Agenda Report

TO: CITY COUNCIL
THROUGH: FINANCE COMMITTEE

DATE: JANUARY 27, 2003

FROM: CITY MANAGER

SUBJECT: DISCUSSION OF FACTORS IMPACTING THE CITY'S OPERATING BUDGET

RECOMMENDATION

The following report is for information only no Council action is requested.

BACKGROUND

On January 10th Governor Gray Davis proposed a $96.4 billion state budget for 2003-04. Included in the budget was his plan for addressing an estimated $34.6 billion, 18-month deficit. The plan calls for major tax increases with over $9 billion in direct tax and fee increases and actions that could trigger $3.4 billion more.

In addition to tax increases, the plan calls for significant spending cuts in a number of programs with major cuts planned in such programs as education, health and welfare, as well as the Traffic Congestion Relief Fund by taking sales tax money earmarked by voters for transportation.

As expected, these proposals have not been well received. Counties, local governments, school districts, union leaders and others have begun to mobilize support as each seeks to avoid the full impact of the Governor's proposals. In the Legislature, Democrats and Republicans are lining up for the budget battle, as the former propose increased taxes, such as reinstating the Vehicle Licensee Fee to its 1998 level, while the latter are resisting any tax increases.

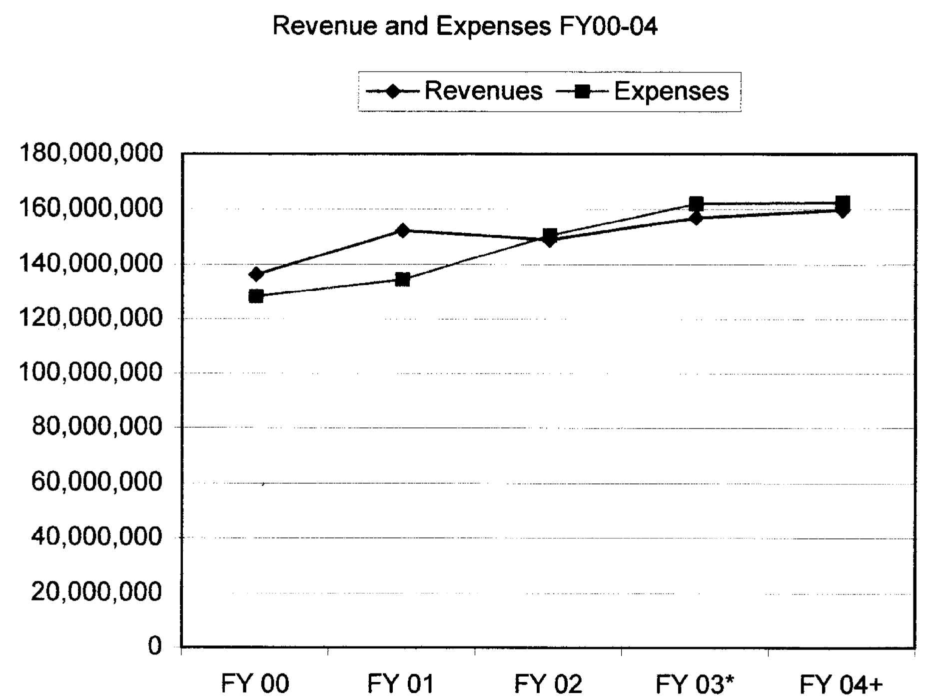
With so much at stake and so many stakeholders, the budget process in Sacramento is likely to be the longest, most complex and difficult in California history. And although the impact on Pasadena is likely to be profound, it is not the only factor impacting the City's budget. As the City begins the process of developing the Operating Budget for fiscal year 2004, this report is intended to touch upon those factors which in addition to the state budget, are putting pressure on the City's financial resources. By clearly establishing this context early on, the City is best positioned to develop sensible budget strategies that enable it to continue to provide a high degree of service to the community.

To best understand the City's current picture it's worth taking a quick look back at recent years. City revenues had several years of solid growth in the late 1990's and early 2000's that were capped by an extremely strong fiscal year 2001. In that year, General Fund revenues received during the year were some $13 million higher than budgeted. As a result the City was able to add new programs and enhance existing ones, including the establishment of the Parks Safety Program as well as embarking on a comprehensive, multi-phase approach to park enhancement. The City extended hours at seven branch libraries, an achievement made more notable by the fact that less than ten years prior the City contemplated reducing hours and/or closing branches as a means of addressing then current shortfalls.

Throughout fiscal year 2002, the local economy remained surprisingly resilient in the wake of the September 11th terrorist attacks and a prolonged statewide recession.

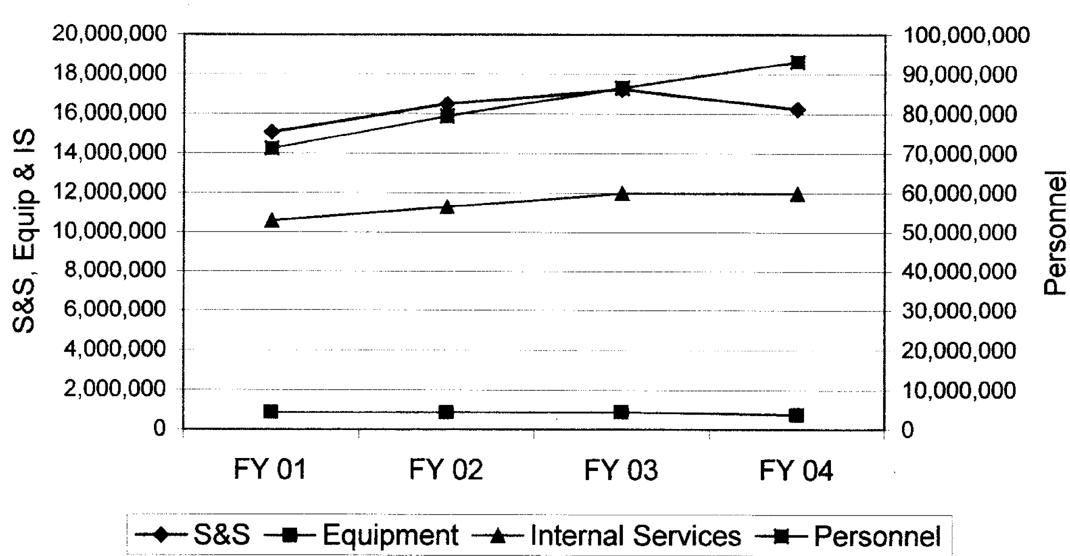
The City tends to budget conservatively and as a general rule, a tolerance of 2-3% is used as a guide in the development of the budget, i.e., if anticipated revenues and expenses are within about 2-3% of each other, even if expenses appear higher, the budget is considered to be essentially balanced since departments typically under spend overall, and revenues tend to come in a bit higher than predicted. The adopted fiscal year 2003 General Fund budget estimates that $5.1 million will be needed to balance this year. This is within the accepted tolerance; however, as illustrated by the most recent General Fund 5 year financial forecast, which is attached, revenues and expenses need to be watched carefully over time and adjustments made if at some point they stretch beyond currently accepted tolerances.

So what's driving this? In short, revenues although remaining strong, have been growing at rates less than expenses.



*adopted budget
+current projection

Analyzing expenses by major category reveals that personnel-related costs have grown the most in recent years.



The growth in Personnel costs is not surprising given that the City is a service organization that operates through people. The Personnel costs depicted above do not represent solely increases in wages, but reflect enhanced staffing levels necessary to provide the ever-expanding level of services to the community. Since fiscal year 2000 the General Fund has added the equivalent of 82 full-time positions, 26 of which (or 32%) have been in public safety, 14 in youth services, recreation and after school programs and 7 in park maintenance. To the extent that wages have increased, they have done so as a means to attract and retain qualified staff and are in line with increases provided by comparable municipal organizations.

Within the Personnel category more than just base salaries have been increasing. In fact, certain non-direct wage items have grown proportionately higher in recent years, as illustrated by the table on Attachment A.

With the exception of the dramatic rise in SPERS rate, which is attributed to an approximate 3.5 percentage points or 68.8% rate hike based on PERS calculations and an additional 9% associated with the enhanced 3% at 55 benefit which is expected to be approved in the near future, the largest increases in Personnel-related costs have been in the area of Workers' Compensation and Medical insurance.

These two costs have been spiraling out of control in both the private and public sectors. The City continues to make every effort to reduce Workers' Compensation costs, however, the current no fault system along with enhanced benefits approved by the state greatly limit the City's ability to control costs. Nevertheless, through the recently enacted Return To Work program as well as Gain Sharing, the City is addressing the issue where it can.

The cost of providing medical insurance to employees has jumped over 70% since fiscal year 2001. The City is exploring options for providing medical insurance, perhaps outside of the PERS umbrella. However, as widely reported, the growing cost of medical insurance is a national phenomenon and surveys have placed the anticipated increase for calendar year 2003 at roughly 15% nationwide with even steeper increases in subsequent years.

Two other issues on the horizon that will impact the City's budget are a reflection of the decline in the stock market. As a result of investment loses incurred by the Fire and Police Retirement System, in order to maintain the established funding level an anticipated $4 million supplemental contribution is likely to be required in fiscal year 2004 and potentially beyond. Employer-portion contributions for non-safety personnel into PERS is likely to be required to be made beginning in fiscal year 2006, as PERS adjusts its actuarial tables to reflect loses in its own investment portfolio.

While the factors outlined in this report pose challenges for the City, as has been the case historically, staff has every confidence that each can be addressed in a reasonable and appropriate fashion without jeopardizing service to the community. Unfortunately, added to the challenge is the yet unknown impact of the state budget. As reported to Council on January 13th, preliminary assessments are that under the proposal released by the Governor on January 10th, the City can expect to lose approximately $2.9 million this current fiscal year and anywhere between $7 to $15 million in fiscal year 2004.

To address the anticipated loss of revenue a series of short and longer-term actions are being planned. The first of which went into effect long before the Governor released his budget proposal, when the depths of the state's fiscal crisis was first tested.

In fiscal year 2002, the City reserved $1.89 million against the possible loss of Vehicle License Fee backfill. Another $1.8 was added to this reserve in the current year's budget. Subsequently, about $200,000 of this reserve was earmarked to offset reductions in the Library and Health Funds for fiscal year 2003. Consequently, the reserve remains at $3.49 million. Rather than significantly deplete this reserve in an effort to offset the anticipated current year loss of $2.9 million only to be faced with a significant budget shortfall in fiscal year 2004, staff proposes to use this reserve in combination with budget reductions in the current and future year(s) to ease the impact of revenue losses.

Although reductions in specific programs have yet to be determined, a total of $1.5 million in General Fund reductions will be recommended in the current fiscal year's budget. General Fund reductions for fiscal year 2004 will be targeted at $8 million. Although revenue losses to the state may be higher, staff believes a reasonable approach is to estimate state-related revenue reductions in fiscal year 2004 at $7 million. To this is added $1 million, which represents the impact on the City as a result of an increase in the PERS rate for safety personnel, from 2.46% of salary in fiscal year 2003 to 6.01% in fiscal year 2004.

To the extent that the current year reductions represent ongoing savings, they will be applied toward the fiscal year 2004 target. Although the $1.5 and $8 million figures may seem small in relation to the current size of the City's General Fund ($162 million), once critical services such as public safety and fixed items such as debt service are removed from the equation, the remaining "discretionary" amount is reduced to something in the $60-$70 million range.

The state's plan for addressing its deficit should come into focus about the time the City adopts its fiscal year 2004 Operating Budget. At that point, the City will be in a better position to assess what, if any, further actions will be necessary in fiscal 2004 and beyond. The City also continues to seek out new revenues and develop innovative funding mechanisms. The possibility of seeking voter approval for Park funding to further enhance the City's open spaces has recently been mentioned. This possibility will be discussed with the Parks and Recreation Commission and then with the City Council as a regular scheduled agenda item. Additionally, staff will review fees and other revenue sources and make recommendations to the Council, as believed fair and appropriate as a part of the City Manager's Fiscal Year 2004 Recommended Budget in April/May.

FISCAL IMPACT

Under the proposal released by the Governor on January 10th, the City can expect to lose approximately $2.9 million this current fiscal year and anywhere between $7 to $15 million in fiscal year 2004. In response, a total of $1.5 million in General Fund reductions will be recommended in the current fiscal year's budget, specific reductions are currently being identified. General Fund reductions for fiscal year 2004 are currently targeted at $8 million, but will depend heavily on actions at the state level.

There is no anticipated impact on the City's Capital Improvement Program Budget as the amount of General Fund dollars devoted to the CIP are relatively minimal.

Respectfully submitted,

Cynthia J. Kurtz,
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