Hot Topics ‘n Burning Issues
A City Finance Update

California Municipal Treasurer’s Association
April 18, 2014  Burlingame, CA

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The California Local Government Finance Almanac

Bad Brew in Troubled Cities

- Over-reliance on land development revenue
- Over-reliance on redevelopment revenues
- Risky financing schemes
- Fear & Denial
- Toxic relationships
- Unsustainable and Intractable employee compensation, especially public safety pension and retiree health care
- Ceding of management and policy choices to others
- Unsustainable Decline in Core Revenues
Difficulties in Assessing Municipal Financial Health

- Published data are not complete or timely.
- Do we know how to assess those facts?
- Comparisons are often false and tell us nothing about solvency.
- Requires analysis, forecasting, context, legal ... it’s not just an accounting or statistical exercise
- Looking forward to sustainability
  - *history doesn’t tell you enough about the future*

Defining Municipal Financial Health

**Solvency**

1. **cash solvency** - ability to meet immediate financial obligations; i.e. over next 30 or 60 days (accts payable, payroll).
2. **budgetary solvency** - ability to meet all financial obligations during a budget year.
3. **long-run solvency** – ability to meet all financial obligations into the future.
4. **service-level solvency** – ability to provide the desired level of services for the general health and welfare of the community.
California Municipal Financial Health Diagnostic:

- Get to the primary indicators - useful & essential
- Leave out extraneous / secondary
- Add in overlooked & underappreciated factors
- Drill down to the real numbers
- Allow for nuance / clarification / differences
- Reduce invalid conclusions and comparisons
- Constructive, thoughtful approach

The California Municipal Financial Health Diagnostic beta

City of __________
Fund: __________

Financial Distress Checklist

1. The city has recurring general fund operating deficits.
2. General fund reserves are decreasing over multiple consecutive years.
3. General fund current liabilities (including short-term debt and accounts payable within 90 days) are increasing. Cash and short-term investments are decreasing.
4. General fund fixed costs, salaries and benefits are increasing over multiple years at a rate faster than recurring revenue growth.
5. The general fund is subsidizing other enterprises or special funds.
6. The city council’s authority to make changes is constrained by charter, contract, or law. (e.g. binding arbitration, minimum spending, minimum staffing or compensation formulas, etc.)
7. The general fund budget has been balanced repeatedly with reserves, selling assets, deferring asset maintenance.
8. The general fund budget has been balanced repeatedly with short-term borrowing, internal borrowing or transfers from special funds.
9. General fund pension liabilities, post-employment or other non-salary benefits have been repeatedly deferred or costs have not been determined, disclosed or actuarially funded.
10. General fund debt service payments have been “backloaded” into future years.
11. Ongoing general fund operating costs are being funded with temporary development revenues.
12. Financial Reports are not being filed on time. (CAFR, Annual Audit, State Controller’s Financial Transactions Report)
13. Public service levels are far below standards needed in this community.

For detailed indicators related to these points see the Financial Health Indicators.

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The State of the State: Governor’s Proposed Budget 2014-15

2014-15 Governor’s Budget General Fund Budget Summary

($ in millions)

<table>
<thead>
<tr>
<th></th>
<th>2013-14</th>
<th>2014-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Resources</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior Year Balance</td>
<td>$2,528</td>
<td>$4,212</td>
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<tr>
<td>Revenues and Transfers</td>
<td>$100,147</td>
<td>$104,503</td>
</tr>
<tr>
<td>Total Resources Available</td>
<td>$102,675</td>
<td>$108,715</td>
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<tr>
<td><strong>Expenditures</strong></td>
<td></td>
<td></td>
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<tr>
<td>Non-Proposition 98 Expenditures</td>
<td>$57,515</td>
<td>$61,731</td>
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<tr>
<td>Proposition 98 Expenditures</td>
<td>$40,948</td>
<td>$45,062</td>
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<tr>
<td>Total Expenditures</td>
<td>$95,463</td>
<td>$106,793</td>
</tr>
<tr>
<td><strong>Fund Balance</strong></td>
<td>$4,212</td>
<td>$1,922</td>
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</table>
| Budget Stabilization Account / "Rainy Day Fund" | $1,591
Governor’s Proposed Budget
State General Fund and Realignment Fund Revenue

- Personal Income Tax, $69,764, 59%
- Corporation Tax, $9,682, 8%
- Insurance Tax, $2,297, 2%
- Other/Transfers, $1,281, 1%
- Sales & Use Tax, $24,071, 20%
- Vehicle License Fee, $2,071, 2%
- Realignment Sales Tax, $9,569, 8%
- “Local Revenue Fund”

State General Fund and Realignment Fund Expenditures

- Health& HumanSvcs, $28,793, 24%
- Mentally Health, SupportSvcs, $9,330, 8%
- Law Enforcement, Trial Court, $2,296, 2%
- “Local Revenue Fund”
- K-12 Education, $45,251, 38%
- Corrections, $9,560, 8%
- Higher Education, $12,377, 11%
- General Govt, $3,191, 3%
- ERB Payment, $1,591, 1%
- Resources& Environment, $2,229, 2%
- Transporation, $212, 0%
- BusnConsSvcsHsg, $745, 1%
- Legisl Judicial Exec, $2,844, 2%

April 18, 2014
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Governor’s Proposed Budget 2014-15

Reserves, Rainy-Day Funds
- 2014-15 would end w/ $2.3 billion reserve (incl $1.6 bil in Prop58 resv)
- Proposes new rainy–day fund mechanism

Pay Down “Wall of Debt”
- Accelerate pay down of economic recovery bonds $1.6 billion
- Pay off school and community college deferrals +$6.2 billion
- Repay $1.6 bil in special fund loans

Education
- K–12 schools +$4.5 billion
- Community Colleges +$355 million
- UC and CSU + $142 million each
- Higher Ed Innovation grants +50 million

Infrastructure, etc
- Deferred maintenance projects +$815 million (one-time)
- Water Plan +$618 million plan incl groundwater basin protection, local water supplies, flood protection.
- Cap–and–Trade $850 million incl: high–speed rail system +$250 million, low–emission veh progr +$200 million

Also...
- Judiciary and Criminal Justice + $105 million ongoing
- State employees +2% pay $173 million (all funds)

For FY2014-15, the Governor proposes to...
- Pay down remainder of school deferrals $6.2 billion
- Pay off Economic Recovery Bonds early $1.6 billion
- Repay special funds $1.6 billion

Eliminating the “Wall of Debt”

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Deferred payments to schools and community colleges</td>
<td>$10.4</td>
<td>$6.4</td>
<td>$6.1</td>
<td>$0.0</td>
<td>$0.0</td>
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<td>Economic Recovery Bonds</td>
<td>7.1</td>
<td>5.2</td>
<td>3.9</td>
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<td>0.0</td>
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<td>Loans from Special Funds</td>
<td>5.1</td>
<td>4.9</td>
<td>3.9</td>
<td>2.9</td>
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<tr>
<td>Unpaid mandated costs to local govs, schools, colleges</td>
<td>4.3</td>
<td>4.9</td>
<td>5.4</td>
<td>5.4</td>
<td>0.0</td>
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<tr>
<td>Underfunding of Proposition 98</td>
<td>3.0</td>
<td>2.4</td>
<td>2.4</td>
<td>1.8</td>
<td>0.0</td>
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<tr>
<td>Borrowing from local governments (Proposition 1A)</td>
<td>1.9</td>
<td>1.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Deferred Medi-Cal Costs</td>
<td>1.2</td>
<td>2.0</td>
<td>1.8</td>
<td>1.7</td>
<td>0.0</td>
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<tr>
<td>Deferral of state payroll costs from June to July</td>
<td>0.8</td>
<td>0.7</td>
<td>0.8</td>
<td>0.8</td>
<td>0.0</td>
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<tr>
<td>Deferred payments to CalPERS</td>
<td>0.5</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.0</td>
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<tr>
<td>Borrowing from transportation funds (Proposition 42)</td>
<td>0.4</td>
<td>0.4</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$34.7</strong></td>
<td><strong>$28.2</strong></td>
<td><strong>$24.9</strong></td>
<td><strong>$13.1</strong></td>
<td><strong>$0.0</strong></td>
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</table>

City/County mandate cost repayment:
- 2015-16 $748m
- 2016-17 $152m
California’s Fiscal Outlook

**Risks**

- **Threat of Recession.** It’s inevitable.
- **Federal Challenges** – action/inaction.
- **Health Care Costs.** Medi-Cal is budget’s 2nd largest program.
- **Natural Disasters:** draught, fires, flood, earthquake.
- **Debts and Liabilities.** In addition to budgetary debt:
  - $218 billion state retirement-related unfunded liabilities
  - $65 billion deferred maintenance
  - $9 billion unemployment insurance
- **Capital Gains** (10% of General Fund tax revenues) volatile, affected by stock market behavior.

**California’s Fiscal Outlook**

**Risks**

**Capital Gains are Extremely Volatile**

year over year percentage change

![Graph showing volatility of capital gains](chart.png)
LAO’s Hypothetical Recession

Operating Deficits Return Under Hypothetical Recession Scenario

General Fund and Education Protection Account Combined (In Billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Deficit</th>
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</thead>
<tbody>
<tr>
<td>2013-14</td>
<td>2</td>
</tr>
<tr>
<td>2014-15</td>
<td>3</td>
</tr>
<tr>
<td>2015-16</td>
<td>-2</td>
</tr>
<tr>
<td>2016-17</td>
<td>-3</td>
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</tbody>
</table>

Proposition 58 (2004)
- Requires 3% of estimated General Fund revenues deposited to Budget Stabilization Account (BSA)
- Deposits continue until BSA reaches $8 billion or 5%.
- Half of BSA deposit repays Economic Recovery Bonds (ERBs) until repaid.
  - Used ’06-07 & ’07-08, then emptied.
  - Suspended each year since then.
- Half of BSA deposit repays Economic Recovery Bonds (ERBs) until repaid.

Governor: replace Prop58
- Annual required deposit - size based on capital gains income tax revenues over 6.5% of annual General Fund revenues.
- Increase size to 10% of estimated General Fund.
- Proposition 98 component: amt counts for current year guarantee - to be used when guarantee drops.
- May pay down budgetary debt instead of depositing to reserve.

Governor’s Proposal for Rainy Day Reserves
Governor’s Proposed 2014-15 Budget
Local Government Issues

- Supplemental Frontline Law Enforcement funding continued at $27.5 million (began in 2012 with Prop30)
- State law enforcement grant program continued.
  (since 2011 funded from VLF shifted from cities)
  - COPS Frontline Law Enforcement program at same level (SLESA)
  - Jail Detention Facility Grants (in lieu of booking fees)
- Insufficient ERAF compensation for cities/counties in Alpine, Amador, San Mateo. (re triple flip, VLF swap)
- State-County Assessors’ Partnership Agreement Program.
  - Three year program, $7.5 million/yr for nine chosen counties with matching funds to catch-up on property assessment.
- $3.3 million for public libraries for equipment to access high-speed internet networks.

Pernicious Effects of the VLF-Property Tax Swap of 2004
The VLF-Property Tax Swap of 2004

$4.4 b* in FY2004-05

Schools

VLF Backfill

Cities & Counties

Property Tax in Lieu of VLF

$4.4 b

$4.4 b

The Lack of VLF Replacement Makes New Cities Fiscally Unviable

City of Jurupa Valley General Fund

Denied PropTax-\(\times\)Several VLF that all other ro

Millions

$0.0
$5.0
$10.0
$15.0
$20.0
$25.0
$30.0

SalesTax

Property Tax

Other

Franchise Fees

Licenses/Permits

If incorporated before 2004 swap

After Swap

w/AB1602 VLF patch assumed in incorp process

Actual (after SB89 shift)
The Lack of VLF Replacement Makes many Annexations Fiscally Unviable

Annexation of Inhabited Area

Example

VLF

If incorporated before 2004 swap

Swapped for PropTax in 2004

VLF AB1602 Special Patch

with AB1602 VLF patch (assumed in annex process)

Actual (after SB89 shift)

Millions

$0.0  $0.2  $0.4  $0.6  $0.8  $1.0  $1.2  $1.4  $1.6  $1.8

Property Tax  SalesTax  Other

Ending the Triple Flip

Can we stick it?
The Triple Flip

- Increases State Sales Tax Rate by +0.25%
- Decreases Local Sales Tax Rate by -0.25%

Cities & Counties

Property Tax in Lieu of Sales Tax

$1.4 b

State Fiscal Recovery Fund

State General Fund

$1.4 b

Schools

Triple Flip Timing

City/County Sales Tax Compensation

Fiscal Year

May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | ... | May

SUTCF Estimates

Property Tax Allocation

SUTCF Estimates

Property Tax Allocation

Actuals Determined

True-Up

True-Up

True-Up

Property Tax Allocation

Property Tax Allocation

Property Tax Allocation
The Triple Flip

- Expected to end in 2015-16
  - From debt service from ¼% state sales tax
  - Likely residual wind-down into 2016-17
- Governor proposing add’tl $1.6 billion payment from general fund in FY2014-15
  - Would end the Triple Flip in 2014-15 with residual effects into 2015-16.
- Prop1A (2004) prevents any mischief
- One time boost of revenue for cities & counties at end
  - Equivalent to 1.5 months of your sales tax

H.U.T.A. Headaches

The Fuel Tax Swap of 2010
Motor Vehicle Fuel Taxes
before 2010

Revenues

Allocation

$6

$5

$4

$3

$2

$1

$0

Base Fuel Excise Tax 18¢/gal

State Sales Tax 5% of sale

$5

$4

$3

$2

$1

$0

Public Transit Acct

Prop 42 Transit Acct

Prop 42 State Hwy Acct

Prop 42 City & Co

State Highway Acct

City & Co HUTA

$6

$5

$4

$3

$2

$1

$0

Revenues

Allocation

Motor Vehicle Fuel Taxes
Fuel Tax Swap of 2010

Base Fuel Excise Tax 18¢/gal

State Sales Tax 5% of sale

$5

$4

$3

$2

$1

$0

Public Transit

State Transportation

State Highway Acct

City & Co HUTA

City & Co

City & Co HUTA

Swap Excise Tax 21.5¢/gal (variable)
Highway User Tax Revenues Allocation

- 39.5¢ Per Gal Gasoline
- 21.5¢ Swap rate (varies)
- 18¢ base rate

Transportation Debt Service
State General Fund Relief

- Weight Fees ~$900 million

State Highway Account:
- 44%

Counties:
- 22%

Cities:
- 22%

Remainder:
- Str&Hwys §§2104-2108

Highway User Tax Revenues

- Str&Hwys §§2104 cities
- §2105 cities & counties
- §2106 cities & counties
- §2107 cities

Highway User Tax Revenues

- FY10-11
- FY11-12
- FY12-13
- FY13-14 estimated
- FY14-15 projected

Millions

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April 18, 2014
Highway User Tax Revenues

Take-aways

- Base HUTA (§§2104-2107) revenue growth is flat, will decline in future.
- §2103 revenue is complex and volatile.
- 3.5¢/gal gas excise tax increase by BOE next week will NOT change these revenue projections (the increase is assumed)
- FY2014-15 proposed budget includes $100 million loan repayment to HUTA for cities & counties (Sec 2104-2107)
  - Not in projections. Don’t count on it yet.
- Estimates will be updates in May.