



Finance Director's Overview

Adopted FY 2020 Budget



CITY OF SANTA CRUZ

FY2020 BUDGET
\$3.2 MILLION IN SOLUTIONS TO FULLY FUND GENERAL FUND

FISCAL 2023 SUSTAINABILITY PLAN

FY 2016-2018
\$ 9.3 MILLION SAVED

FY2019
\$4.6 MILLION SAVED

SERVICE & COST DEMANDS

Housing-related services and expectations are growing

Other service expectations increasing



CAPITAL INVESTMENT LIABILITY

Fire engines & storm drain improvements joined the long list of unfunded facility and other capital projects



POINT OF NO RETURNS

Taxpayers on the hook for state pension system choice of politics over investment returns

TAX BASE DECLINES

Sales tax base continues to decline as the State delays reforms.

Other tax bases that funds core services also declining.

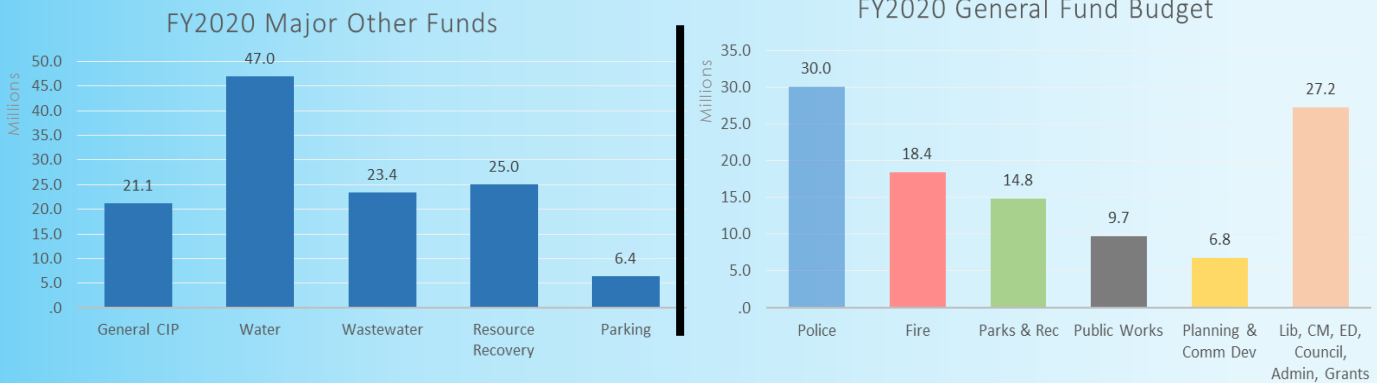
A GAME CHANGER SALES TAX REFORM



BACKFILL PENSION INVESTMENTS

Poor State investment returns result in another doubling of costs. Reforms are helping but not quickly enough.

The \$263.9 million FY2020 Adopted Budget is reflective of the decades of forward-looking fiscal strategies and, except for the General Fund, provides for critical investments to serve our community.



However, the FY2020 General Fund required at least \$3.2 million in budgetary solutions before considering costs for infrastructure & capital investments, or additional community services.

To adopt a balanced General Fund Budget, staff proposed \$3.2 million in service and cost reductions and new revenue options to rebalance the FY 2020 General Fund budget.

During the May 8, 2019 City Council Budget Study Session, an initial package of \$2.4 million in proposed budget solutions was previewed by the City Council for initial feedback. While these solutions were not presented for final direction, there was general support by the City Council for nearly \$2.0 million of the solutions. Staff used the public and City Council feedback to identify and create the proposed \$3.2 million in General Fund budget solutions presented to Council during the Budget Hearings on May 28th and June 11th. These solutions limited the impact on reductions to Fire, Parks & Recreation, and Police.

The solutions included both cost and service reductions (like graffiti abatement, employee training, facility maintenance, and browning out grass & vegetation), as well as options to increase revenue (further study of a first responder fee, further study of increasing Golf fees, expanded cost recovery of credit card fees, and increases for parking).

FY 2020 was a landmark year

The FY 2020 year had emerged in our prior forecasts as the proverbial “fiscal cliff” with deficits ranging up to \$12 million. Due to commitment to the City’s Fiscal 2023 Sustainability Strategies, these deficits were reduced down to \$1.6 million at the start of this budget season but increased to \$3.2 million by the time the proposed budget was presented.

Our forecasts still indicate ongoing out-year deficits, due in large part to: (1) higher levels of cost and service demands; (2) increasing need for emergency capital investments; (3) declining revenue tax bases; and (4) sub-performance of the State Pension investments.

1 Service & cost demands

The City continues to face challenging economic conditions where costs of services continue to increase while the revenue required to support those increases is falling short. As referenced in the City Manager's Message, the City is making big investments to retain employees by covering retirement and health care cost increases while providing employees with resources to remain competitive in the market and provide cost-of-living adjustments.

In addition, there continues to be increased demand and pressure on city operations due to the housing crisis and those living without shelter. While the City is grateful for the State's participation in and funding towards finding local solutions, the demand for housing and basic human services has overwhelmed the County, resulting in demand for City resources. With respect to services for unsheltered persons, staff are developing systems to reasonably report on the cost of providing these services.

Finally, there are some additional fiscal impacts to the City under State proposed bills and within the Governor's budget goals. Staff will continue to monitor these closely as these impacts can influence road funding, as well as create more unfunded mandates or move local control to the State.

2 Capital investment liability



As reviewed in the 3rd part of the FY 2019 Mid-Year Report on March 12, 2019 and highlighted in the "Unfunded" section of the FY2020-FY2024 CIP, the City's capital demand has increased over \$310 million, yet the General Fund is poised to have another year without a dedicated CIP funding source. This will further delay projects like West Cliff Drive erosion protection and various storm drain projects that otherwise would have already been funded. There are also other community investments for projects like Wharf or Civic Auditorium upgrades, or setting aside funding for the replacement of our aging Fire fleet.

3 Tax base declines

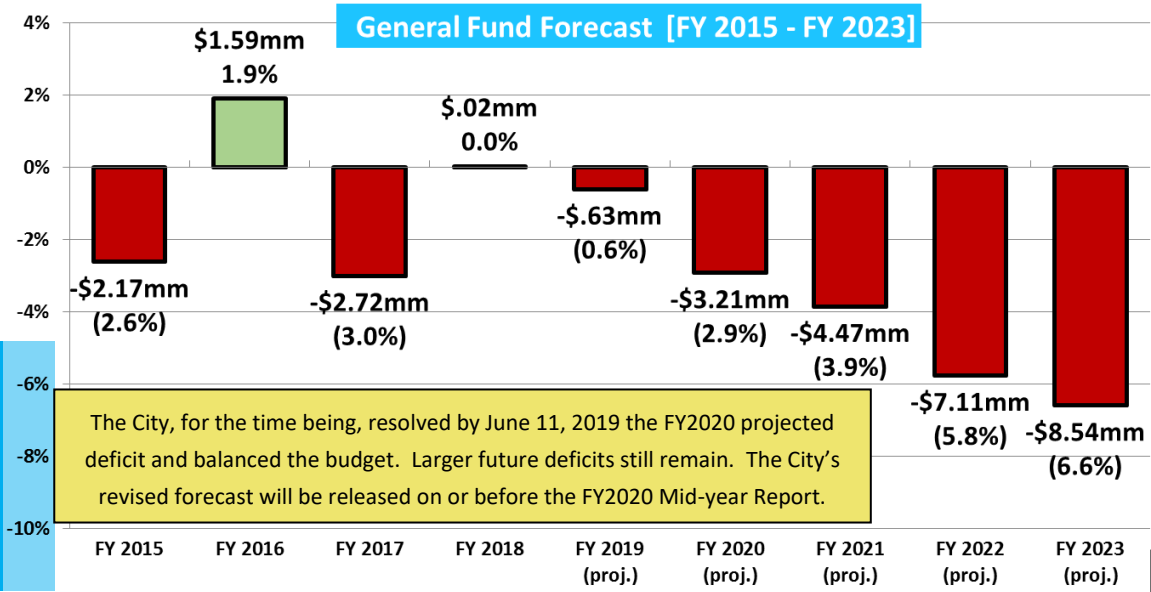
As chronicled in the recent FY 2019 Mid-Year Council reports and prior budget messages, three of the City's top tax bases are eroding. Sales and utility taxable goods are falling into untaxed "service"-like categories (downloads & streaming) while previous declines in gas prices and fuel efficiency have impacted sales tax on gasoline. Locally, the Transient Occupancy Tax base has been eroding by online booking companies that still refuse to be responsible to collect and report on tax collections. However, staff have been successful in identifying and collecting on many of these properties locally.

4 Backfill pension investments

The General Fund is on pace for a second doubling of CalPERS pension costs, driven by Great Recession losses and subsequent market underperformance by the State pension investment fund. As noted in the May 8, 2019 Budget Hearing presentation, if the State had earned their historical averages or average returns from various index funds, the pension system would be fully funded. Instead, the City has seen its share of investment shortfalls increase by over 1,700% since the early 2000s.

This chart from the Proposed Budget illustrates the fiscal challenges facing the General Fund and highlights the need for continued, decisive action to stabilize services.

General Fund

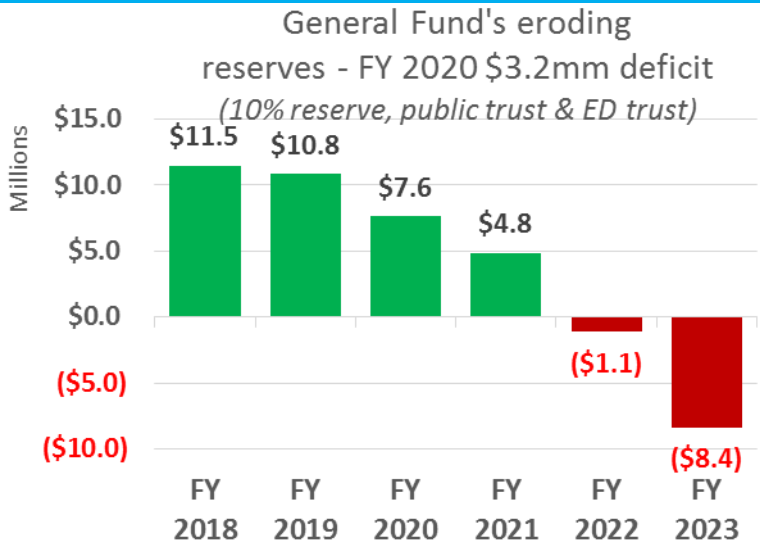


The City, for the time being, resolved by June 11, 2019 the FY2020 projected deficit and balanced the budget. Larger future deficits still remain. The City's revised forecast will be released on or before the FY2020 Mid-year Report.

The Threat to Years of Unbalanced Budgets

Without the City Council's budget solutions made by June 11, 2019, the General Fund's 10% reserve, public trust, and economic development trusts would have all been gone by FY 2022.

The public trust and economic development trust are still in jeopardy.



The General Fund's Adopted FY 2020 Budget of \$107.0 million required \$3.2 million in departmental budget solutions (see the Index section of this document for the complete list of budget solutions). With the high likelihood of future deficits, it was imperative that the bulk of these moderate solutions had to be implemented. By doing so, the City Council relieved some pressure on future service reductions and positioned the General Fund to build up cash reserves for the coming economic slowdown. The City Council actions also continued to invest in pension solutions to counteract the State of California's mandate that all California agencies must pay more to fund pension coffers for poor investment decisions. The City Council unanimously adopted the FY 2020 budget on June 11, 2019.

Solutions to fully fund FY 2020 General Fund

As summarized in the table below, from the City Council Budget Study Session and Budget Hearings on May 8th, May 28 and June 11, 2019, staff identified \$3.2 million in reasonably bearable budget reductions and revenue enhancements to balance the General Fund Budget. In addition to the solutions, several new additions were identified and added to the budget. Many of the proposals required Council and public discussion.

The full list of budget solutions is included in the Index section of this document.

Department	May 8th Baseline	May 28th Approved	Final Adjustments June 11th	Total Changes
City Council	8,000	8,000		16,000
City Manager/Clerk	35,000	40,000	(209,100)	(134,100)
City Attorney			(300,000)	(300,000)
Community	102,000	0	(60,000)	42,000
Economic Development	115,000	152,000		267,000
Finance	236,000	24,300		260,300
Fire	264,000	0		264,000
Human Resources	31,000	50,000		81,000
Information Technology	98,000	144,000		242,000
Parks & Recreation	158,000	360,000		518,000
Planning & Community Dev.	270,000	100,000	60,000	430,000
Police	0	182,000		182,000
Public Works	348,833	212,350	63,000	624,183
Staff labor cost increases			(595,000)	(595,000)
Other/Salary Savings			1,368,000	1,368,000
Totals	1,665,833	1,272,650	326,900	3,265,383

Fiscal 2023 Sustainability Plan

\$13.9 Million Gained



Future year gaps have shrunk

But more work is required to mitigate growing deficits

Starting formally in FY 2016, the Finance Department, in partnership with the City Manager's Office and other City leaders, developed the Fiscal 2023 Sustainability Plan. The primary objective was to develop a potential roadmap to proactively restructure the General Fund's fiscal outlook with the goal of eliminating the deficits projected through Fiscal Year 2023. This last year was targeted due to expected fiscal relief from the retirement of long-term pension debt, the completion of various large-scale development projects, and that the steep increases in costs to backfill the California pension investment funds would start to level out.

FY 2016 - FY 2018 Major Solutions

- \$6.7 million in base budget reductions
- \$1.6 million in updated cost plans and fee recovery
- \$360k in pension cost savings by Trust earnings and advanced payment

FY 2019 Major Solutions

- \$2.8 million in base budget reductions
- \$1.6 million in new sales tax (\$3.3 million annually)
- \$370k in pension cost savings by liability pay-down

FY 2020 - FY 2023 Possible Major Solutions

- Action Lab 2.0
- Budget Reductions
- Phase III Cost Recovery - Building
- Further Reduce Pension Costs
- 2020 Ballot Measures

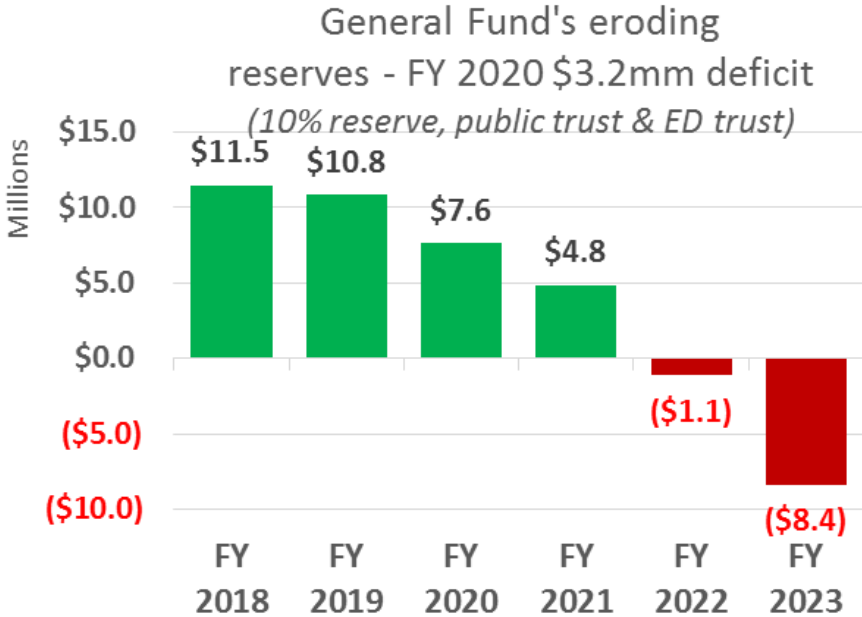


General Fund Declining Reserves, Trusts, and Climate Resiliency Fund

Without solutions to fully fund the FY2020 Budget and future General Fund deficits, the General Fund’s 10% reserve, public trust, and economic development trusts would have been gone by FY 2022.

In addition, the General Fund does not currently hold flexible cash balances that can be applied to immediate needs without pulling from reserves or trust balances. For example, if the City had a sufficient Climate Resiliency Fund, it would be able to sustain itself during a disaster, given the increasing risk of disasters due to climate change. Reserves could also be a resource to help fund any immediate and/or significant capital need or to mitigate a potential asset failure.

The City’s policy identified a goal of a 5% contingency balance to address any of these situations. However, no progress has been made to achieve that goal. The charts below summarize the existing balances as of the last completed, audited financial statements and the projected decline of the General Fund reserves.



Audited General Fund Balances	at 6/30/18
Primary reserve (10%)	\$ 4,215,019
City Public Trust	\$ 4,263,232
Economic Development Trust	\$ 2,998,292
Total	\$ 11,476,543

Frequently Asked Questions

Q: Where is the revenue coming from in the General Fund?

General Fund revenue is made up of several sources. The largest piece, taxes, accounts for 75% of total revenue (Property Taxes, 22%; Sales Tax, 20%; Utility Tax, 12%; Transient Occupancy Tax, 12%; and Other Taxes, 9%). Other pieces of the budget include charges for services (17%), use of money and property (4%), fines and forfeitures (2%), licenses and permits (1%), and other revenues (1%).

Q: Please explain General Fund vs. Enterprise Fund and are there any funds outside the General Fund that impact the General Fund?

The General Fund is the primary operating fund of the City. All revenues that are not allocated by law or contractual agreement to a specific fund are accounted for in the General Fund. The revenue sources in the General Fund can be utilized for any legitimate governmental purpose. The City has five enterprise funds: Water, Wastewater, Storm Water, Refuse, and Parking. These funds generate their own revenue through fees to support their operating and capital needs. Enterprise Funds and General Funds cannot be commingled. With the passage of Proposition 218 in November 1996, restrictions on use of fees make it illegal for Enterprise Funds to be used for General Fund purposes.

Q: Regarding long-term assumptions about declining revenues, will they level out, or not? How are estimates determined?

Annual increases to revenues such as Property Tax are expected to remain in a 2% to 4% growth pattern. However, growth could be restrained by the next economic slowdown. The General Fund's other top three revenue sources are likely to face declines: Utility Users Tax, very modest to no growth; Sales Tax; and modest growth in Transient Occupancy Tax from the re-opening of hotels and future planned development by FY 2023 around La Bahia. Estimates are determined by a combination of historical data (trending), known future changes on the horizon (i.e. completion of a new hotel -TOT revenue), and input from consultants.

Q: What is the unfunded list?

The "Unfunded List" refers to a list of Capital Investment Program projects that will be proposed, once funding has been identified and staff resources are available. The City of Santa Cruz has identified these projects and prioritized a portion of them based on the City's strategic goals.

Q: What is the long-term plan to deal with deferred maintenance? Aren't you just going to end up with more emergency spending to fix things that break?

The City has prioritized budget allocations to fully fund core capital equipment needs as well as leveraged grants and restricted funding for investments in areas like our community parks. In addition, with the increased funding for transportation, the City is making progress on investments in our road and bikeways. The City will also follow policies that prioritize one-time revenues from property sales (like Skypark) to be set aside for future capital projects. However, the size of our unfunded list will require a dedicated funding source that can be used to fund projects like Civic Auditorium remodel, Wharf investments, as well as fund the planned replacement for our fire engines.

Q: Why is my city having trouble now?

Short-term expenditure increases can be attributed to increases from the State for pension investment shortfalls (3 out of the last 6 annual investment returns in this strong economic market were far below 7.5% of expected returns; hitting 0.1%, 2.4%, and 0.6%). Long-term revenue decreases can be attributed to shrinking tax bases (i.e. non-taxable online alternatives) and the changes in consumer spending (shifting from buying goods to buying services: health, travel, streaming, downloads, and consumer experiences).

Q: Is the City exploring how (are we going) to capture that lost revenue (from Sales Tax)?

Yes, with the passage of Measure S in June 2018 (.25% increase in the sales tax rate), the City was able to offset the loss of sales tax revenues due to changes in spending patterns such as an increase in service (non taxable) purchases, and a decrease in supply purchases (taxable). The City is also very active with the League of California Cities in pushing for reforms that have online taxable sales flow back to Santa Cruz, and pushing for elimination of exemption for certain online sales.

Q: Measure S was supposed to solve the City's budget problems. So why is the deficit increasing instead of decreasing?

Measure S was critical in stabilizing our operating costs, but the City does not yet have a dependable funding source for facility and infrastructure (see our current unfunded capital list in the budget). In addition, the City continues to bear a larger proportional share of costs related to our local housing shortage and the support of those experiencing homelessness. The City also continues to see increasing trends of our front-line and professional staff leaving for better pay or areas with lower housing costs, causing higher-than-expected upward pressure on compensation.

Q: How can we create new revenue? Can we leverage technology?

The City is actively looking at new revenue sources including eliminating the subsidies for certain fees for services, as these fees were historically subsidized by other taxes. We also rolled out new online payment options for Business Licenses and recently, Transient Occupancy Taxes. Local efforts have been underway in identifying and re-capturing lost Transient Occupancy Tax revenues.

Q: Enterprise – How much allocation for IT Services, etc.? How much do the Enterprise Fund pick up for service costs provided by the General Fund?

The General Fund does allocate costs to the Enterprise Funds and Internal Service Funds for administrative services (HR, Finance, IT, City Manager, City Attorney) through its cost allocation plan. The Administrative Services personnel budget makes up only 14% of the General Fund budget. About 8% of personnel costs are recuperated through this plan. The largest portion of the General Fund's personnel budget is Public Safety, Parks & Recreation, Public Works, and Planning; none of which is able to be recovered through the cost allocation plan.

Q: I think I do pay sales tax with Amazon. Doesn't the City get it?

Even though for those limited times when Amazon charges your City rate for sales tax, it goes into our County or another County's "pool" and only a proportional share of the total is distributed back to the City. In other words, the sales tax you pay on the Amazon website is allocated to another County or is shared with Santa Cruz County and other cities within the County. Furthermore, 3rd party retailers on Amazon do not collect sales tax.

Q: Regarding pensions, who is managing it? And what is the plan to correct average market returns? And what (local) measures are being considered for new staff and the pensions that are in place?

The CalPERS public pension fund is managed by the State and their investment office. The City of Santa Cruz has no authority over how the pension fund is invested. The League of California Cities is actively looking at solutions for cities to deal with this pension issue. The City of Santa Cruz introduced a tiered retirement system for new employees back in 2011 and added a third tier in 2013. As a result, new employees are entered into the pension system at the lowest tier and pay more into their retirement than those in higher tiers.

Q: What's the City's long term-plan to deal with escalating retirement costs?

The City developed the Fiscal 2023 Sustainability Plan and will be updating it during this coming budget season. The source of the escalating payments is the debt owed to the State to backfill for State Pension investment shortfalls. The total allocated to the City is projected at \$170 million with an approximate 7.25% interest rate.

First, City staff are actively engaged with CalPERS through the League of California Cities Revenue and Taxation Committee, which supported more CalPERS recent reforms that resulted in shortening the payback period, thereby reducing interest costs on the debt owed to the State. Second, the City Council directed that staff advocate and support State Pension efforts to return their investment earnings to prior historical levels. Based on high level analysis, if the Pension Investments had earned returns equal to their historical averages during a recovery period, or what broadly-used investment funds have earned during this current recovery period, the entire \$170 million debt allocated to the City would be gone.

Third, the City is on schedule to fully pay off in June 2022 \$24 million in debt related to Public Safety pensions.

Fourth, the City is making extra principal payments to significantly reduce future interest costs. By the end of FY 2020, the City will have saved over \$1 million in interest.

Fifth, the City has established restricted, retiree investment funds to build up cash towards future payments, and to allow the City to increase the expected rate of return from 2%+ to nearly 5%.

Sixth, the City has taken advantage of annual pre-payment programs to reduce the current year's payroll pension costs. Instead of making payments throughout the year, the City receives a 6% discount by making a single payment at the beginning of the year.

Q: Why is the City spending so much on people experiencing homelessness?

The City is not alone. Communities across the country are struggling with funding programs and services to help those experiencing homeless. Fortunately, the State of California made a historical commitment and allocated a portion of its budget surplus towards nearly \$10 million in one-time funding for our County.

Q: Is the City going to cut jobs? Is the City going to have to do layoffs?

No. The City's Fiscal 2023 Sustainability Plan is based on the premises of retaining current service levels, as well as allowing for fiscal flexibility to provide for strategic investments.