Budget Checkup
City Hits List of 20 Most Financially Distressed U.S. Cities

By Craig Powell
Inside City Hall
November 2017

After devoting my last two columns to Sacramento's homeless crisis, I figure we're due for a review of the city's financial situation since Darrell Steinberg became mayor.

Among the more than 3,300 issue files that Eye on Sacramento (the civic watchdog group that I head) maintains on municipal issues is one that is often whimsical: our city rankings file. We track every time a study or publication ranks Sacramento against other cities on everything from its appeal to millennials to the quality of our coffeehouses. (There's considerable crossover there.) But the latest ranking, published by JPMorgan Chase, is anything but whimsical. It's disturbing.

Since JPMorgan Chase manages about $90 billion in municipal bonds, it's pretty concerned about whether cities will be able to pay back their bond debt. So it created what one financial analyst calls a comprehensive guide of "which municipalities haven't the slightest hope of surviving their multi-decade debt binge and lavish public pension awards"—i.e., Chicago, Pittsburgh, Atlanta, Cleveland.

Without getting too wonky, the study examines just how financially burdened the country's 77 largest cities are by their bond debt payments, their current and accrued pension costs, and their current and accrued retiree health care costs.

Note that these are all annual legacy costs, in that they repay a city's past borrowings or fund employee benefits on services already rendered. These costs are anchors around the necks of U.S cities, sucking up dollars that could otherwise be used to pay for current services. The study ranks each city's burden by comparing its total legacy costs to its tax revenues. The resulting ratios of legacy costs to revenues are then ranked by city. Sacramento is ranked as having the 20th worst legacy-cost-to-revenues ratio among the country's 77 largest cities. It has the second worst in the state, behind only perennial financial basket case Oakland.

Think of it in terms of your own family's finances. The higher the ratio of your family's annual debt payments are to your family's income, the more

vulnerable you are to personal bankruptcy if you should experience a significant drop in income or are hit with unexpected bills. The same holds true for cities.

But wait a minute. The city's economy has been humming along nicely, with rates of economic and employment growth well above national averages in the past few years. That includes the fresh injection of additional revenues from Measure U, the half-percent city sales-tax hike approved by voters in 2012. Measure U was originally projected to bring in $27 million a year but is now tapping taxpayers for $46 million a year. How is it possible for the city's finances to be in such a perilous state when jobs, economic output and city tax collections are all ramping up? Welcome to the story of the city's self-inflicted financial wounds.

The Debt Spike

In 2010, the city's total debt (including its bond, pension and retiree health care liabilities) stood at $1 billion. In just six years, the city's total outstanding debt rose to an eye-popping $2.6 billion (according to the city's June 2016 balance sheet), a whopping 160 percent increase. The city's issuance of arena bonds and water and sewer bonds and a major run-up in its pension liabilities are responsible for most of the spike. And each increase in city debt carries with it a corresponding increase in the city's annual debt carrying costs.

And much more is coming. The city is planning to borrow more than $200 million to fund rehabs of its convention center, community theater and Memorial Auditorium, by pledging the city's hotel tax to bondholders. The city is also signaling its willingness to subsidize some portion of the cost of a new hotel to the east of the convention center. City leaders hope that another hotel in the area will staunch the river of red ink that's been pouring out of the convention center for more than 20 years. (EOS puts the convention center's annual losses at $19 million.)

The mayor also announced his desire to have the city borrow another $50 million or so against the hotel tax to fund unspecified projects that would help nurture development along the city's long-neglected Sacramento River waterfront. Meanwhile, the City Council recently promised to help fund the construction and a portion of the annual operating costs of the long-planned Powerhouse Science Center just north of Old Sacramento. (The city's total subsidy of around $25 million would also be financed through the hotel tax.)

The city's hotel tax is the city's most volatile revenue source: It spikes up when the economy is strong and crashes during recessions. The city's overreliance

on the hotel tax as a source of future financing is akin to a homeowner counting on future stock market gains to make the mortgage payments on his or her house. It's reportedly giving the city's treasurer fits.

In addition, the city is poised to issue $173 million in additional water bonds to complete the city's water-meter project. With the city's plans to issue additional bonds and its ongoing accrual of pension and retiree health care liabilities, the city's total debt will likely exceed $3 billion in the next 12 months or so.

Pension Costs Projected To Double

At a recent City Council workshop, city finance director Leyne Milstein shared the startling news that the city's annual pension contribution to CalPERS is expected to double, from $67.2 million to $129.4 million, over the next seven years. (Just eight years ago, the city's general fund pension bill was just $31 million; six years before that, the city declared a pension holiday and contributed nothing to its pension plan.)

There's no way to sugarcoat the effect of a $62.2 million pension cost hike on the city's annual general fund budget, which currently stands at $459 million. It far exceeds anticipated growth in city tax revenues.

The spike in pension costs will likely lead to layoffs, reminiscent of the layoffs the city made during the Great Recession. Rationally, the city should reduce employee compensation in order to preserve public service levels and avoid layoffs. But city compensation rates are notoriously "sticky," locked in by labor contracts and highly resistant to reductions, particularly given the strong political influence of city unions. In practice, that means that the city will likely end up closing its looming budget deficits with layoffs and public service reductions.

The city is currently legally unable to trim the pension benefits it provides to current employees, even with respect to future employee services not yet rendered. That's because of the judicially recognized "California Rule," which holds that a pension benefit, once granted, cannot be modified after an employee is hired. But the California Rule is being tested in a case currently pending before the California Supreme Court. The court is reviewing an appellate court ruling that held that a municipality can modify pension benefits for current employees prospectively so long as the modification leaves employees with a meaningful pension. Bankruptcy courts have ruled that municipal pension benefits can be reduced in a municipal bankruptcy setting.

Growing Retiree Health Care Costs

The city is legally able to reduce its growing costs and liabilities for health care benefits to its retirees, since such benefits are not subject to the rigid California Rule. Sacramento County phased out its retiree health care benefit entirely in the last recession. While the City Council held workshops last year where it learned of ways it could reduce such costs, it hasn't exhibited the political courage to pursue any of them, despite the fact that many retired city employees are eligible for health insurance subsidies under Obamacare.

The City Council currently appropriates a miniscule $1 million annually toward a trust to cover its $350 million unfunded liability for retiree health care costs. It made a show earlier this year of allocating $5 million in funds left over from the previous fiscal year to the city's retiree health care trust fund. But then, several months later, it canceled the allocation because it needed the money to pay for the huge salary hikes the city promised to police under a new labor contract.

Blowing It on the Police Contract

The city is in the midst of negotiating new contracts with most of its unions. The first big union contract approved by the City Council was with the Sacramento Police Officers Association. It was negotiated against the backdrop of plunging morale in the police department and an increasing numbers of officers leaving the department to work elsewhere. (Sacramento police officer salaries have been lagging behind the salaries of their peers in nearby departments.) After approving a one-time, $2,500-per-cop retention bonus last spring, the council recently approved a new two-year labor contract with SPOA that granted unprecedented, budget-busting raises for officers with at least four-and-a-half years of tenure with the department: 17 percent pay hikes over one year. The justification for the raises was to restore flagging police morale and prevent more defections to other cities.

Why is morale so bad? Officers feel that city leaders are not sufficiently supportive of them in the face of allegations of police misconduct and implicit racial bias. They perceive a recently reconstituted police review commission as inherently biased against the police. There is some justification for the charge: The rules adopted by the City Council defining the qualifications of commission members bar anyone from serving who has any prior law enforcement experience, which guarantees that commission members evaluating allegations of police misconduct will lack the critical perspectives and experience of law enforcement.

So instead of addressing the underlying reasons for poor police morale, the council opted instead to try to buy morale by approving record raises. Most HR

managers will tell you that money goes only so far to resolve serious morale problems, a pricey lesson that the city and its taxpayers are likely to learn.

One matter that was glaringly missing in the council's discussion of the new SPOA contract was the echo effect that such huge raises would have on the city's already-exploding pension costs and liabilities. The direct costs to the city of the police raises will amount to more than $20 million over the next two years. But because annual pension benefits are based on the "pensionable pay" that a city employee receives in his or her last few years of employment, the raises are very likely to lead to pension costs and liabilities that are several multiples of $20 million. Regrettably, the council voted to approve the new contract with zero analysis of the likely magnitude of the effect of the raises on city pension costs or liabilities.

One Bright Spot: Weed

One bright spot in the city's budget picture is the prospect of the city cashing in on the legalization of the cultivation, distribution and sale of recreational marijuana. It's expected that the city will allow its existing medical marijuana dispensaries to sell recreational pot beginning Jan. 1 if they have all of their city paperwork in order. More than 200 parties have applied to the city for permits to cultivate marijuana in indoor grows around the city. Sacramento Business Journal reported last month that market rents for industrial space around the city have nearly quadrupled since last year's passage of the ballot measure that legalized pot under state law. Pot growers are snapping up available space and driving out existing industrial tenants, which are seeking lower-cost space elsewhere in the county or beyond. The city is the only government in the region that is throwing open its doors to industrial-scale pot growers.

No one knows how much tax revenue recreational pot will generate for the city. Currently, the dispensaries generate $4.6 million annually in city taxes. Some see recreational pot as a future bonanza for the city, with tax revenues tripling or even quadrupling in the coming years. Of course, such expectations are based on the uncertain assumption that the Trump administration won't take legal action to invalidate California's new pot laws under the U.S. Constitution's Supremacy Clause.

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