

Date: May 22, 2015  
To: Finance and Budget Commission  
From: Dan Carson  
Subject: 2015-16 Budget Proposal and Five-Year Projections

The proposed 2015-16 budget plan released Thursday by the city manager reflects a significant improvement in city finances due to the passage last year of Measure O, the underlying strength of the city's revenue base, and the beneficial effects of budget reductions enacted during the last few years. The city administration also released a new and updated set of five-year projections of city finances that tie to the budget plan.

This fiscal assessment is a far cry from the projections released in December 2013 depicting an annual structural budget shortfall of \$5 million annually and a growing accumulated deficit over the next few years. Under the new budget plan and projections, the fiscally prudent goal of achieving a 15 percent budget reserve that could help out in future economic downturns or other emergencies has been attained. However, as the city manager emphasized in his statement announcing the budget proposal, much work remains to be done to meet future cost pressures for infrastructure and personnel and continued close scrutiny of city finances is still warranted.

The sets of numbers released Thursday are meant to be a tool for future budget decision-making. The one thing that is certain is that the numbers will change as these decisions are made. In keeping with the mission of our commission to seek transparency in city finances, my goal in this memo is to encourage our city leaders make those decisions based on the most accurate and complete set of numbers and assumptions.

Based on my initial analysis of the proposal, this memorandum highlights some technical budgeting issues and questions that the commission may wish to explore at our scheduled meeting on June 8.

***Property and Sales Tax Revenues Likely Understated.*** The 2015-16 budget proposal reflects recent surges in the city's property and sales tax revenues during 2013-14 and 2014-15. However, the future rate of growth assumed from these tax sources remains largely unchanged from prior budgets. A plan by city staff to develop and use new, more data-driven revenue projection techniques was delayed. My analysis suggests these revenues are again being underestimated.

Specifically, the budget plan assumes 3 percent growth in certain property tax revenues in 2015-16 and 3.5 percent growth thereafter. It assumes 1 percent growth in sales tax revenues in 2015-16 and 2.5 percent annual growth in subsequent years. Notably, comparable assumptions built into the 2014-15 budget underestimated the combined General Fund revenues from sales and property taxes for that year by almost \$1.4 million.

If city revenues from these two important tax sources grew instead more in line with actual city historical trends, new statewide projections by the Department of Finance and the Legislative Analyst's Office, and as suggested by other relevant data (like the 38 percent increase in resale permits), the city could realize annual growth in property tax revenues in the range of 5 percent annually, and sales tax growth in the range of 4 to 5 percent annually, over the next five years.

If these alternative revenue projections proved correct, the city General Fund could realize \$750,000 in combined additional revenues in 2015-16 from these two tax sources. By 2020-21, the final year of the five-year projection period, the compounded effect of better revenue growth could be as much as \$4 million more annually than is now being estimated if positive economic trends continue.

So one important issue is whether these budget assumptions should be revisited to be more realistic and reflect the likelihood of improved revenue growth, especially in the near-term. One key additional bit of information will be available later this month to help in the assessment of 2015-16 revenues. The amount the city will receive from county distribution of 45 percent of the secured property tax roll should be known by the end of this month and could increase or lower the current projected property tax revenue amounts. The commission may wish to request that staff comment on the magnitude of the May property tax revenues, once known, as well as the reasons for their conservative estimates of General Fund revenues.

***Future Hotel Room Tax Revenues Estimates Should Be Reviewed.*** The new set of five-year projections for the city assumes that revenues from the hotel room tax will grow by \$128,000 in 2017-18 primarily as the result of the opening of the new hotel and convention center now under consideration for near Richards Boulevard. However, a city staff report about the project presented to the City Council in December cited estimates by project proponents that these revenues would grow by \$450,000 once the new facility opened. The commission may wish to request that city staff reconcile the two different estimates and discuss the basis for the \$128,000 figure.

***Cable Television Fund Surplus Could Be Shifted to General Fund.*** As we have discussed at the commission on several occasions, city cable television franchise fees are deposited into a special fund called the Cable Television Fund. Annual city financial reports disclose that the balance of the fund has grown by about \$300,000 in recent years to exceed \$1.6 million even though the city regularly taps the fund to support the city manager's office and other administrative services.

In public discussions about the fund, city staff have confirmed that this fund balance is far in excess of any related programmatic needs, especially since plans for a community media center were abandoned some years ago. The commission was advised that up to \$1 million could be transferred by council action from the Cable Television Fund to the General Fund, where these monies could be used to address

city priorities. (Release of part of the funds may require consultation with the firm holding the cable television franchise.) The commission may wish to recommend to the council initiate such a transfer in the absence of any decision to dedicate these monies to other purposes. Of course, such a large transfer could occur only on a one-time basis and thus the monies should ordinarily be used for one-time purposes, such as capital expenditures.

***2014-15 Expenditures for Litigation Reserve Likely Overstated.*** During the last budget cycle, the city set aside \$1.2 million in 2013-14 fiscal year funding for unspecified purposes that were referenced as a “litigation reserve.” Because none of these monies were spent in 2013-14, they were rolled over and set aside for expenditure in 2014-15.

The latest set of five-year budget projections discontinues the prior practice of building the expenditure of such a litigation reserve into projected future year expenditures. However, the 2015-16 budget plan implicitly assumes all of the \$1.2 million litigation reserve will be spent in 2014-15 and that none of the money will carry over into 2015-16 for the support of city priorities. This seems unlikely. As of several weeks ago, none of these monies had been spent. Thus, it is likely that 2014-15 expenditures are overstated in the new city fiscal projections and that the starting General Fund balance for 2015-16 is understated by an equivalent amount.

The commission may wish to request that city staff clarify the status of spending the litigation reserve funds and their intended use, if any. Because these funds would be available on a one-time basis, they should ordinarily be used for one-time purposes, such as capital expenditures.

***Additional Funding May Be Needed for Drought Surcharge.*** In response to state orders that communities like Davis reduce their water use because of the severe drought, city staff has been considering a proposal to activate a “drought surcharge” on the bills of consumers of the city water system. If the City Council decides to impose such a charge, presumably the city itself, as a consumer of water, would also be subject to paying it. This could have an impact on General Fund expenditures for parks maintenance, especially. On the other hand, the city is continuing to take steps to reduce its consumption to meet the state water reduction target and has achieved significant savings in its water costs. The commission may wish to inquire of city staff the net potential cost impact of such a drought surcharge in 2015-16 on the city General Fund, if any, and recommend budgeting accordingly.

***Projections Do Not Reflect Fiscal Impacts of Any New Collective Bargaining Agreements.*** The budget projections show that, after excluding one-time monies, ongoing city revenue sources would grow faster than the increasing costs of pensions and other benefits provided to city employees over the five- year projection period. While adjusted revenues would grow about 2.6 percent annually, total budgeted compensation costs would go up about 2.2 percent annually.

However, those projections implicitly assume, for the time being at least, no further increases in pay for city employee beyond those approved in prior collective bargaining agreements with staff. Previously, city projections had assumed 1 percent annual increases in employee pay.

Negotiations with employee groups are pending and thus were not concluded at the time the draft budget plan was prepared by the city manager. Agreements do not appear to be close. The eventual outcome of these negotiations, however, could have a significant impact on city finances. For example, by my estimate, if all city employees received annual 1 percent increases in pay during the five-year projection period, the annual increase in pay and pension costs could amount to \$1.7 million annually to the General Fund by 2020-21. Accordingly, the commission may wish to closely monitor the progress of negotiations and their impact on city finances.

***Impact of Expiration of Measure O.*** Under the terms of Measure O, approved by the voters last year, the city's sales tax was increased by one-half cent effective last October. Under the terms of the measure, however, the full 1-cent city sales tax expires December 30, 2020, unless extended in the interim by action of the City Council and voters. While this expiration date falls in the middle of the last year of the forecast, I am advised by city staff that lags in the collections and distribution of sales tax monies mean that the loss of these revenues would not be realized until the subsequent two fiscal years.

My estimate is that the loss of these revenues would eventually amount to \$8 million annually. This potential revenue loss underscores the need for the city to execute a long-term fiscal strategy that includes fiscal constraint, economic development, and efforts to lease or sell surplus city properties. All of these strategies will need to be considered in the 2015-16 and subsequent budgets, because there is no way to know for certain whether future City Council members and voters will extend the tax measure, or whether it would be continued at the current level.

***Conclusion.*** While I believe that many of these points warrant discussion with city staff at our meeting, I look forward to hearing your observations and issues pertaining to the 2015-16 budget proposal when we meet.