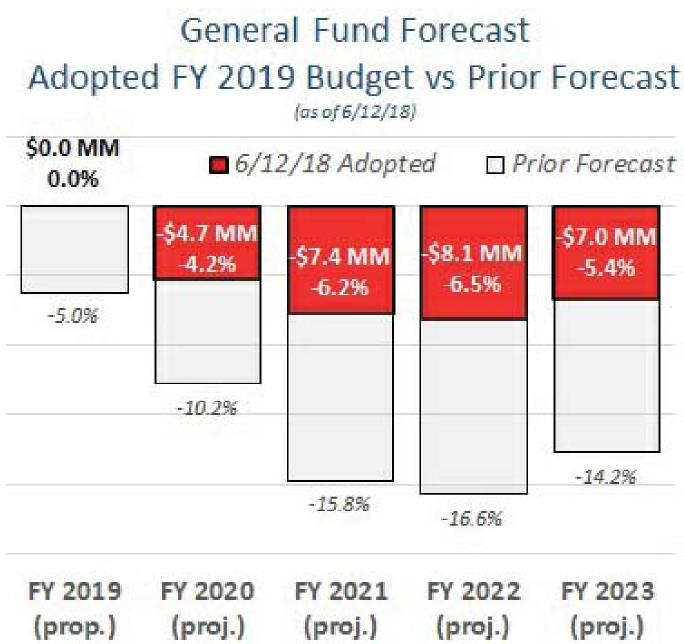
# FINANCE DIRECTOR'S OVERVIEW

<u>$264.6 million Total Budget</u>
$41.2 million Capital- initial
$ 1.5 million Capital- Measure S
$102.2 million General Fund

## Balanced FY 2019 Budget

This FY 2019 Annual Budget represents another pillar of our five-year fiscal sustainability plan (referred to as our fiscal bridge project). This budget plan continues the City's proactive traditions to insulate our community against a looming but credible economic slow-down and state-wide government funding crises.

We are therefore proud of this FY 2019 Adopted Budget as it has balanced our General Fund operations and has reduced the General Fund's gaps in our out years.




To get to this point, City staff crossed departmental lines to develop this reduced budget in accordance with our long-term sustainability plan.

These staff were the City's budget leads, supervisors, managers, and department heads from the General Fund's largest departments (Police, Fire, and Parks and Recreation), from operational departments like Public Works, Planning & Community Development, and Economic Development, to smaller, support departments like City Manager, Information Technology, Human Resources, and Finance.  Staff from Public Works and Water enterprise operations also brought valuable insight to inform our path forward.  Ultimately, we are thankful to the City Council for their leadership and the community for their trust and support.

The output was a budget plan that eliminated the General Fund's $5.5 million funding gap (equivalent to  5%), preserved core service level expectations, and, in alignment with the long-term plan, already significantly reduced the future funding gaps previously projected (FY 2022 16.6% gap was reduced to 6.5%) to move us further along our plan to offset the entire projected gaps.

# Unprecedented Financial Time

During this booming economic recovery, Cities across the State are facing unprecedented, financial challenges from similar, looming, fiscal threats.  From Davis to Berkeley, from Monterey to Santa Maria, from Santa Barbara to Ventura, we share similar themes, such as a lack of housing, demand for greater social services, tax revenue deterioration, State pension investment shortfalls, and the need for significant infrastructure investments.

For the City of Santa Cruz, a mile marker on our long-term financial bridge occurred in February 2018, when the City Council formally adopted a declaration of fiscal emergency to place Measure S on the June 2018 ballot.  Measure S would increase the City's sales tax rate by 0.25% to the State cap of 9.25%.

Like prior actions in 2005 and 2008, this action was motivated for the primary purpose of placing a tax measure on a ballot where there are no Council Members up for election.  In this case, the City Council wanted to avoid competing with a significant, count-wide, housing ballot measure planned for November 2018.  However, the basis of the fiscal emergency is sound and in alignment with the City's long-term financial strategy to take bold and smart action now to plan for future challenges.

By the 9th year of a typical recovery period, local government revenues would be typically thriving, portfolio investment returns would be accumulating large gains, and Federal and State programs would be pushing increased support to local communities.

However, during these past 9 years, a new and dangerous paradigm has emerged.  Instead of thriving revenue growth, many of the City's primary revenues are experiencing only modest growth while their tax bases are shrinking.

Instead of strong portfolio returns, the Federal Agency bond market has held steady, far below the 4% to 6% prior recovery period rates.  The State's Pension Investment Fund in the prior two boom cycles saw average returns of greater than 15%; but in this 8-year strong bull market it is hitting a poor 10% average, while other index funds are enjoying significantly greater returns.

And while the State's income based tax structure is producing large surpluses, neither the State nor Federal government is allocating significantly new resources to local government programs.

Meanwhile, for a 150+ year-old City, much of our infrastructure is in need of considerable investment.  But, this recovery period has not provided the typical additional resources that would be used.  To this point, the General Fund would now be in its third Budget Year without any planned capital investment funding.

With support by the City Council, City staff have been closely following and forecasting the impacts of these trends.  And, as far back as the February 2014 mid-year report, the City's long-term forecast models were indicating this time period to be the start of increasing General Fund projected deficits.  In fact, the 2014 model's deficit projection for FY 2018 was nearly perfect, projecting a deficit of <2.2%> (the actual FY 2018 adopted deficit was <2.6%>).

# A Modern Fiscal Strategy

This unprecedented financial time for local government requires a new game plan, one that requires long-term commitment and restraint. Contrary to historical budget planning that focused largely on how to financially navigate the next one or two years, the City Council has continued to support their Fiscal Sustainability Strategy that includes taking aggressive action early, to provide for meaningful, compounding savings for greater future flexibility.

This blueprint includes three major strategies: First, reset the General Fund net costs by FY 2020 with upwards of a 7.5% to 8.0% reduction in today's budget dollars. Second, accumulate resources to pay down high-rate debt while strategically evaluating service models and prior operating practices, and identifying opportunities to eliminate unintended subsidies. And third, have the City Council explore ballot measure options to increase tax resources by $8 million.

Some results and past successes of this plan to build on included:

- Submitted for voter consideration the Measure S ballot (0.25% Sales Tax increase; equivalent to 25-cents for every $100 spent)
- Eliminated and reduced consulting and legal costs for most debt issues (Road and Water as recent examples)
- Took advantage of pre-payment discounts, especially for CalPERS
- Refinanced and paid down prior debt
- Maximized investment portfolio with Section 115 trust plans
- Adopted a cost-recovery policy and phased out certain subsidies
- Built an internal audit program for transient occupancy tax
- Invested in a tax compliance program
- Reduced operations and other changes to eliminate the projected FY2018 $2.7 million deficit
- Reduced operations and other changes to eliminate the projected FY2019 $5.5 million gap
- Budget award recognition by GFOA

As a validation of these current and past efforts, Standard and Poor's in April maintained the City's bond rating at AA+, the highest in Santa Cruz County and among the highest for Cities in the State.

To support the financial plan, the City consider new budget development approaches that included the pilot test of a new Action Labs model. Here, lead budget managers from across the City met for several days to consider near-term, mid-term and long-term options to build into the fiscal strategy. In total, 67 concepts were identified and will be studied further within the second phase of the Action Lab process, with 10 prioritized for consideration during FY 2019.

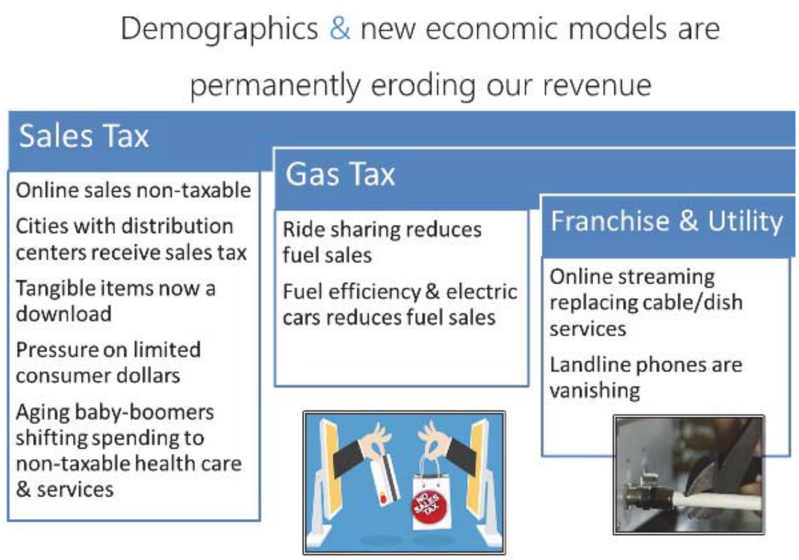
In addition, the City Council established the Council Budget Ad-Hoc Committee, led by Mayor David Terrazas, with Vice Mayor Martine Watkins and Council Member Sandy Brown. This committee led to the growth of the former "Budget in Brief" schedule into an entirely new Budget document meant to provide key reference points for the City Council and Community. They also supported the development of a community focus group to ensure future budget documents, processes, long-term financing strategies, and outreach efforts are in alignment with community expectations. Another outcome was the development of new outreach tools, expanded communication strategies to meet with interested stakeholders and community groups, and the return of a community budget meeting, the May 31st Budget 101 Community Forum.

# The Four Major Financial Trends

As introduced earlier, in addition to demands for services like housing, homeless, and other safety net systems, there are four unique financial trends currently overlayed on top of this period of economic growth: tax revenue deterioration, State pension investment shortfalls, core cost increases, and the need for significant infrastructure investments.

1

Revenue declines. The single largest threat to long-term financial sustainability of local governments are declining tax bases of traditional revenue, such as Sales Tax, Utility Users Tax, and Transient Occupancy Tax.



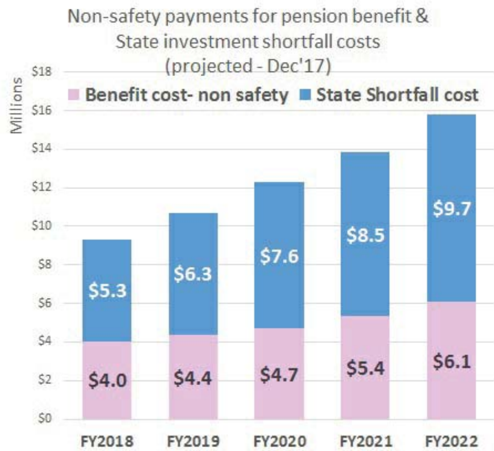

- Sales Tax. As more sales are conducted online without collecting sales tax, or the tax does not flow to where the customer lives, the impact to the City could be an annual decline of $2 million annually (based on historically normal collections during an econonmic boom).
- Utility User Tax. Declines are coming from consumers switching to non-taxable streaming TV and video services and choosing to cancel their land-line phones.
- Transient Occupancy Tax. Another well-discussed but continuing impact is the expansion of online, residential vacation rental, with many still bypassing local regulation and tax requirements. Efforts continue to be expanded to educate and bring these operations under compliance.

2

State investment losses. CalPERS, the State's pension fund, relies on investment growth to pay for 60% of the public safety and general employee retirements costs. When their investments underperform, cities are obligated to make up the difference.

In the last three years, the general market outperformed CalPERS' investment returns by nearly double. If CalPERS had been closer to market indexes, they would have gained an additional $30+ billion. And in 3 of the last 6 years, their returns fell massively below their 7.50% target, with returns of 0.1%, 2.4% and 0.6% (2012, 2015, and 2016 respectively).

As a broader example, by 2016, CalPERS missed their investment target by over $300 billion (their expected value was $613 billion but their actual value was only $295 billion), according to a study published in the LA Times.




An unfortunate outcome of these poor investments is the State pension systems allocation of these shortfalls to cities throughout the State (and any other member district or agency).

The table on the left shows for all the City's non-safety plan members (2,043 active & retired) the steep, annual increases in the payments to the state to back fill for their investment shortfalls (from $6.3 million in FY 2019 to $9.7 million by FY 2022).

And, when layering in the City's Fire and Police pension plans, the total impact of this investment shortfall cost becomes even more challenging.

By comparison, for FY 2019, the $6.3 million State shortfall for non-safety grew to $10.0 million with the addition of 480 Fire and Police members (active & retired).

The modest silver lining for these costs is that they are projected to peak in the mid-2020s and could start small declines by the beginning of the 2030s.

In addition, the City was an early adopter of pension reforms along with agreements where employees pick up a large percentage of the normal benefit cost.


3

Increases to core costs. The City's cost for projects, supplies, and services are quickly increasing as government serving industries pass along increases in their materials and labor. Additionally, other general costs, such as software maintenance, general utilities, and water costs are also on new, steeper increase trends. These core cost increases are in addition to other, normally rising cost increases, such as the City's share of health care premiums.

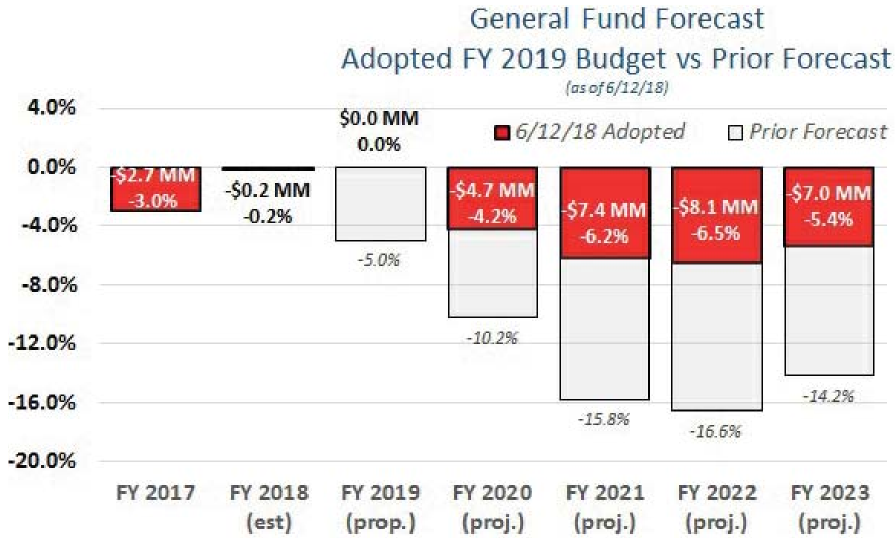
4

Infrastructure decay. Like most US cities, Santa Cruz's infrastructure is decades old and much of it has outlived its useful life. While some infrastructure needs can be deferred, critical infrastructure like roads, storm drains, and some City buildings must be replaced or rehabilitated.

The City expects to continue to have unexpected infrastructure repairs costs from decaying infrastructure and facilities, and from impacts from climate change. Recently, water pipe breaks, the loss of portions of the cliff along West Cliff Drive, roadway failing along our greenbelts, unexpected cost increases for projects like the Corporation Yard, and the 2017 FEMA storms highlight the cost impact of an aging infrastructure.

# General Fund Forecast Improves

With all the City's efforts leading to this balanced budget, the out-year gaps in our forecast model have reduced such that the former FY 2022 gap of 16.6% has been lowered to 6.5%. But, this is still a significant gap that will require continued adherence to the City's long-range financial plan.




As with any forecast, it is important to highlight the design criteria of the forecast. In our case, our model was designed to produce what we believe to be the most likely outcome, based on historical trends and credible future assumptions. Some of the high-level assumptions in our forecast are that the City will:

- ✓ Maintain current service levels and programs;
- ✓ Experience increases in costs, such as capital investment, equipment replacement, and related personnel costs;
- ✓ Continue for the 3rd year with no funding for capital investments; but with funding returning to a modest $1.5 million in FY 2020;
- ✓ Be required to make payments to CalPERS for their investment shortfalls, that by FY 2022, reach $16 million annually for the City and over $10 million annually for the General Fund;
- ✓ Continue to see annual revenue growth, albeit smaller tax growth due to the declining revenue base and a 3-year economic slowdown starting in late FY 2019;
- ✓ Not be able to fund any of the City's estimated $300 million of unfunded infrastructure and facilities;
- ✓ Benefit from fees and taxes from planned development projects that will continue for the next 24 months, including new housing, businesses, and remodel of hotel properties; and
- ✓ By FY 2023, see major developments like a new La Bahia project will be complete, the final payment of 2010 public safety pension debt will be made, and recovery will begin from a 3-year economic slowdown.

Some specific major assumptions are disclosed in the table to the right.

Again, our forecast is reflective of what we believe to be the most likely to occur. The model would worsen from unexpected events like: disasters such as the 2017 winter storms; road or cliff failures; a worse-than-expected economic slowdown; or more declines to our tax base.

| Category | FY2019 - FY2023 Range of Change |
|---|---|
| Property Tax | 4.0% - 6.3% |
| Sales Tax | 1.0% - 5.0% |
| Transient Occupancy Tax | 3.0% - 12.0% |
| Utility Users Tax | 3.0% - 4.0% |
| Pension benefit- Public Safety | 10.6% - 31.1% |
| Pension shortfall- Public Safety | 12.1% - 27.7% |
| Pension benefit- General Employees | 7.7% - 13.7% |
| Pension shortfall- General Employees | 11.5% - 20.1% |
| Health Care | 6.0% - 8.0% |

# An Engaged Community

This FY 2019 Adopted Budget is the product of the hard work of so many dedicated and engaged stakeholders within the community and within City staff.


The overall process was initially guided with the Community and City Council needs in mind and was later modified by input from the community, City Council, and the City Council's Budget Ad-Hoc Committee, led by Mayor David Terrazas and included Vice Mayor Martine Watkins and Councilmember Sandy Brown.

The actual Budget development process began in early January 2018 with simultaneous processes: the traditional budget development by departments and their talented budget teams; the new employee Action Labs; and the establishment of a Council Budget Ad-Hoc Committee and a Council Revenue Committee. With the support of so many and guided by such diverse input, this balanced budget was developed. While we're proud of presenting a balanced budget, we're more proud of the continued growth in the high production quality of the document itself, the inclusion of diverse input, and plans for expanded outreach efforts and development of new reporting formats.

This year we introduced the expanded Budget in Brief edition that brings together key documents the community and our elected officials may want to refer to over the years. Second, we developed new outreach tools and communication strategies to meet with interested stakeholders and community groups, including the May 31st Budget 101 Community Forum. Third, we've embarked on creating a diverse Budget Focus Group to ensure future budget outreach, processes, and budget reporting are aligned with and support long-term financial sustainability and community expectations.

And though there remains more work to be done in the coming months to build on our FY 2019 successes, it is important to acknowledge today the outstanding, cross-departmental work of City staff.

Starting with the leadership and initial guidance by our City Manager Martin Bernal and Assistant City Manager Tina Shull, and the City's Department Head team, we developed an inclusive approach to support each of the City's strategic goals through long-term financial strategies.  The ultimate goal of these strategies is to ensure we sustain the services the community expects and plan for additional investments in services and future capital needs.

We were supported by talented City staff including department heads and their dedicated budget financial teams, by those participating in the new Action Lab sessions, and by other staff in the City Clerk and City Manager's offices who together helped pull together the balanced FY 2019 Budget.

And, beyond these dedicated staff, there was a smaller team who were involved at every development stage of these processes, up through the day we finalized and published this FY 2019 budget document.  The team was led by Cheryl Fyfe, Assistant Finance Director and by interim budget leads Elizabeth Millwee, Buyer II and Tracy Cole, Accountant II/temporary Principal Management Analyst. Key contributors included Raymond Chin, Finance Manager; Lisa Saldana, Senior Accountant; Nick Gong, Accountant II; Michael Manno, Accountant I; Jessie Soto, Administrative Assistant III; Cathy Bonino, Principal Human Resources Analyst; Lisa Murphy, Human Resources Director; Denise Reid, Accounting Services Supervisor; and Natalia Duarte, Accounting Technician.

Because of all of these collective efforts, along with the support of other Finance Department members, we are confident in our current financial plan, we trust that the City will again be recognized with receipt of the Distinguished Budget Presentation Award from the national Government Finance Officers Association, and we are inspired to build more inclusive and engaging future budget processes.

Marcus Pimentel, Finance Director