January 25, 2014

Dear Finance and Budget Commissioners and City Council Members:

It is my understanding that the City Council intends to make some preliminary decisions at its scheduled January 28 meeting in regard to potential revenue measures to help address the city's structural budget shortfall as well as to meet the city's various infrastructure needs. Specifically, city staff and a council subcommittee are recommending (1) a June ballot measure to increase the current half-cent sales tax by three-quarters of a cent that would generate $5.4 million and (2) a November ballot measure for a $150 per parcel tax that would generate an additional $4.1 million to support park capital improvements to reduce water consumption, paving, and recreational amenities such as the city purchase of Nugget Field.

In light of these specific staff recommendations for tax increases that were made public yesterday, and because the commission is not scheduled to meet again until next month, I offer you an analysis of the city's fiscal condition that I hope you will take into account as you consider these tax increase proposals.

Because yesterday's staff report to Council does not provide a detailed list of the items that would be funded through the parcel tax, or their cost, I am not currently in a position to assess the proposed size of the $4.1 million tax measure. (Hopefully, the commission will have such an opportunity before such a measure is placed before voters.) However, I can provide you some insights into the proposal to raise $5.4 million to address the city's "structural shortfall" -- the amount by which annual city expenditures would exceed annual revenues if nothing is done.

The city administration has based its case for such a tax measure on the five-year projection of the condition of the city's General Fund it released last month. The projection indicates that the city's structural shortfall could be up to $5 million in 2014-15 and could grow to $7 million by 2018-19.

Based upon my review of the budget materials available online on the city website, public hearings on the budget, and other relevant data I have collected, it is clear that the city manager has it fundamentally right. The city does face a serious structural shortfall that must be addressed in the 2014-15 budget cycle. I appreciate that the consensus of the City Council, expressed at its December 17 meeting, is that additional revenues are needed along with other actions to align the city's revenue base with the cost of services provided to city residents and to sustain the city's infrastructure. But the key question before the City Council remains, what size of a revenue package is really needed for this purpose?

Summary of Findings. In summary, my analysis suggests that revenue growth from the city's existing shares of sales and property taxes will likely be somewhat greater than assumed in the five-year projection presented to the City Council last month. In addition, I believe some personnel and pension costs that are assumed in the five-year projection are somewhat overstated. Finally, although the city administration and council have taken a number of meaningful steps to reduce city labor costs and staffing, I believe that further some further budget efficiencies are possible that could help address the deficit problem. I believe all of these factors should be taken into account in decisions to "right-size" a city revenue measure or measures destined for the ballot.

If my findings are correct, the City Council has the option of adopting a somewhat smaller revenue package to address the structural deficit -- in the vicinity of $2.5 million per year -- rather than the $5.4 million proposal to address the deficit that is now being proposed.

If city officials prefer to incorporate a $5.4 million sales tax measure into its budgeting, my analysis indicates that at least part of the new monies -- almost $3 million a year on average over the next five years -- could be made available to build needed infrastructure and help maintain deteriorating city facilities. While that does not match the $4.1 million in revenues that would be gained from the second proposed parcel tax measure, these resources might be sufficient for now to do without a second ballot proposal in November.

My rationale for these conclusions is explained below.

Property Tax Assumptions. The city manager's five-year fiscal projection assumes that property tax revenue growth will be 1 percent in 2013-14, 2 percent in 2014-15, and reach 2.88 percent by the end of the projection period in 2018-19. However, these revenue growth estimates seem somewhat conservative for a Davis housing market well along on the road to recovery from the recession.

The Yolo County Assessor announced last June that Davis' 2013-14 assessment roll had increased by 5.75 percent over the prior year. This was a stronger performance than any other jurisdiction in Yolo County and much better than the 4.3 percent average growth in assessment rolls statewide identified by the state Board of Equalization in October. An initial payment received by the city Thursday from the county tax collector for secured property tax receipts (the bulk of the money the city receives each year from property taxes) showed growth of about 5.7 percent, well above the projected overall property tax growth rate of 1 percent built into the city's five-year fiscal forecast. City staff are monitoring these payments and expect to update their projections of property tax revenues sometime this spring.

Economists believe the rebound in housing values is likely to drive up property tax revenues on a statewide basis. Notably, my former employer, the Legislative Analyst's Office (LAO), estimated in November that property tax growth will average about 7 percent during the next five years, consistent with the historical growth rate for this revenue source. The Governor's 2014-15 budget proposal assumes 4.2 percent property tax growth statewide in 2013-14, accelerating to 6.3 percent in 2014-15 due to a recovery in home prices that had sagged during the 2008 recession.

Relatively low turnover rates for homes in Davis neighborhoods could slow this growth. However, there is some reason for optimism that Davis will fare better in this regard in the future. The build-out of The Cannery during the projection period would add $680,000 to the city's property tax base within five years, according to the city's fiscal model for the project, as new homes are sold and increase the property tax base.

Because property tax is the most significant single General Fund funding source, a more robust property tax growth rate could affect the magnitude of the structural shortfall. For example, if city property tax revenues grew 5.7 percent overall in 2013-14 in line with the increased secured property tax revenue payment that the city received this week, the city would gain roughly $700,000 in unanticipated General Fund revenue in 2013-14 that would carry over to help solve the city's 2014-15 fiscal problems. These extra property tax revenues would likely reoccur in 2014-15. Moreover, if a 5 percent rate of property tax growth were sustained in 2014-15 through 2018-19, the property tax base would grow by an additional $1.9 million annually by the end of the forecast period and help reduce the magnitude of the city's structural deficit.

Sales Tax Assumptions. The city manager's five-year fiscal forecast assumes the city will receive sales tax revenues of $9.4 million in 2013-14, the same amount of General Fund revenue budgeted from this source for 2012-13. After 2013-14, the property tax base was predicted to grow about 2.5 percent each of the following five years of the forecast.

However, the city has already enjoyed growth in sales tax receipts that has surpassed these assumptions. The city's total receipts from sales taxes were about $10.3 million in 2012-13 and city revenue collections for the first five months of this year so far have remained on track to provide another $10.3 million to the city General Fund in 2013-14. Documentation of these additional tax receipts in shown in Attachment A

City managers are expected to update their estimates of sales tax revenues in the spring. By then, another quarter of tax receipt data will be available, including information on the critical big revenue months of December and January that are driven by retail holiday season sales.

My analysis suggests that the city will likely hold onto the big gains in sales tax revenues achieved in 2012-13 as it goes through 2013-14 and 2014-15. The city is also likely to experience a healthier rate of sales tax revenue growth in 2015-16 through 2018-19 than the 2.5 percent annual rate assumed in the projection for the rest of the five-year forecast.

Economists are projecting steady increases in Californians' personal income and an improved labor market during that period, factors that tend to drive more consumer spending and sales tax receipts. For example, Davis' biggest employer, UC Davis, is already receiving budget increases as the state's fiscal situation improves; its student body and staff are already expanding significantly. The addition of T.J. Maxx and the other new stores coming to the Target center are projected to add $100,000 annually to the city's sale tax base and modestly reduce the "leakage" of sales outside of the city. The build-out of retail at The Cannery project is estimated to bring in another $239,000 annually within five years, according to the city's fiscal model for the project.

The statewide annual average growth in state and local sales tax receipts since 1980 has been above 5 percent. Statewide expectations coming out of the recession are positive. The LAO foresees statewide increases in taxable sales of about 7 percent in 2013-14, falling gradually to below 5 percent over five years. The state Department of Finance expects 6.7 percent growth in taxable sales in 2014-15.

The recent growth in sales tax revenues above budgeted levels means that the size of the city's 2014-15 fiscal problem could be reduced by about $1.8 million, assuming an additional $900,000 in sales tax revenues is carried over from 2013-14 to help balance the budget and these additional revenues reoccur in 2014-15. It is likely that this higher sales tax base will grow 2.5% in 2014-15, as city staff has estimated, and in my view will grow by a more robust 5 percent annually during the rest of the forecast period. This would lessen the structural budget shortfall by another $1 million annually by 2018-19, the end of the forecast period.

PERS Rate Adjustments. Both employers and employees contribute monies to offset the costs of CalPERS pension benefits. The five-year fiscal projection appropriately reflects the sizable impacts of employer rate increases for CalPERS pension benefits on city personnel costs in 2014-15. The employer rates shown in the city manager's five-year projection in that year for both public safety personnel and miscellaneous staff equal the rates shown in an annual valuation reports CalPERS has presented to the city for both employee groups.

However, my analysis indicates that the employer rates assumed in the remaining years of the five-year forecast may be overstated, in effect assuming greater cost increases than are likely to occur. CalPERS has already increased rates to account for post-recession investment losses and overly optimistic assumptions about future earnings by the pension fund. Yet another set of adjustments are now planned to reflect the fact that pensioners are living longer, on average, for which the pension system will need additional funding from employees and employers, including the City of Davis.

The five-year forecast reflects an assumption that this last factor will be incorporated into employer rates beginning in 2015-16. However, in December, CalPERS staff recommended that this last factor be phased into employer rates one year later than that -- beginning in 2016-17. If this recommendation stands, it would mean that the rates assumed in 2015-16 as well as the subsequent years of the forecast are somewhat overstated. The rates the City of Davis would contribute to CalPERS would still grow significantly -- just not quite as rapidly as assumed in the forecast.

My rough estimate is that the structural budget shortfall would be lessened by $100,000 annually from 2015-16 through 2018-19 if CalPERS employer contributions were less than currently assumed due to the expected delay in CalPERS rate changes for longevity of pensioners.

Salary Savings Assumptions. My reading of the five-year forecast is that, beginning in 2013-14, it reverses various previously adopted budget actions that assumed savings in personnel costs, such as due to staff turnover and vacancies. The forecast reflects an assumption of $936,000 in additional spending for this reason beginning in 2013-14 and the restoration of 3.5 positions and $250,000 in General Fund costs for similar reasons in 2014-15. Further, the five-year projection assumes no carryover of savings occurs at all during the entirety of the five-year projection period. All budgeted monies are assumed to have been spent by the end of each fiscal year.

However, in reality, some staff members quit or are fired or go on unpaid leaves. Staff turnover is unavoidable and inevitable, and it sometimes takes time to find and hire replacement workers. The city routinely rolls over $1 million to $2 million in General Fund monies that went unspent by the end of the fiscal year from one year to the next, according to past comprehensive annual financial statements. A significant share of this rollover comes from personnel savings.

It is a reasonable fiscal practice to assume, based on past experiences of departments with steady turnover, that some funding for staff positions will go unspent each year and to budget accordingly. At the state level, for example, positions are generally budgeted on the assumption that 5 percent of personnel costs will go unspent for these reasons. Of course, the budgeting of excessive level of salary savings beyond "normal" levels can result in an erosion of city services or force the council to consider mid-year budget augmentations. Some city departments will have little turnover and thus should not be subject to such a budgeting approach.

The structural budget shortfall shown in the five-year forecast would be lessened by roughly $200,000 annually over the entirety of the five-year projection period if the city achieved the equivalent of 1 percent of personnel costs due to salary savings.

Some Additional Budget Reductions Could Be Assumed. The five-year forecast is by definition a tool to define the extent of the deficit problem facing city leaders. Accordingly, the forecast does not take into account any of the $5 million worth of General Fund budget reductions prepared by the city manager to illustrate what a "cuts-only" budget solution would involve. This approach to the forecast is reasonable and consistent with projections issued by other agencies.

However, for the limited purpose of trying to assess the size of the budget gap that should be addressed through a new revenue measure, I have adjusted the five-year projection estimates to assume that a limited amount of savings would be adopted. In particular, I assumed that $500,000 in savings, equal to 10 percent of the structural deficit problem in 2014-15, could be achieved through the selection of items from the city manager's cut list or from other approaches that are yet to be discussed. At least some of these budget reduction proposals appear to be technical in nature. For example, the list of cuts includes $25,000 in savings due to a reduction in Muni Services auditing fees, and $50,000 in savings by shifting property management to a half-time contract. Other similar savings actions could be identified in the regular budget process.

If such an annual budget reduction target were assumed, the structural budget shortfall shown in the five-year forecast would be lessened by $500,000 annually.

How It All Adds Up. For illustrative purposes, I have incorporated each of the potential actions discussed above into an alternative five-year forecast. As shown in Attachment B, this proposed approach would reduce the magnitude of the structural deficit to roughly $2.4 million in 2014-15, It would peak at $2.8 million in 2015-16, then gradually decrease to about $1.7 million annually by the end of the five-year projection period.

For comparison purposes, Attachment C provides a summarized version of the city manager's five-year projection, which depicts a structural deficit that is initially about $5 million annually that escalates to more than $7 million a year by the end of the five-year projection period.

The Council Has Tax Options. If my assumptions on the size of the structural shortfall proved correct, the City Council could consider tailoring a new revenue measure on the order of magnitude of $2.5 million to fill this funding gap instead of the recently proposal for $5.4 million. It could then proceed later with a separate November parcel tax measure in an amount that city staff demonstrated in future hearings was justified.

In the alternative, the City Council could stay the course with a sales tax revenue measure in June of $5.4 million. After using roughly $2.5 million a year in tax proceeds to balance the budget, the Council could earmark the remaining almost $3 million per year in revenues for new infrastructure and city facility maintenance projects, such as those proposed to be funded via the separate parcel tax increase measure.

Conclusion. The options outlined in this note represent my "quick and dirty" analysis of the city's fiscal situation that I have been able to accomplish in the eleven days since my appointment by the City Council. They represent my views only, and not those of the Finance and Budget Commission. However, I intend to request that the commission discuss these budget issues with city budget staff at its next meeting. I would hope that the commission, in turn, will share the outcome of its discussions about these and other approaches to resolving the budget problem with the City Council as it deliberates on these highly difficult issues.

Please feel free to contact me if you have any questions about my conclusions. I appreciate the narrow timeframe you have to address these important city fiscal issues.

January 25, 2014

Sincerely,

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(c) 530 400-1447
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Attachments

January 25, 2014

1/22/2014 :

Attachment A

City of Davis Revenue Information
Sales and Use Tax
Summary

	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14	Diff 13-14 vs 12-1
Prior Year Triple Flip Recon	84,423.57	(43,488.01)	310,430.69	(6,385.66)	57,727.76	(142,470.92)	(233,674.05)	(200,198.68)
Reverse prior year Accrual of Triple Flip on Advances					(244,900.00)	69,627.94		314,527.94
September								
May-Aug 2nd Qtr								
Direct Coll	2,242,168.28	2,093,417.14	1,954,966.05	1,836,372.27	1,975,565.03	2,408,296.50	2,512,924.67	104,628.17
Pool	228,970.52	160,447.63	166,330.93	160,466.60	167,457.74	184,734.86	220,340.77	35,605.91
Less Admin	(19,641.83)	(20,943.17)	(23,218.82)	(23,945.11)	(21,827.73)	(24,824.05)	(29,712.00)	(4,887.95)
Less Adv	(1,766,600.00)	(1,824,600.00)	(1,402,700.00)	(1,880,733.33)	(1,692,800.00)	(1,705,200.00)	(2,086,300.00)	(381,100.00)
Less Triple Flip	(422,721.48)	(374,565.22)	(344,213.52)	(324,162.58)	(345,675.87)	(423,138.20)	(445,897.50)	(22,759.30)
New Adv	514,700.00	554,800.00	435,000.00	439,100.00	430,000.00	534,600.00	594,700.00	60,100.00
October	514,700.00	550,300.00	449,300.00	462,600.00	460,100.00	563,500.00	589,900.00	26,400.00
November	686,200.00	733,600.00	579,800.00	585,300.00	573,300.00	712,600.00	786,600.00	74,000.00
December								
Aug-Nov 3rd 1/4								
Direct Coll	2,177,915.19	2,068,082.27	1,875,502.17	1,767,829.18	2,063,555.24	2,244,555.66	*2,284,754.72*	40,199.06
Pool	205,208.48	181,998.36	106,749.69	140,433.66	164,043.16	200,880.86	*200,696.41*	(184.45)
Less Admin	(19,155.80)	(21,016.44)	(21,442.58)	(22,839.69)	(21,991.97)	(23,424.29)	*(27,559.38)*	(4,135.09)
Less Adv	(1,715,600.00)	(1,838,700.00)	(1,464,100.00)	(1,487,000.00)	(1,463,400.00)	(1,810,700.00)	*(1,971,200.00)*	(160,500.00)
Less Triple Flip	(399,815.79)	(369,665.21)	(319,979.52)	(304,784.29)	(353,085.88)	(396,323.91)	*(391,415.60)*	4,908.31
New Adv	519,000.00	494,900.00	423,500.00	496,400.00	497,100.00	533,200.00	602,000.00	68,800.00
January	519,000.00	487,900.00	440,100.00	522,100.00	519,700.00	533,200.00	*601,100.00*	67,900.00
February								-
Adv	653,000.00	394,900.00	564,600.00	661,900.00	662,900.00	739,700.00	*739,700.00*	-
Plus Triple Flip	664,617.43	876,694.51	334,143.81	663,811.98	*559,720.56*	815,222.99	*815,222.99*	-
Less Triple Flip Admin	(10,691.42)	(11,327.02)	(10,902.21)	(11,899.70)	*(12,670.00)*			-
March								
Nov-Feb 4th 1/4								
Direct Coll	1,991,435.75	1,981,204.47	1,872,292.26	1,916,416.04	1,964,200.64	2,298,342.69	*2,298,342.69*	-
Pool	202,707.82	81,213.01	161,066.51	145,725.06	199,515.94	226,535.22	*226,535.22*	-
Less Admin	(19,319.07)	(20,101.43)	(21,182.11)	(22,605.31)	(20,810.39)	(23,698.64)	*(23,698.64)*	-
Less Adv	(1,691,000.00)	(1,377,700.00)	(1,428,200.00)	(1,680,400.00)	(1,679,700.00)	(1,806,100.00)	*(1,942,800.00)*	(136,700.00)
Less Triple Flip	(364,849.08)	(324,256.83)	(325,715.47)	(319,219.23)	(341,158.71)	(405,633.28)	*(405,633.28)*	-
New Adv	454,600.00	436,900.00	389,700.00	446,600.00	454,800.00	495,700.00	*495,700.00*	-
April	454,600.00	446,500.00	408,900.00	472,300.00	479,500.00	527,000.00	*527,000.00*	-
May	606,000.00	551,800.00	569,500.00	654,800.00	606,300.00	661,100.00	*661,100.00*	-
Plus Triple Flip	749,041.00	833,206.50	644,574.50	663,811.97	629,348.50	698,051.50	*698,051.50*	-
June								
Feb-May 1st 1/4								
Direct Coll	1,946,656.83	1,648,461.00	1,757,615.18	1,811,066.49	1,990,086.14	2,141,104.11	*2,141,104.11*	-
Pool	165,425.70	142,495.22	142,973.88	149,134.36	153,664.63	207,879.47	*207,879.47*	-
Less Admin	(20,320.50)	(17,111.74)	(19,967.03)	(20,081.37)	(19,275.83)	(23,665.91)	*(23,665.91)*	-
Less Adv	(1,515,200.00)	(1,435,200.00)	(1,368,100.00)	(1,573,700.00)	(1,540,600.00)	(1,683,800.00)	*(1,683,800.00)*	-
Less Triple Flip	(354,183.66)	(287,495.05)	(305,626.15)	(315,344.43)	(349,347.28)	(379,382.23)	*(379,382.23)*	-
New Adv	548,500.00	417,200.00	557,800.00	499,500.00	504,200.00	615,800.00	*615,800.00*	-
July	546,900.00	429,200.00	579,200.00	527,400.00	530,100.00	649,400.00	*649,400.00*	-
August	729,200.00	556,300.00	743,733.33	665,900.00	670,900.00	821,100.00	*821,100.00*	-
Triple Flip Reconciliation	43,488.01	(310,430.69)	6,385.66	(57,727.76)	142,470.92	233,674.05	*342,728.17*	109,054.12
Total	**9,129,359.95**	**7,844,919.30**	**8,418,817.25**	**7,638,139.15**	**8,349,012.60**	**10,267,444.42**	**9,987,942.13**	**(4,341.96)**
Less: Rebates								
Less: Implementation Costs	-	-	-	-	-			
Net	**9,129,359.95**	**7,844,919.30**	**8,418,817.25**	**7,638,139.15**	**8,349,012.60**	**10,267,444.42**	**9,987,942.13**	
GMBA Total	**9,117,999.36**	**7,844,919.30**	**8,121,483.92**	**7,894,938.84**	**8,279,384.66**	**10,267,444.42**		
Difference	11,360.59	-	297,333.33	(256,799.69)	69,627.94	-		
	Estimate	**Estimate**	**Estimate**	**Estimate**	**Estimate**	**Estimate**		
	9,126,100.00	8,200,000.00	7,600,000.00	7,922,500.00	8,001,725.00	9,400,000.00		
	Budget	**Budget**	**Budget**	**Budget**	**Budget**	**Budget**		
	9,090,600.00	9,354,200.00	7,844,000.00	7,800,000.00	8,001,725.00	8,451,760.00		

Difference in between worksheet and GMBA is due to GMBA figure includes an increase compensating for triple flip on the advances for June, July and August. Worksheet does not.

Attachment B

Alternative Five-Year Projection of City of Davis General Fund Condition

	Estimate	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Beginning balances	6,203,519	5,303,117	2,945,195	167,441	(2,373,970)	(4,705,937)
Audit adjustments/prior year encumbrances/carryovers	0	0	0	0	0	0
Revenues	43,629,820	44,438,987	46,104,550	47,826,484	49,592,726	51,404,483
Expenditures	(44,530,222)	(46,796,909)	(48,882,304)	(50,367,895)	(51,924,693)	(53,087,581)
Transfers	0	0	0	0	0	0
Unreserved fund balance	5,303,117	2,945,195	167,441	(2,373,970)	(4,705,937)	(6,389,035)
Structural imbalance	(900,402)	(2,357,922)	(2,777,754)	(2,541,411)	(2,331,967)	(1,683,098)
Notes						
-- Change in revenues assumed under administration plan		424,342	995,531	1,099,423	1,129,531	1,160,520
Assume increased property tax revenues						
-- Assume higher property tax revenue growth rate	5.70%	5.00%	5.00%	5.00%	5.00%	5.00%
-- Property tax growth rate assumed by administration	1.00%	2.50%	2.50%	2.88%	2.88%	2.88%
-- Net additional annual property tax growth	723,471	384,825	412,532	358,573	366,175	373,938
Assume increased sales tax revenues						
-- Increase in sales tax base in 2012-13 above budgeted level	900,000					
-- Assume more significant future sales tax revenue growth		2.50%	5.00%	5.00%	5.00%	5.00%
-- Future sales tax growth assumed by administration		2.50%	2.50%	2.50%	2.50%	2.50%
-- Net additional sales tax growth		0	257,500	263,938	270,536	277,299
Assume additional budgetary savings						
-- PERS rate adjustment for longevity postponed one year			100,000	100,000	100,000	100,000
-- Assume salary savings equivalent to 1% of staffing costs		200,000	200,000	200,000	200,000	200,000
-- Adopt additional budget reductions		500,000	500,000	500,000	500,000	500,000
-- Total additional budget reduction solutions		700,000	800,000	800,000	800,000	800,000

Attachment C

City Manager's Five-Year Projection of City of Davis General Fund Condition

	Estimate	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Beginning balances	6,203,519	3,679,646	(1,386,572)	(7,642,654)	(14,284,904)	(21,354,421)
Audit adjustments/prior year encumbrances/carryovers	0	0	0	0	0	0
Revenues	42,006,349	42,430,691	43,426,222	44,525,645	45,655,176	46,815,696
Expenditures	(44,530,222)	(47,496,909)	(49,682,304)	(51,167,895)	(52,724,693)	(53,887,581)
Transfers	0	0	0	0	0	0
Unreserved fund balance	3,679,646	(1,386,572)	(7,642,654)	(14,284,904)	(21,354,421)	(28,426,306)
Structural imbalance	(2,523,873)	(5,066,218)	(6,256,082)	(6,642,250)	(7,069,517)	(7,071,885)