Hot Topics ‘n Burning Issues
A City Finance Update

Orange County Division
League of California Cities
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The California Local Government Finance Almanac

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

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>Resources</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior Year Balance</td>
<td>$2,528</td>
<td>$4,212</td>
</tr>
<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>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Proposition 98 Expenditures</td>
<td>$57,515</td>
<td>$61,731</td>
</tr>
<tr>
<td>Proposition 98 Expenditures</td>
<td>$40,948</td>
<td>$45,062</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>$95,463</td>
<td>$106,793</td>
</tr>
<tr>
<td>Fund Balance</td>
<td>$4,212</td>
<td>$1,922</td>
</tr>
<tr>
<td>Budget Stabilization Account / &quot;Rainy Day Fund&quot;</td>
<td>$1,591</td>
<td></td>
</tr>
</tbody>
</table>

California State Budget Outlook

Voter Approved Revenues

- ✔ Personal Income Tax (Prop30)
- ✔ Sales and Use Tax (Prop30)
- ✔ Corporate Tax simplification (Prop39)
Governor’s Proposed Budget
State General Fund and Realignment Fund Revenue

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

Governor’s Proposed Budget
State General Fund and Realignment Fund Expenditures

- Health & Human Svcs: $28,793, 24%
- Mental Health Support Svcs: $9,330, 8%
- Corrections: $9,560, 8%
- Law Enforcement, Trial Court: $2,296, 2%
- K-12 Education: $45,251, 38%
- Higher Education: $12,377, 11%
- General Govt: $3,191, 3%
- Transporation: $212, 0%
- Resources & Environment: $2,229, 2%
- BusnConsSvcsHsg: $745, 1%
- Legisl Judicial Exec: $2,844, 2%
- ERB Payment: $1,591, 1%
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

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.

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California’s Fiscal Outlook

Risks

**Capital Gains are Extremely Volatile**

year over year percentage change
California’s Fiscal Outlook

LAO’s Hypothetical Recession

Operating Deficits Return Under Hypothetical Recession Scenario

Operating Deficits

<table>
<thead>
<tr>
<th>Year</th>
<th>2013-14</th>
<th>2014-15</th>
<th>2015-16</th>
<th>2016-17</th>
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</thead>
<tbody>
<tr>
<td>General</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Protection</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Combined</td>
<td>In</td>
<td>In</td>
<td>In</td>
<td>In</td>
</tr>
<tr>
<td>Billions</td>
<td>billions</td>
<td>billions</td>
<td>billions</td>
<td>billions</td>
</tr>
</tbody>
</table>

Governor’s Proposed 2014-15 Budget Infrastructure

Governor’s Proposal for Deferred Maintenance

<table>
<thead>
<tr>
<th>Department</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>California Department</td>
<td>$815</td>
</tr>
<tr>
<td>Caltrans - State Highways</td>
<td>$237</td>
</tr>
<tr>
<td>Caltrans - Local Streets and Roads</td>
<td>100</td>
</tr>
<tr>
<td>K-12 Schools Emergency Repair</td>
<td>188</td>
</tr>
<tr>
<td>Community Colleges</td>
<td>175</td>
</tr>
<tr>
<td>Parks &amp; Recreation</td>
<td>40</td>
</tr>
<tr>
<td>Corrections &amp; Rehabilitation</td>
<td>20</td>
</tr>
<tr>
<td>Judicial Branch</td>
<td>15</td>
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<tr>
<td>Developmental Services</td>
<td>10</td>
</tr>
<tr>
<td>State Hospitals</td>
<td>10</td>
</tr>
<tr>
<td>General Services</td>
<td>7</td>
</tr>
<tr>
<td>State Special Schools</td>
<td>5</td>
</tr>
<tr>
<td>Forestry and Fire Protection</td>
<td>3</td>
</tr>
<tr>
<td>Military</td>
<td>3</td>
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<tr>
<td>Food and Agriculture</td>
<td>2</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$815</strong></td>
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</table>

Governor’s Proposed 2014-15 Cap-and-Trade Expenditure Plan

<table>
<thead>
<tr>
<th>Department</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>High-Speed Rail Authority</td>
<td>$250</td>
</tr>
<tr>
<td>Rail planning, land acquisition,</td>
<td></td>
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<tr>
<td>construction</td>
<td></td>
</tr>
<tr>
<td>Air Resources Board</td>
<td>200</td>
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<tr>
<td>Low-emission vehicle rebates</td>
<td></td>
</tr>
<tr>
<td>Strategic Growth Council</td>
<td>100</td>
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<tr>
<td>Transit oriented development grants</td>
<td></td>
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<tr>
<td>Community Svcs. and. Dev.</td>
<td>80</td>
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<tr>
<td>Low-Income Home Energy Assistance</td>
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<tr>
<td>Program</td>
<td></td>
</tr>
<tr>
<td>Caltrans Intercity rail grants</td>
<td>50</td>
</tr>
<tr>
<td>Forestry and Fire Protection</td>
<td>50</td>
</tr>
<tr>
<td>Fire prevention and urban forestry</td>
<td></td>
</tr>
<tr>
<td>Fish and Wildlife</td>
<td>30</td>
</tr>
<tr>
<td>Water Action Plan - wetlands</td>
<td></td>
</tr>
<tr>
<td>restoration</td>
<td></td>
</tr>
<tr>
<td>CalRecycle</td>
<td>30</td>
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<tr>
<td>Waste diversion</td>
<td></td>
</tr>
<tr>
<td>General Services</td>
<td>20</td>
</tr>
<tr>
<td>Energy efficiency upgrades in</td>
<td></td>
</tr>
<tr>
<td>state buildings</td>
<td></td>
</tr>
<tr>
<td>Food and Agriculture</td>
<td>20</td>
</tr>
<tr>
<td>Reducing agricultural waste</td>
<td></td>
</tr>
<tr>
<td>Water Resources</td>
<td>20</td>
</tr>
<tr>
<td>Water Action Plan - water use</td>
<td></td>
</tr>
<tr>
<td>efficiency</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$850</strong></td>
</tr>
</tbody>
</table>

Water Bond Plan: $618m for groundwater basin protection, local water supplies, flood protection.
Governor’s Proposal for Rainy Day Reserves

**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.

**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.

California was hit especially hard
- Housing: construction / real estate
- Exports: goods / tourism / licenses
- Business Spending – especially IT

California is leading in recovery
- Homebuilding improved
- Employment growing steadily
- Business investment, exports, etc.

Local Budgets
- Taxable sales up but regional variation – serious allocation issues
- Property tax growth is finally up – still flat in some areas
- Short term band-aids are gone
- Redevelopment dissolution could not have come at a worse time.
  - Not just the revenue loss … uncertainty & workload.
- Pension/OPEB problems are huge and cannot be ignored
  - 2012 reform package is helpful … but more is needed

What will the State Legislature do? Fix? Shift?
- Staff & councils are overwhelmed
- Some key players believe the recovery will solve it (wrong!)
Bad Brew in Troubled Cities

Local revenue risk and uncertainty
- State actions
- Local conditions

Tax structures out of step with changing society:
- Sales tax, hotel tax, gas tax,
- Utility user tax

Fragmentation of local finance and governance among overlapping governments

Disconnect between service costs & revenues in urban development.
“Fiscalization of Land Use”

Over-reliance on land development revenue
Over-reliance on redevelopment revenues
Risky financing schemes
Unsustainable Decline in Core Revenues
Fear & Denial
Toxic relationships
Ceding of management and policy choices to others

Unsustainable and Intractable employee compensation, especially public safety pension and retiree health care
Diagnosing Municipal Fiscal Health

Indicators of Impending Financial Crisis

- Failure to pay an undisputed claim from a creditor within 90 days past claim date.
- Failure to forward income taxes withheld or Social Security contributions for over 30 days past due date.
- Failure to make required pension fund contributions on time.
- Missing a payroll for 7 days.
- General fund available unrestricted balance for the end of the current fiscal year will be negative.
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.

Initiated by the League at the urging of numerous mayors, councilmembers, city managers.

In development; not final; not being publicly distributed

Current: ♦ testing ♦ fine tuning

♦ preparing staff before public release

Stats and charts alone don’t explain things. A wrap around narrative report is essential.
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**

Other Financial Health Analysis Tools

ICMA Financial Trends Monitoring System (FTMS)

- **12 Factors, 42 indicators**
- **Early warning trends**
- Factors affecting financial condition

- **ENVIRONMENTAL FACTORS**
  - Population
  - Income
  - Property value and distribution
  - Home ownership
  - Community needs and resources

- **ORGANIZATIONAL FACTORS**
  - Growth
  - Efficiency
  - Administration
  - Interdepartmental relations
  - Revenue base

- **FINANCIAL FACTORS**
  - Revenues
  - Expenditures
  - Operating position
  - Financial structure
  - Unfunded liabilities
  - Condition of capital plant
Other Financial Health Analysis Tools

Financial Trends Monitoring System (FTMS)
12 Factors, 42 indicators

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

City of ____________

Financial Health Indicators

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 60 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.
Standard plans

Prior to 1999 were:
✔ Misc. 2% at age 60
✔ Fire & Police 2% at 50

After 1999:
✔ Misc. 2.5% at age 55
✔ Fire & Police 3% at 50

(Retroactive for all employees)

PEPRA - Public Employees Pension Reform Act (Jan 2013)
✔ Misc. 2% at age 62
✔ Fire & Police 2.7% at 57
✗ Does not deal with current employees
✗ Modest reductions for police and fire

Updating Economic Assumptions

Discount Rate
✔ CalPERS Staying at 7.5%

Price Inflation,
Wage Inflation,
Payroll Growth
✔ No changes
Pension Funding Costs Going Up
Updating Demographic Assumptions

- Disability Retirement
  ✔ Lower rates for industrial and non-industrial disability, lower liabilities for safety plans
- Retirement
  ✔ Earlier retirements for safety members
- Salary Scale
  ✔ Greater salary increases for safety members later in careers
- Mortality
  ✔ Longer life expectancy for all groups, expected future mortality improvement

Are Incorporations and Annexations Extinct?
Pernicious Effects of the VLF-Property Tax Swap of 2004
The VLF-Property Tax Swap of 2004

State General Fund

$4.4 b

VLF Backfill

Cities & Counties

Property Tax in Lieu of VLF

$4.4 b

Schools

* in FY2004-05

The Lack of VLF Replacement Makes New Cities Fiscally Unviable

City of Jurupa Valley General Fund

- VLF "Bump": Declines to zero over 5 yrs
- Swapped for PropTax in 2004
- AB1602: VLF to zero over 5 yrs
- Actual (after SB86 shift)

Denied PropTax, P-Switched VLF that all other cities get

If incorporated before 2004 swap

After Swap w/AB1602 VLF patch assumed in incorp process

Millions

$30.0

$25.0

$20.0

$15.0

$10.0

$5.0

$0.0

SalesTax

Property Tax

Franchise Fees

Licenses/Permits

VLF

AB1602 Special

Other

Deny PropTax P-switch VLF that all other cities get

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The Lack of VLF Replacement Makes many Annexations Fiscally Unviable

Annexation of Inhabited Area example

- VLF
- VLF AB1602 Special
- Other
- SalesTax
- Property Tax

If incorporated before 2004 swap
-w/AB1602 VLF patch (assumed in annex process)
-Actual (after SB89 shift)

Denied PropTax in lieu of VLF that all other areas of city get