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Balanced in Name Only

Small budget surplus is no cause to break out the champagne

By Craig Powell

There is only a tiny handful of policy wonks who actually look forward to the release each year of the city manager's proposed city budget for the fiscal year that starts on July 1. I'm one of them. City budget manager Leyne Milstein drove that point home in my interview of her last month, joking that I was one of only three people who have actually read the document that only a wonk could endure, much less enjoy.

But endure it I did and, knowing that most of you don't spend your nights curled up with the city budget, I'm offering you the CliffsNotes version of it this month.

The good news is that after five years of battling chronic budget deficits, city manager John Shirey is proposing a $383 million general-fund budget that actually ekes out a small $2 million budget surplus. (The *total* city budget, which includes fee-collecting "enterprise funds" like city utilities, the convention center and marina, is actually $872 million, but most attention is paid to the city's general-fund budget, which funds basic city services such as police, fire, parks, etc.) That means no cuts next year in services or city employees.

All three of the city's primary sources of income (property, sales and utility user taxes) are expected to grow modestly next year with Sacramento's very modest economic recovery. The city will see a one-time bump in property taxes from the rapid return of housing prices to 2008 levels, which will lead to a quick restoration of reassessments for many (particularly newer) homeowners.

The 11 percent utility tax on city utilities is generating a gusher of new taxes for the general fund as a result of three years of double-digit hikes in water and sewer rates. (The final year of hikes kicks in on July 1.) But the city decided in 2012 to set aside those fresh revenues ($3.8 million next year) to fund a new subsidy program to insulate low-income homeowners (but not low-income renters) from the impact of the major run-up in water and sewer rates. Given the city's coming fiscal problems (see below), don't be surprised if this new welfare program gets the ax sometime in the next few years.

The one-half-cent sales tax hike approved in 2012, Measure U, is expected to bring in $31 million next year, up from $29 million this year. The city, having already used current Measure U money to reopen all browned-out fire stations, plans to use it next year to hire 14 new sworn police officers and preserve 10 police positions that are funded with expiring grants. Measure U, however, expires in five years, and city officials have announced no plans to adapt the city budget over the next few years to a post-Measure U world. My city hall sources report that city officials hope to make the case to voters in 2018 that an extension of the tax is essential to avoid cuts in city services, which may be considered by some residents who voted for Measure U a breach of faith since it was sold as a temporary fix of the city's temporary budgetary problems.

On the expense side of the budget, the city is actually "bending the cost curve" and reining in health-care costs for current employees. From 2009 until 2013, the city's cost of health care per employee rose from about $10,500 to more than $15,000. By offering city employees a $2,000 incentive (all right, call it a bribe) to shift from traditional insurance coverage to a high-deductible, health-savings-account-based health plan, the city, for the first time in memory, is actually holding the line on health-care costs on a year-over-year basis.

With the arrival of the Affordable Care Act (aka Obamacare), the city is dealing with the ACA's requirement that benefits be provided to all employees working "full time," meaning 30 or more hours per week. Like private employers, the city is making sure that part-time employees do not exceed 30 hours per week without having a darn good reason for doing so. Also, the city is expected to be caught by the

ACA's 40 percent excise tax on "Cadillac" health-care coverage beginning in 2018 due to the generosity of its coverage. The Cadillac tax kicks in on individual coverage valued at more than $10,200 annually and family coverage valued at more than $27,500 annually.

One question that remains unanswered is whether the city could reduce its health-care costs for current and retired employees if it were to shift health coverage for lower-paid workers from city plans to plans offered under the ACA, taking advantage of the significant ACA subsidies. Several cities around the country are actively considering such shifts. Human resources director Geri Hamby, however, was unavailable to discuss the issue.

A major uncertainty for the city in planning next year's budget is that it's negotiating new contracts with each of its major unions. The city and the police union are locked in binding arbitration that will result in a high-risk "winner take all" resolution, with one side or the other prevailing based on the terms of its last best offer. The city is trying to compel police to pay their full "employee's share" of pension contributions, which amounts to 9 percent of their salary.

The only significant change in the city's fiscal circumstances since Measure U was approved by voters in 2012 has been the council's approval of the arena deal and issuance of up to $325 million of arena bonds. The arena bonds will impose a projected $21.9 million annual hit to the general fund, softened by the $6.5 million annual lease payments (which will increase 3 percent annually) from the Kings owners. The city plans to cover the net $15.4 million shortfall, at least in the first three years, by borrowing more on the arena bonds and by tapping a modest one-time $6 million liquidity reserve that the city plans to fund from the city's hotel tax. After the first three years, the city expects to cover the shortfall through a major increase in city parking profits, according to city treasurer Russ Fehr, despite the fact that close to one-half of city parking garage spaces are being handed over to the Kings owners as part of the arena deal.

But there is a disconnect between Fehr's projection that the city's parking profits will increase by $7.5 million and Milstein's far more modest projection that city parking revenues and expenditures will grow by 1 percent to 2 percent annually for the next five years. Fehr claims that the city plans to rapidly grow parking-meter profits by expanding the number, hours, rates and locations of parking meters in the city. If so, either no one told Milstein or she's not buying the projected rapid rise in parking profits.

Fehr claims that measures to hike parking profits are not being designed merely to raise revenue for the arena. According to Fehr, the city's public works department developed the measures to "modernize" the parking system and use it most efficiently. This is, to put it charitably, balderdash. The plan to increase parking profits was developed *solely* to fund the city's arena obligations. If the plan to greatly increase parking profits had originated in the public works department, the city budget director would have been privy to the plan and would've included the higher profits in the city's five-year budget forecast.

Why is this rather obscure budgetary issue so important? Because the Legislature enacted a statute in 1943 limiting how local governments can use profits from municipal parking. It provides that such profits can be used only to fund a municipality's parking operations and may not be used for any other purpose (like making arena bond payments). Fehr is trying his best to portray his plan to spike parking profits as an ongoing city effort to "modernize" city parking and make it more "efficient" in order to shoehorn his arena financing plan into the state law that strictly limits the use of muni profits to supporting parking operations. In my view, and as a president from Texas used to say, that dog won't hunt.

A taxpayer suit may be brought against the city to enforce the state law restriction on the use of parking profits (or under Proposition 26, which limits the amount a government can charge for certain fees to the "reasonable cost" of services). If such a suit succeeds in embargoing parking profits from being used to make arena bond payments, the city will have to scramble to fund the $15.4 million annual arena bond funding shortfall through other means, most likely by using the tried-and-true method of cutting city services.

The city manager is projecting that the general fund will return to deficit in two years, starting with a $2.2 million deficit in 2016, a $12 million deficit in 2018 and by 2019, due to sharp increases in pension contributions mandated by CalPERS and the 2019 expiration of Measure U, leaping to $41 million of red ink. If higher parking profits are either not realized or are legally prevented from being used to fund arena bond payments, the general-fund deficit would likely grow to around $53 million.

The city is being hammered with a third round of pension contribution hikes from CalPERS. The first two hikes were to deal with losses in the pension fund's portfolio and a reduction in its forecasted earnings rate on invested funds from 7.75 percent to 7.5 percent. The latest contribution increase (to be phased in over five years) is both good news and bad news. The good news is that city employees are living much longer. The bad news is that the city must pay for their pensions for a longer time. Cumulatively, these increases will raise the city's annual CalPERS contribution by $33 million over the next five years, from the current $49 million to $82 million. In terms of salaries, the city's current pension contribution rate for public safety workers will rise from 31 percent of salary to about 42 percent. For all other city employees, the rate will increase from 14.5 percent of salary to almost 19 percent.

Also looming on the horizon is the possibility of a fourth increase in the pension contribution rate should the CalPERS board conclude that the new 7.5 percent earnings assumption is still too optimistic, as pension reformers, a major ratings agency (Moody's) and even the Government Accounting Standards Board assert.

While the city manager's proposed budget reflects a small surplus, it relies on weak government accounting rules that ignore the current costs being run up for city retiree health-care costs, as well as deferred maintenance of city facilities.

Because the city hasn't been setting aside funding for retiree health-care costs until very recently, the city is facing a $470 million unfunded liability for such costs. The city is accruing $29 million per year in such costs, which are owed to city employees for services rendered in the current year, but which are not reflected in the city's general-fund budget. If the current costs of providing retiree health-care benefits were included, the projected $2 million surplus would become a $27 million deficit, while the $41 million projected deficit in 2019 would become a $70 million deficit. This year, for the first time, the city manager is proposing a contribution to a trust fund for such costs as part of the annual budgeting process. While the $1 million allocation is largely symbolic, it's a start. Unfortunately, it's also designated as a one-time allocation, not a recurring one.

Another off-budget expense that misses the general-fund budget is the accrual of deferred-maintenance expenses. The city currently has a $37.4 million backlog of deferred maintenance on city facilities and intends to accrue (instead of paying) another $1.5 million to $2 million in deferred-maintenance expenses in the coming year. If the city council is wise, it would protect its physical assets by using its $2 million surplus next year to fully fund current maintenance costs—and set up a funding plan to work off the $37.4 million maintenance backlog as soon as practicable.

Author's note: This column went to press before the May 20 city council meeting at which the council was expected to approve the arena deal and the sale of arena bonds.

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