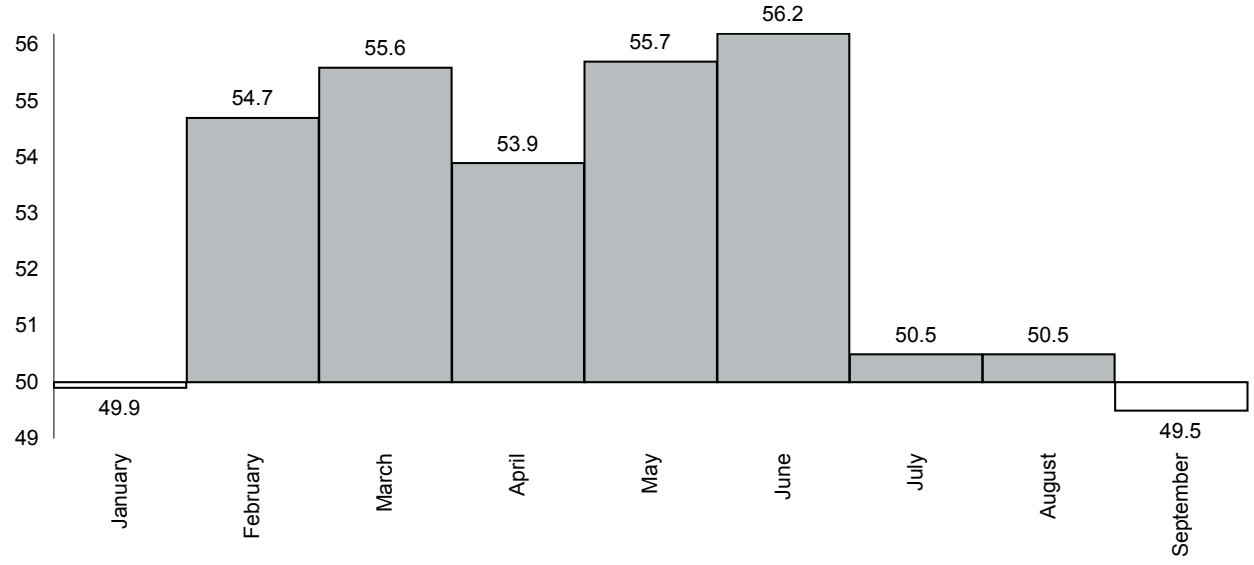


Following September 11th, Washington mirrored the national experience: consumer confidence dropped, consumption generally weakened outside of less-productive areas like security, and travel and tourism expenditures were utterly decimated. Total passenger traffic at Seattle-Tacoma International Airport dropped by 1.4 million in 2001, with little recovery to date this year.[2] With the cancellation of several large conventions, the 2002 hotel occupancy rate in Seattle through July stood at just 66 percent, even after a decrease in average prices over the previous year of almost nine percent. Bellevue's occupancy rate for the same period was just 60 percent.[3]

For the first time in 19 years, the state Office of the Forecast Council is expecting a decline in real personal income of 0.9 percent for 2002, despite a record low inflation rate. Although the entire state has suffered during the downturn, the epicenter of the recession is clearly King County. Since 1999, total non-agricultural employment in King County has fallen by 5.7 percent while the rest of the state declined by 2.7 percent.

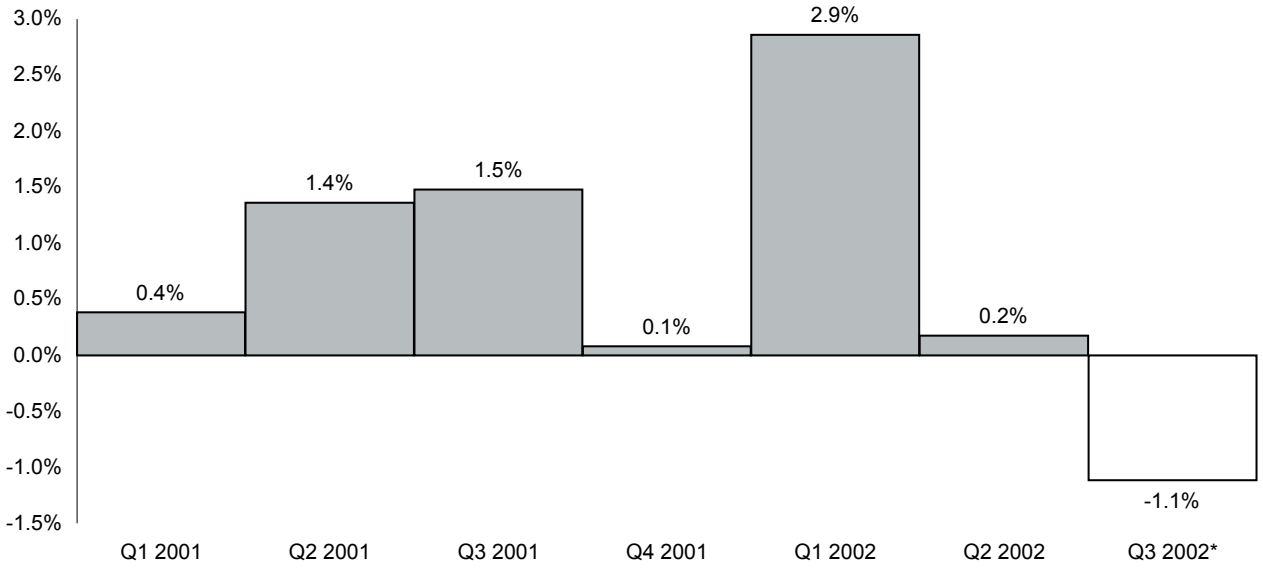
2002 Manufacturing Activity Index

PMI Monthly Data; Scores Below 50 Indicate Contraction



Private Residential Construction

Quarterly Change, Constant Dollars



In the last year, Puget Sound employment dropped three percent; the rest of the state is down just half a percentage point.[4]

The region has been hit the hardest in manufacturing. In the last year, aerospace employment is down 14.2 percent, with further declines in every category of durable good production. Finance, insurance, and real estate, a source of growth at the state and national levels, nonetheless continue to fall in the Puget Sound region. Despite strong growth in health care, service sector employment is down 2.5 percent, fueled largely by a 7.2 percent drop in business services.

One of the few bright spots has been residential real estate. Sales are at near record levels, and prices have remained high, although a gradual increase in the average days on market in recent months suggest that prices may be on the way down. Total activity in August for King County was up 8.4 percent versus a year ago. The median price was $257,000 – up 4.9 percent from a year ago but not necessarily comparable due to differences in statistical sampling.[5] Construction activity has remained remarkably robust in light of record low mortgage rates, but rental properties have not fared as well. The apartment vacancy rate for the Puget Sound region rose from 5.1 percent in 2001 to 7.7 percent in July.[6]

The local market for commercial real estate has by most estimates suffered its worst downturn since the Boeing collapse in the early 1970s. Commercial office space vacancy rates in Seattle fell from 3 percent in 1999 to 1.4 percent at the start of 2001. A Federal Reserve Bank of San Francisco estimate for the second quarter of 2001 pegged vacancy rates 0.3 percent below the estimated natural rate[7] – that is, the rate of expected frictional turnover even at full utilization. Current estimates place the Seattle vacancy rate at 14.6 percent (over five million square feet),[8] with northern and southern suburbs in excess of 16 percent.[9] Another estimate of vacancies in the Bellevue central business district reached 29 percent for the third quarter of 2002.[10] Aside from completing projects initiated before the recession, commercial construction has largely stopped, with little activity expected until the second half of 2003.

Summary Economic Forecast

Percentage Change from Preceding Year

	2001	2002	2003	2004	2005
Puget Sound Region					
Employment	-0.7%	-2.9%	0.0%	1.6%	2.6%
Nominal Personal Income	2.3%	2.0%	2.1%	4.1%	5.4%
Housing Permits	-5.3%	-1.8%	-0.7%	-4.1%	3.8%
Population	1.1%	1.0%	0.8%	0.6%	0.8%
Consumer Price Index	3.7%	1.9%	2.0%	2.3%	2.4%
Washington State					
Employment	-2.9%	0.5%	1.1%	2.2%	2.1%
Nominal Personal Income	2.3%	2.4%	2.4%	4.2%	5.5%
Housing Permits	-1.7%	2.9%	-3.9%	-0.6%	4.6%
United States					
Employment	0.2%	-0.8%	1.1%	1.8%	1.5%
Nominal Personal Income	3.3%	3.2%	5.3%	5.7%	5.6%
Housing Starts	2.0%	3.1%	-3.0%	0.8%	-0.2%
Three-month Treasury Yield	-22.0%	-47.1%	47.2%	61.5%	9.5%
Consumer Price Index	2.8%	1.6%	2.4%	2.6%	2.7%
GDP	0.3%	2.3%	3.2%	3.4%	3.3%

ECONOMIC FORECAST

The national economy entered recession in March 2001. Although significant Gross Domestic Product growth occurred in the first quarter of 2002, technically ending the recession,[11] the US has yet to experience more than a shallow recovery. When the first quarter is analyzed as an accounting byproduct – simply a smaller proportion of final demand was met through existing inventories – the recovery nearly vanishes altogether.

A more robust national recovery is anticipated in 2003. Nonetheless, after four straight years of real GDP growth in excess of 4 percent in the late 1990s, business conditions in 2003 will remain relatively tepid. Employment and investment will remain below 1998-2000 levels, and residential real estate and construction will fall off after being artificially boosted by low interest rates.

The Federal Reserve Board of Governors began easing interest rates well in advance of the recession, cutting the federal funds rate a total of 300 basis points from January to August of 2001, and another 175 basis points following the September 11th terrorist attack. The forecast anticipates a further decline of 25 basis points in the fourth quarter of 2002, before a gradual build-up in interest rates occurs in response to increased economic activity over the second half of 2003.

Much as the Puget Sound region has been more disrupted by the recession, the local recovery is expected to lag national conditions. The slowdown in technology already caused disproportionate injury to the region. In the aftermath of September 11th and its devastating impact on air transportation, it is clear that King and Snohomish Counties have suffered the most severe economic harm of any part of the country, other than possibly Manhattan.

No net change is assumed in total regional employment in 2003, as structural changes continue. Constrained by high unemployment and three years of retrenchment in the technology sector, personal income is projected at an anemic 2.1 percent, only a tenth of a percentage point above 2002 levels. The engine of personal income growth in the late 1990s was the software sector and the value of exercised stock options. Because of the poor short-term outlook for US equity valuations, this forecast assumes no boost to personal income levels from option and bonus income.

After rising by over 3.6 percent in both 2000 and 2001, the Seattle area consumer price index is not likely to exceed 2.0 percent in 2002. Low inflation is expected to continue in 2003, however, volatile energy costs remain as a potential threat to overall price stability. The prospect of war in the Middle East and disruption to oil supplies are cause for concern even in the natural gas and electricity markets. Western Washington's less competitive market for wholesale gasoline makes any constraint on supply even more likely to increase prices.

KING COUNTY REVENUES

Total revenue into the county exceeds $2 billion dollars,[12] which King County distributes into over 50 separate funds. The largest funds include those for transit, wastewater, surface water management, roads, and the county general fund. The largest revenue source is taxes, followed by charges for services; together they account for over half of all revenues. Taxes include three major property tax levies, three different sales

All King County Funds

Major Revenue Sources, 1997-2003

	1997 Adopted	1998 Adopted	1999 Adopted	2000 Adopted	2001 Adopted	2002 Adopted	2003 Proposed
TAXES	675,767,143	717,567,775	765,481,815	719,275,061	715,108,733	746,850,357	769,340,873
LICENSES & PERMITS	14,820,717	16,064,790	16,040,636	18,022,369	18,066,214	18,472,802	20,793,110
INTERGOVERNMENTAL REVENUE	26,180,043	28,640,718	26,756,947	26,756,947	26,756,947	35,829,205	-
FEDERAL GRANTS-DIRECT	28,330,493	24,137,304	26,852,073	28,650,976	30,207,497	32,359,967	35,913,905
FEDERAL SHARED REVENUES	770,375	721,204	732,617	678,590	688,182	699,091	1,069,761
FEDERAL GRANTS-INDIRECT	41,299,570	46,529,744	47,740,164	44,605,870	62,580,257	65,173,089	87,021,399
STATE GRANTS	80,210,099	81,134,564	81,737,617	99,941,683	103,615,392	100,044,636	122,000,599
STATE SHARED REVENUES	751,562	151,721	177,911	176,000	1,301,000	1,045,016	-
STATE ENTITLEMENTS	32,166,680	29,530,487	26,326,768	46,590,108	53,726,160	30,125,795	30,789,593
GRANTS FROM LOCAL UNITS	143,616	150,175	300,732	1,448,525	1,435,851	4,087,240	1,786,320
INTERGOVERNMENTAL PAYMENT	83,555,711	104,876,440	118,425,668	123,027,845	135,928,603	124,894,603	117,281,111
CHARGES FOR SERVICES	535,392,848	543,716,432	599,020,549	661,206,645	741,870,293	811,142,004	812,941,701
FINES & FORFEITS	6,775,148	6,300,462	6,493,323	7,069,093	7,232,871	7,537,213	7,803,918
STADIUM OPERATING REVENUES	10,517,057	9,744,434	6,853,074	221,000	-	-	-
OTHER	957,566,731	1,076,293,410	1,045,807,767	814,292,570	844,656,259	983,258,002	1,107,220,333
ALL FUNDS TOTAL	2,495,643,901	2,685,559,660	2,769,718,509	2,591,963,282	2,744,603,933	2,964,476,448	3,116,989,706

King County Current Expense Subfund

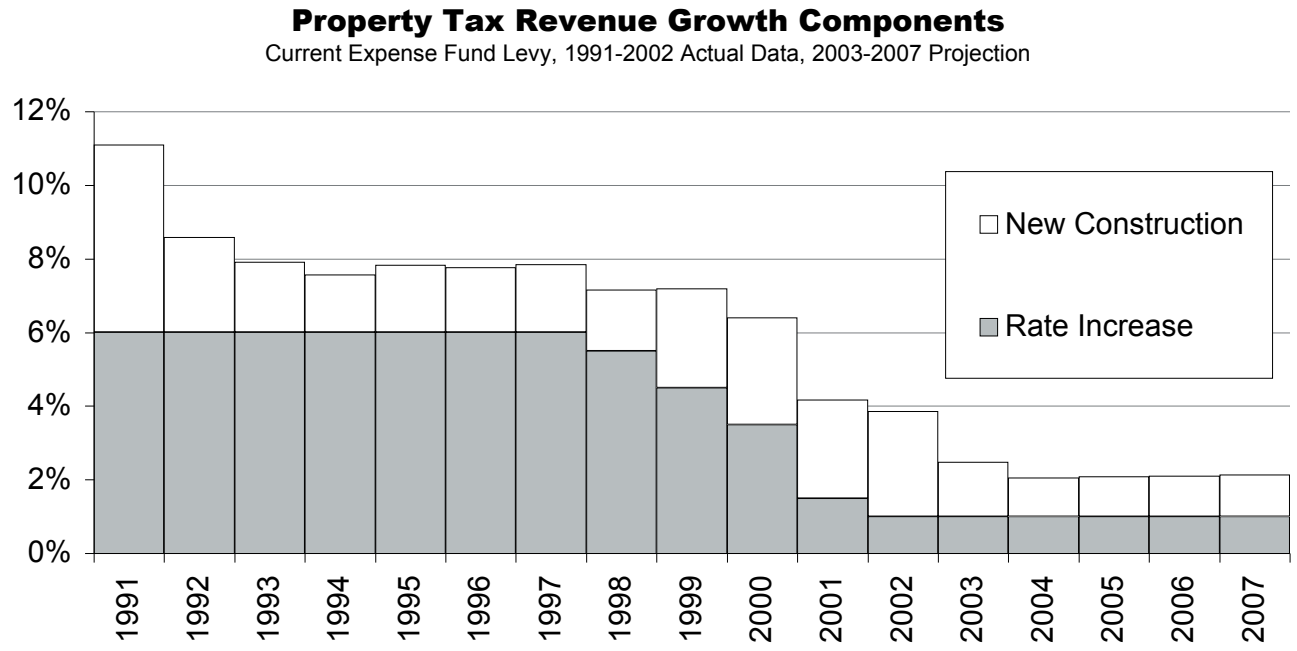
Major Revenue Sources, 1997-2003

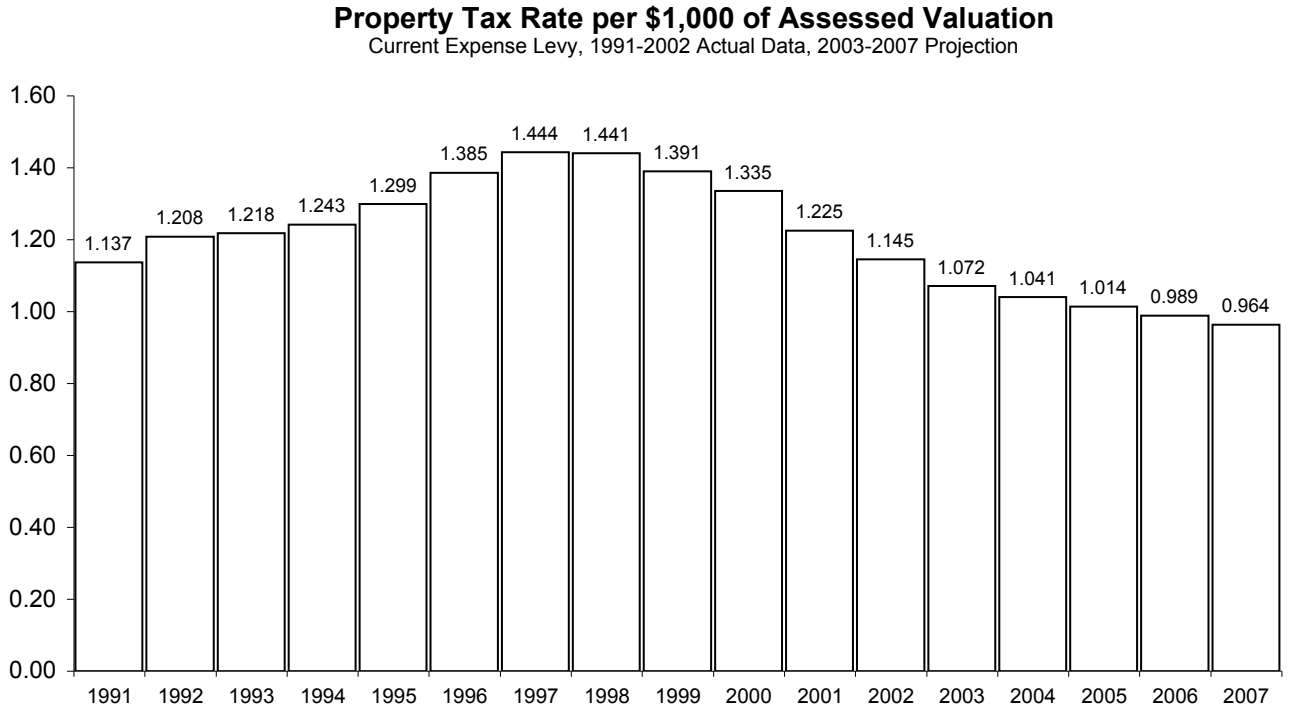
	1997 Adopted	1998 Adopted	1999 Adopted	2000 Adopted	2001 Adopted	2002 Adopted	2003 Proposed
TAXES	222,453,792	243,205,844	252,491,551	269,023,158	286,051,603	297,677,856	302,081,751
LICENSES & PERMITS	4,297,300	5,159,300	4,858,255	4,886,200	5,140,510	5,694,121	5,674,471
FEDERAL GRANTS-DIRECT	353,070	567,654	1,105,599	1,879,779	1,897,000	954,000	2,361,514
FEDERAL SHARED REVENUES	34,500	38,000	39,140	39,140	39,140	40,314	50,000
FEDERAL GRANTS-INDIRECT	3,553,889	4,293,999	4,657,898	4,328,755	5,900,152	4,817,776	6,546,708
STATE GRANTS	1,713,228	1,624,236	1,548,526	1,637,478	1,535,680	1,712,365	1,863,402
STATE SHARED REVENUES	141,000	141,000	167,030	176,000	176,000	181,280	-
STATE ENTITLEMENTS	1,325,000	1,317,000	1,257,917	1,297,505	1,554,125	1,383,967	1,308,505
GRANTS FROM LOCAL UNITS	63,164	70,728	20,320	14,000	14,000	2,614,420	-
INTERGOVERNMENTAL PAYMENT	22,311,034	46,388,515	49,080,342	52,656,427	55,772,028	56,733,723	52,269,056
CHARGES FOR SERVICES	80,249,108	57,621,784	70,993,265	76,991,057	80,258,079	82,639,182	87,496,426
FINES & FORFEITS	6,630,934	6,223,771	6,420,929	6,810,093	7,164,871	7,524,713	7,780,918
OTHER	20,648,556	33,800,723	24,250,729	25,658,174	25,082,650	19,903,635	17,785,673
CURRENT EXPENSE TOTAL	363,774,575	400,452,554	416,891,501	445,397,766	470,585,838	481,877,352	485,218,424

NOTE: Zero values for Intergovernmental and State Shared Revenues caused by phase-out of Title XIX and Motor Vehicle Excise Tax backfill funds, respectively.

tax assessments, and taxes on real estate transactions. Charges for services include both direct contracts, interfund payments, and other services provided by the county.

Taxes are the largest source of revenues to King County, accounting for 24.7 percent of total revenues and 62.3 percent of current expense subfund revenue. The major tax sources for the county include property taxes, sales and use taxes, hotel and motel taxes, and telephone excise taxes to support the enhanced-911 system. Total King County tax revenue is projected to be $769.3 million in 2003, an increase of 3.0 percent over the adopted 2002 budget. These revenues support operating expenses, debt service, and some capital projects. Property taxes are the largest single tax source for the county, with a proposed levy of approximately $370.9 million in 2003, including $53.8 million collected for Emergency Medical Services, $18.7 million of which is disbursed directly to the city of Seattle.





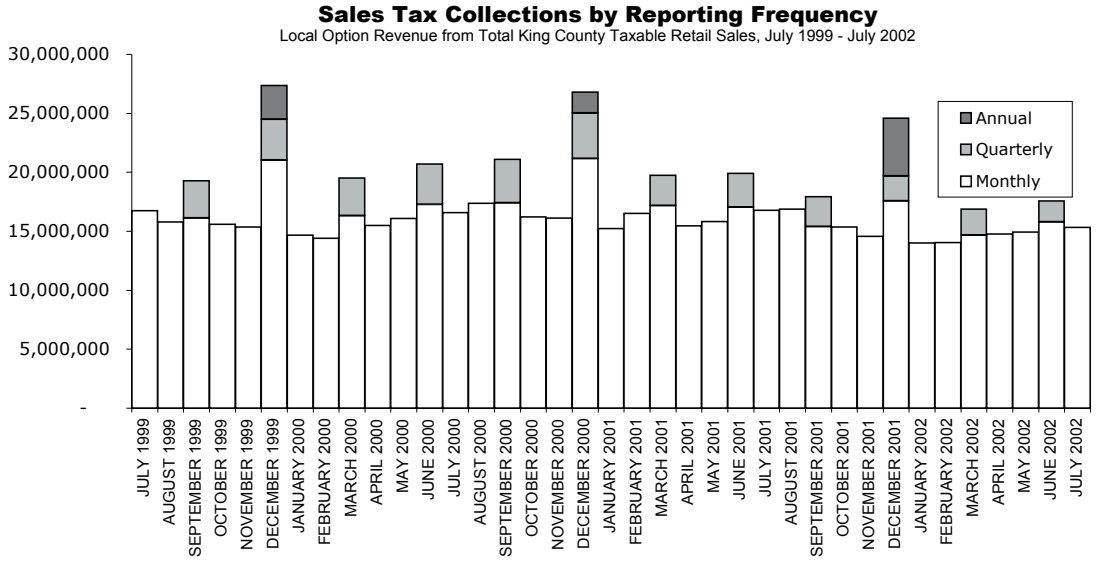
PROPERTY TAX

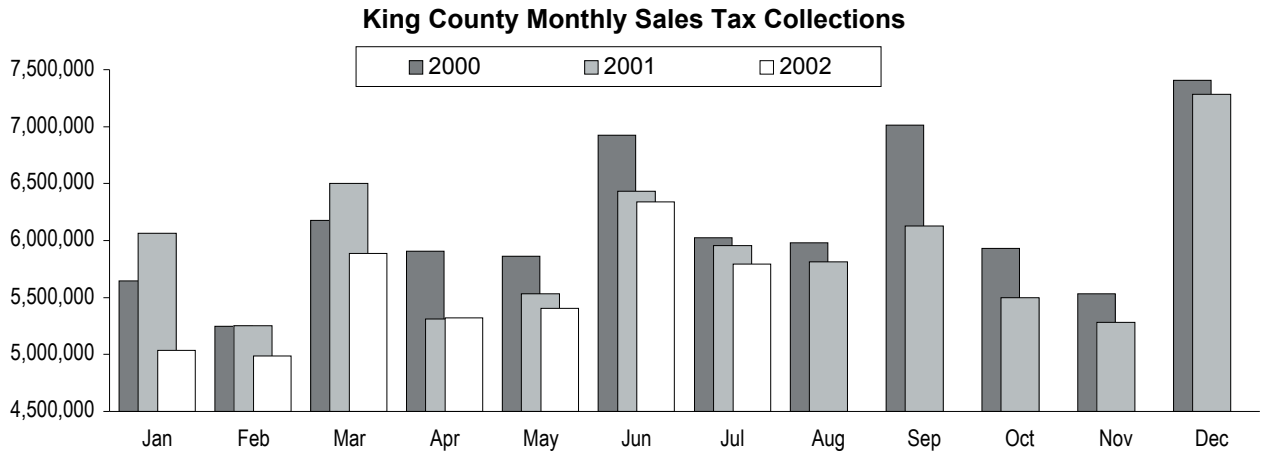
Property taxes are collected through the countywide levy, the unincorporated area levy, the Emergency Medical Services levy, and voter approved debt. These monies are dedicated to various funds within King County.

Property taxes are limited by both county policy and state law. Under Initiative 747, approved by Washington voters in 2001 (but rejected by a majority of King County voters), the regular levy can grow at only one percent annually, plus the increase in new construction. With inflation typically running two or three percent, this measure is gradually decreasing the effective tax paid by typical property owners, and reducing the dollars available for the current expense fund.

The countywide levy[13] is projected to grow by roughly 2.6 percent in 2003, with new construction accounting for 1.6 percent of the increase. The overall countywide levy is projected to increase from $250 million to $258 million in 2003. The amount remaining for the current expense subfund is this amount less distributions for debt service, the Automated Fingerprint Identification System, river improvement, veterans, and other designations. Current expense revenues from the property tax levy are $224.5 million, $6.6 million above the 2002 budget.[14]

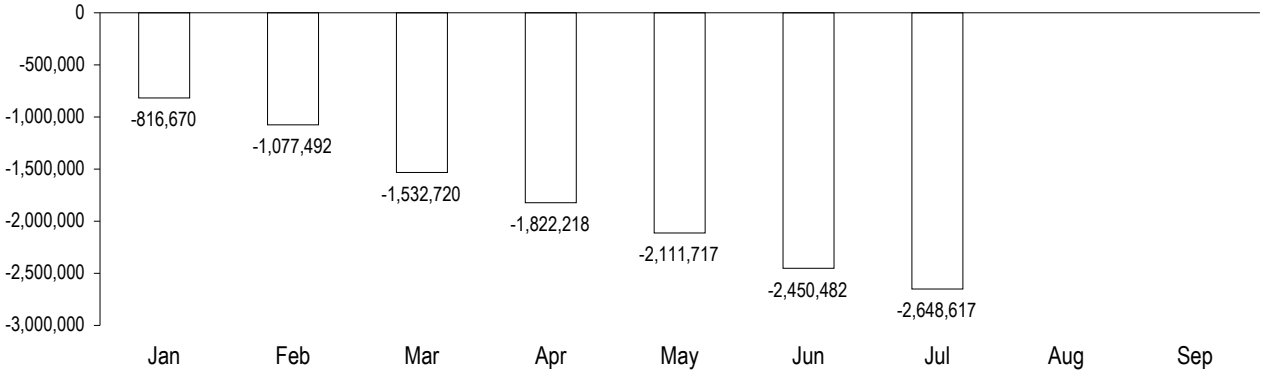
The unincorporated area levy (traditionally known as the road levy) is proposed at $59.1 million for 2003.





Monthly Collection Detail

	January	February	March	April	May	June	July	August	September	October	November	December
2000	5,643,746	5,247,801	6,175,848	5,908,357	5,860,285	6,924,611	6,023,919	5,982,095	7,013,757	5,929,100	5,534,585	7,407,359
2001	6,062,931	5,251,282	6,503,883	5,313,379	5,533,086	6,431,011	5,958,177	5,815,392	6,127,737	5,499,377	5,280,576	7,282,334
2002	5,036,669	4,988,719	5,884,638	5,321,370	5,407,187	6,339,046	5,792,913					



Year-to-Date Collection Detail

	January	February	March	April	May	June	July	August	September	October	November	December
2000	5,643,746	10,891,548	17,067,396	22,975,752	28,836,037	35,760,649	41,784,567	47,766,662	54,780,419	60,709,520	66,244,105	73,651,464
2001	6,062,931	11,314,213	17,818,096	23,131,476	28,664,562	35,095,573	41,053,750	46,869,143	52,996,879	58,496,256	63,776,832	71,059,166
2002	5,036,669	10,025,388	15,910,026	21,231,396	26,638,583	32,977,629	38,770,542					

* Data presented are total sales tax collections less Department of Revenue 1 percent administration fee. 90.4 percent of County sales tax receipts are deposited in the current expense fund.

SALES TAX

Sales taxes are Washington State's largest tax, and the second largest source of tax revenue for King County. A sales tax rate of 8.80 percent is assessed in the county, distributed as follows:

- 6.50 percent is collected by the state;
- 1.00 percent is a local option tax divided between cities and the county;[15]
- 0.80 percent is collected to support Metro Transit;[16]
- 0.40 percent is collected by the Regional Transit Authority (Sound Transit);[17]
- 0.10 percent is collected to support criminal justice programs.[18]

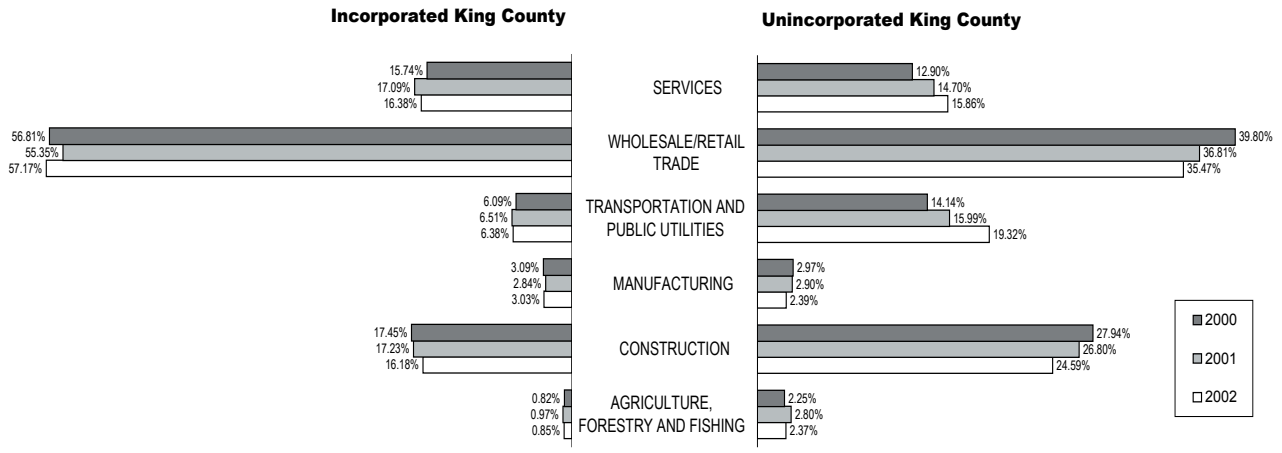
The sales tax is strongly influenced by changes in the economy and by the geographic areas from which it is collected. The public transportation and criminal justice funds receive revenues from countywide retail sales, with unincorporated areas constituting a little over four percent of the tax base. In contrast, over 17.6 percent of King County's general fund sales tax revenue is collected in unincorporated areas. Differences in the geographical composition of taxable retail sales also complicates analysis of revenue over the course of the business cycle. For example, the relative dominance of the construction sector in unincorporated King County makes the current expense subfund more sensitive to economic conditions than countywide taxes for transit and criminal justice.

Sales taxes have been traditionally criticized for placing a disproportionate burden on lower income households. Over time, the inability to tax internet transactions and a general lag behind personal income growth will also prevent King County sales tax receipts from keeping pace with cost of delivering most government services.

Total projected 2003 general fund sales tax revenue is $68.3 million, an increase of 0.60 percent over estimated 2002 receipts. Of the total, nearly $3.1 million will be deposited to the children and family services subfund and $3.4 million to the sales tax reserve subfund, with the remaining $61.8 million dedicated to the current expense subfund. Along with the inmate welfare subfund, this constitutes the general fund. A revised sales tax forecast will be released later this month when August collection data becomes available. Given worsening national economic conditions, the potential impact of exogenous events like the west coast longshoreman labor dispute and war in Iraq, and continued weakness in year-to-date collections, a downward revision is very possible.

Taxable Retail Sales by Standard Industrial Classification

January - July 2002 Business Activity (March - September 2002 Department of Revenue Disbursements)



Sales Tax Forecast Detail

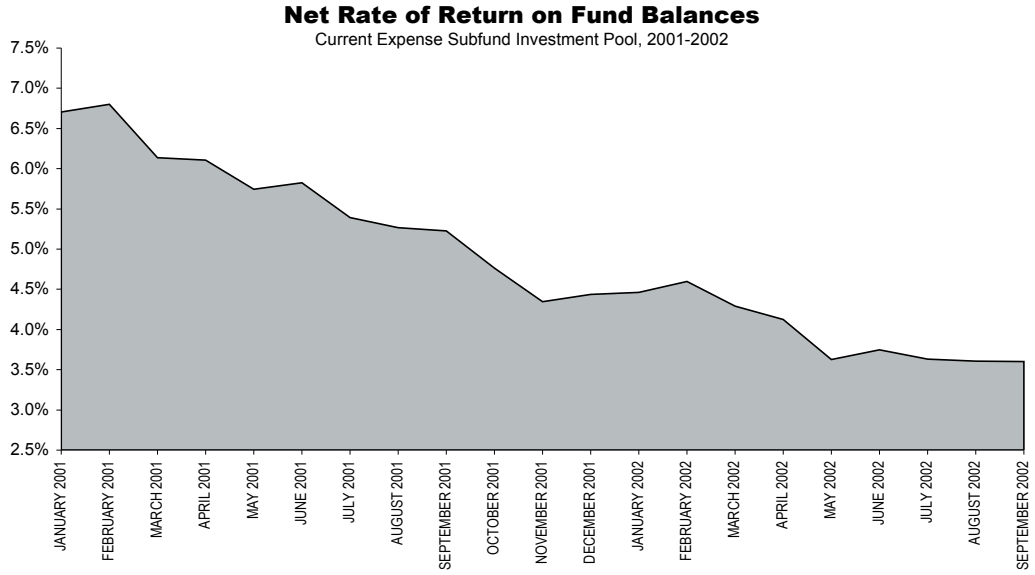
	2000 Actuals	2001 Actuals	2002 Adopted	2002 Estimated	2003 Proposed
General Local Option					
Current Expense	66,580,923	64,237,486	62,952,736	61,411,037	61,779,503
Children and Family	3,387,967	3,268,722	3,203,347	3,124,898	3,143,647
Sales Tax Reserve	3,682,573	3,552,958	3,481,899	3,396,628	3,417,008
Total	73,651,464	71,059,166	69,637,983	67,932,563	68,340,158
Criminal Justice					
Total	11,822,590	10,958,675	11,012,379	10,344,084	10,368,910
Public Transportation					
Total	239,234,385	277,796,321	321,903,534	298,262,875	302,198,931

REAL ESTATE EXCISE TAX

King County levies the Real Estate Excise Tax (REET) in unincorporated King County and administers state and city REET taxes throughout the county. Reflecting unprecedented low interest rates, real estate sales have remained remarkably high in 2002. Reflecting the slowdown in construction and the decreased stimulus effect of low mortgage rates, high REET revenues will almost certainly decline over the next two to three years. REET consists of two 0.25 percent taxes on real estate transactions. Each is forecasted at $4.7 million in 2003, a decline of 13.1 percent from 2002 projected collections.

INTEREST EARNINGS

Because of high volatility, attributable to variance in both interest rates and county fund balances, the Budget Office continues to provide a conservative interest earnings forecast. Interest rates have been projected using futures prices on the New York and London markets and correlating them with historic pool earning performance. For 2003, a rate of return of 3.15 percent is assumed, rising to 4.70 percent in 2004, and 5.05 percent in 2005. This forecast will be revised following the Federal Reserve Open Market Committee meeting on November 6, 2002.



FOOTNOTES

[1] Morningstar, Inc.
[2] Port of Seattle, *Airport Activity Report*.
[3] Wolfgang Rood Hospitality Consulting.
[4] Washington State Employment Security Department.
[5] Northwest Multiple Listing Service.
[6] Dupre + Scott Apartment Advisors.
[7] Federal Reserve Bank of San Francisco, *Economic Letter 2001-27*, "Natural Vacancy Rates in Commercial Real Estate Markets."
[8] Colliers International.
[9] Commercial Space Online, Inc. survey data [http://www.officespace.com].
[10] Cushman and Wakefield.
[11] The National Bureau of Economic Research has yet to announce the end of the 2001 recession. Under the official definition of two or more consecutive declines in quarterly Gross Domestic Product, the recession ended in January 2002.
[12] Interfund transfers, overhead rates, and other transactions duplicate some funds in the total revenue figure of $3.1 billion.
[13] The countywide levy includes the current expense fund and dedicated millage for mental health/developmental disabilities, river improvement, human services, veterans' aid, intercounty, and limited bond redemption.
[14] This is before the collection rate adjustment.
[15] Within cities, 0.15 percent is distributed to the county, and 0.85 percent to the city. King County receives the full 1.00 percent collected in unincorporated areas.
[16] This tax was approved in April 2001 to replaced funds lost with the repeal of the Motor Vehicle Excise Tax by Initiative 695 in November 1999.
[17] This tax is not collected in the rural part of King County where the sales tax rate is 8.40 percent.
[18] 90 percent of these funds are allocated to the cities on the basis of population. King County receives a share based on unincorporated population, in addition to the remaining 10 percent. This tax was approved by county voters in 1992.