



CITY MANAGER'S OFFICE

Council Meeting: February 1, 2005
Staff Report #: 05-14
Agenda Item F-1

REGULAR BUSINESS: Fiscal Year 2005-06 Budget Workshop

RECOMMENDATION

Staff requests that the City Council approve the approach proposed for the preparation of the City Budget for fiscal year 2005-06. In addition, staff looks for Council feedback on and concurrence with the process and timeline outlined to begin the preparation of the City Budget for fiscal year 2006-07.

BACKGROUND

Since its economic cycle peak in 2000-01, the City has faced an imbalance between General Fund operating revenues and expenses. This imbalance has been driven primarily by: a dramatic decrease in Menlo Park's sales tax revenue, which is down more than 50% from its 2000-01 level of \$13 million; revenue takeaways as the State struggles to balance its budget; and large increases in pension costs due to changes in benefit levels and statewide retirement system investment losses. (Graphs of total revenues versus expenses and sales tax revenues over time can be found in Attachments B and C, respectively.)

Some analysts have referred to the current fiscal environment as local government's "perfect storm." At the same time that revenues have become more scarce, the cost of providing City services (70% of which is personnel) has increased. While the number of full-time equivalent (FTE) employees in Menlo Park has gone down 13% over the past four years, total personnel costs have increased 22% due to increased health care and retirement costs.

In response to this challenging fiscal environment, the City of Menlo Park has had to ratchet down its spending each successive year, often reopening the adopted budget during the fiscal year in order to update estimates and make further adjustments. Attachment D identifies the different measures taken to close the gap between revenues and expenses. In total, over the past four fiscal years, the City has trimmed its expenses by over \$4 million (approximately 15% of the City's annual budget) and reduced its workforce by more than 30 regular and part-time FTEs.

Last June, the City Council adopted the 2004-05 budget, which achieved balance through a combination of workforce reductions and other expense cuts, fee increases and a transfer from the General Fund Reserve. This budget was developed through an extensive process which included the revision of the City's mission statement, a community survey, a budget workshop in January and public meetings in April and May leading to the budget public hearing and adoption in June. The ten-year financial forecast presented during these meetings predicted that the use of additional reserve and special fund transfers would be required over the next several years until revenues returned to a sufficient level to cover operating costs. As described below, a revised ten-year forecast continues to show an imbalance between revenues and expenses in 2005-06 and beyond.

The purpose of this Budget Workshop is to kick-off the budget process for the 2005-06 fiscal year, which will begin on July 1, 2005. In particular, staff will update the Council on the status of 2004-05 finances, review new ten-year revenue and expense projections and present a proposed process for adopting the 2005-06 budget and developing the budget for 2006-07. The focus at this time is the General Fund operating budget. A subsequent meeting on March 5 has been planned for Council to consider the ranking of project priorities.

ANALYSIS

Fiscal Year 2004-05 Update

All budgets are a compilation of best estimates in the form of revenue predictions and planned expenditures. The budget adopted in June 2004 was based on the most current information that was available at that time. The Council was in the unenviable position of having to approve a budget without having year-end numbers for fiscal year 2003-04, without knowing for certain what the State was going to do and with all four labor contracts set to expire in the first half of the coming year.

In the time since the 2004-05 budget was adopted, the 2003-04 fiscal year has been closed providing updated information about the City's revenue base, labor agreements have been approved and six months of actual revenues and expenses have accrued. Consequently, the Budget Workshop provides an opportunity for staff to make any warranted updates to the 2004-05 budget.

The adopted budget and revised projections for 2004-05 are shown in the first two columns of Attachment A. As seen in these columns, both revenues and expenses are now expected to be higher than originally budgeted.

Projected revenue has increased by \$1.37 million. This projection is based on the following factors:

- A one-time \$462,000 increase in property tax due to an unanticipated refund of funds previously taken from the City through ERAF transfers.

- A modest increase in both property tax (net of the first of the two \$515,000 per year State take-aways enabled through Proposition 1A) and sales tax receipts. For both property and sales taxes, actual receipts in 2003-04 were higher than expected and exceeded the amount budgeted in 2004-05, resulting in the revised projection.
- A higher than anticipated mid-year Vehicle License Fee transfer from the State.

The expense projection has increased by \$402,000 which reflects the net effect of the additional costs associated with the recently approved labor agreements and the savings associated with a few vacant positions during the first six months of the year.

As a result of the above changes, an approximately \$1 million improvement in the City's fiscal position is projected. In other words, the transfer from the General Fund Reserve is now anticipated to be \$2 million, rather than \$3 million as stated in the adopted budget.

Revised Ten-Year Forecast

Historically, the City has been well served by its financial management practices. The City estimates its revenues using fairly conservative assumptions and plans for expenditures knowing that prudent management often results in less being spent than is appropriated. The following provides some highlights of the assumptions that have been used in developing the ten-year projections shown in Attachment A:

- Throughout the forecast period, the property tax base is projected to grow at 5% per year. This compares to an historic average annual property tax growth in Menlo Park of approximately 7%. In addition, there are some year-to-year fluctuations due to variations in State takeaways. In 2005-06, there will be a reduction in property tax revenue since the \$462,000 ERAF refund paid to the City in 2004-05 was one-time. Also in 2005-06, the \$515,000 State Prop 1A takeaway will continue for the second of two years. Starting in 2006-07, this amount will no longer be subtracted by the State from the property tax base, resulting in a bump up in City property tax revenue.
- Sales tax revenue is projected to increase 4% for the remainder of the forecast period. While this amount may seem conservative compared to sales tax growth rates in the late 1990s, it is considerably more optimistic than the City's most recent history which has seen sales tax losses of 29%, 13% and 10% in 2001-02, 2002-03, and 2003-04 respectively. Staff feels that the projected return to positive sales tax growth is warranted based on sales tax receipts in the first quarter of 2004-05 and a modest overall improvement in disposable income and the business climate. Sales tax revenue assumptions are based on current major sales tax generators, i.e. it is assumed that existing ones stay in place and new ones are not added.
- Intergovernmental revenues are projected to grow at 1.8%, except for an increase in 2006-07 and a subsequent decrease in 2007-08 due to the one-time re-payment by the State of a portion of the Vehicle License Fee revenues diverted by the State and promised back as a "loan repayment."

- Personnel expenses in 2005-06 are based on the remainder of the two-year labor agreements entered into early this year. Possible future contract changes for the remainder of 2006-07 and beyond are not specifically included. For forecasting purposes, a general factor for cost inflation of just under 3% per year is included. Required payments into the Public Employee Retirement System (PERS) are built in, based on the latest estimates provided by CalPERS. These payments are expected to stabilize beginning in 2007-08, in that staff does not anticipate a continuation of the significant annual increases the City has experienced the last three years.
- Operating Expenses, Payments for Services and Transfers Out for Workers Compensation and Liability are assumed to increase at 3% per year. This reflects recent inflation rates, but is less than the historical average of 4% inflation per year. In anticipation of the reopening of the Burgess Pool, associated personnel and operating costs have been added back starting with a half-year of expense in 2005-06 and full-year funding thereafter.
- Transfers Out also include contributions to infrastructure maintenance and improvements. As directed by Council, \$2 million was transferred in the adopted 2004-05 budget to capitalize a five-year infrastructure maintenance plan. The current ten-year projection does not dedicate additional funds for infrastructure for the next four years. Starting in 2009-10, the forecast includes a \$1 million transfer per year for infrastructure. This allows time for the strengthening of the City's financial position, yet results in a significant deferral of critical street pavement and other infrastructure maintenance needs. Hence, in this instance the City faces a trade-off and inter-relationship between its fiscal and physical condition.

Using the above assumptions, the ten-year forecast predicts a \$812,000 shortfall between revenue and expenses in 2005-06. An annual shortfall then continues until 2012-13, at which time the City would once again be in the black. Staff currently projects a positive net revenue in 2006-07 due to the anticipation of the State's repayment of the Vehicle License Fee "loan" taken from the City. If the State did not follow through on this commitment, there would be a deficit of \$383,000 in 2006-07. The total cumulative shortfall from 2004-05 through 2011-12 is currently projected to be \$4.5 million.

Different Approaches for a Return to Balance

There are several typical strategies used by governments to address budget imbalance. These strategies include accounting maneuvers, deferring expenses, borrowing, across the board reductions, ad hoc cuts and fee increases. During the past four fiscal years, Menlo Park has used a combination of these strategies to bridge the gap between revenues and expenditures. A chart summarizing the actions taken by the City since 2001-02 along with the impacts of these actions can be seen in Attachment D.

While such strategies may work in the short-term, they cannot be used indefinitely. Consequently, they are less effective in achieving a sustainable solution when the

problem is structural in nature. As previously mentioned, staff foresees another six years of revenue shortfalls. Staff has identified three possible approaches to address this ongoing situation: 1) Continued ad-hoc/across the board cuts; 2) Substantial reliance on the Reserve; or 3) Ground-up focus on priorities. Each of these approaches is described below.

Continued Ad-Hoc/Across the Board Cuts

In this approach, the City Manager sets a savings target and departments are directed to review all programs and services to identify potential cuts. The City Manager decides on and presents a mix of cuts to the City Council at a public hearing. Impacted constituents comment and the City Council directs any desired changes and ultimately approves the budget. This approach tends to work when the gap between revenues and expenses is relatively small and/or not ongoing.

The advantages to this approach are that it:

- Encourages all programs to improve efficiency and identify avoidable expenses
- Spreads the burden among constituent groups
- Avoids/delays hard decisions, such as the complete elimination of certain services

The disadvantages to this approach are that it:

- Is hard to replicate each year and therefore does not solve structural budget problems
- Under-funds all services, reducing performance across the board (“thins the soup”)
- May allow undue influence from vocal interest groups

As Attachment D shows, the City has made cut backs in every department over the past four years. While these cuts have not been strictly “across the board,” staff has attempted to maintain as full a level of service as possible within most service areas. In identifying cuts, staff has been strategic and has worked to minimize the impact to the customer. With each passing year, however, this has become more difficult. Staff believes that it will not be possible to continue using this approach as the primary means to balance the budget each year until 2012-13 when revenues and expenses are expected to return to balance. Staff believes the City will soon reach the point where continued incremental cutbacks (e.g. reduced operating hours, decreased service frequency, increased turn-around time, etc.) either cease to produce sufficient savings or result in services that do not meet customer needs and are not worth delivering.

Substantial Reliance on the Reserve

In this approach, staff would estimate the cumulative deficit until the budget is projected to return to balance and the Council would set aside this amount to fund ongoing operations. At this point, the total deficit projected over the next seven years is \$4.5 million. This type of approach works well if the size of the Reserve is sufficient to cover the shortfall, as well as the other uses for which the Reserve is intended, and if there is sufficient certainty that the deficit will not be worse and/or the other demands on the Reserve will not be greater than projected.

The advantages to this approach are that it:

- Uses the City's savings as a bridge between revenue and expense until revenues return
- Avoids severe cuts in services and workforce that would negatively impact the community and the functioning of the organization
- Allows staff to focus on the provision of services rather than the challenge of a perpetual budget-cutting process

The disadvantages to this approach are that it:

- Reduces the amount of Reserve funds available for other uses, such as infrastructure maintenance, new capital projects, etc.
- Could deplete the Reserve below levels necessary for the City to address emergency situations or other legal obligations
- May only delay the need for serious cuts, if revenue and cost projections turn out to be wrong and the anticipated return to balance does not occur
- Threatens to deplete the Reserve significantly, thus reducing income from investments, which would further exacerbate a negative budget picture

As mentioned above, the adopted 2004-05 budget did include some use of the Reserve. Staff believes that prudent use of the Reserve as part of a broader, long-term strategy to balance the budget makes sense. Yet, staff takes seriously the duty of management and the Council to safeguard the City's fiscal resources in order to serve the public and meet its legal, fiduciary obligations. Given the consequences of a sustained deferral of street and other infrastructure maintenance, staff believes the City should strive to include annual contributions to infrastructure projects. In addition, staff is aware that the impact on the Reserve could become much more substantial if sales tax revenue does not return as anticipated, State budget balancing measures result in declines in local government funding, or other revenue losses are suffered. Consequently, staff does not recommend use of the Reserves as a stand-alone strategy for achieving balance during each of the next several years.

Ground-Up Focus on Priorities

In this approach, staff and the Council would identify community priorities and develop a budget from the ground up that is designed to address these priorities effectively. The public's willingness to pay for services would also be assessed so that opportunities to develop new funding streams and resource constraints are fully understood. This approach looks at all policy areas and services and focuses on what the City decides to "keep" rather than what it decides to "cut." A comprehensive assessment is done to determine if services can and should be re-engineered. This approach works well when other avenues have been exhausted and a structural imbalance problem is expected to continue.

The advantages to this approach are that it:

- Focuses the City on its priorities and ensures that these are being done well
- Uses a comprehensive process to identify where significant reductions can be made

- Builds community support for cuts (or for increased fees or taxes) by seeking public input and by being clear about what is being funded, not just what isn't
- Increases public trust in/support for government by providing more information about government's ability to use tax dollars wisely and thriftily

The disadvantages to this approach are that it:

- Requires difficult decisions and an openness to significant changes, including the discontinuation of services and changes in the way services are provided
- Involves a long process, requiring a great deal of staff, Council and community time

Staff believes the "Ground Up Focus on Priorities" approach has advantages over an approach that either tries to make ends meet with yet another round of incremental cuts or solely relies on the Reserve. Therefore, staff recommends use of this approach to facilitate a return to long-term balance between revenues and expenses. This approach provides the information necessary to find a structural solution to the City's structural budget gap. It answers the question, "What outcomes are most important and how can we spend limited resources to get them?" rather than simply the question of "What programs can we cut?" Regardless of where sales tax and other revenues end up, the process of identifying priorities will tell the City what should be "above the line" and therefore get funded. Using such an approach facilitates strategic, explicit decision-making, achieving a comprehensive, long-term solution that often cannot be reached through successive rounds of incremental cuts.

Proposed Budget Process

Since the ground up approach is a significant departure from the process used during the past several years, and since deep strategic change takes time, staff recommends that:

- The 2004-05 budget be essentially carried over into 2005-06
- A year long process of community outreach and service evaluation be undertaken in preparation for the development of a ground up budget in 2006-07

A summary of the process and timeline for the 2005-06 and 2006-07 budgets is included below.

FY2005-06 Budget Process and Timeline

The normal process of building next year's budget would entail setting savings targets based on revenue estimates. The City Manager would explicitly state the assumptions to be used and give direction to the departments. Staff members throughout the organization would then carefully examine each program and service to determine which services are to be recommended at current levels and which would be proposed for cuts.

This year, staff recommends a different more streamlined approach. Staff does not foresee changes in the near-term that will substantively affect the current forecast relative to the gap between revenues and expenditures. In order to maintain services

substantially intact, the Council will need to utilize approximately \$812,000 in General Fund reserves to balance the budget in FY2005-06.

In essence, staff is recommending a “hold-over” approach to next year’s budget, with its commitment to continue to look for further cost savings resulting from attrition and increased operating efficiencies. In order to focus the necessary staff resources and Council attention on an entirely new approach to budgeting for fiscal year 2006-07, as outlined in the next section, staff proposes an accelerated timeline resulting in adoption of next year’s FY2005-06 Budget in May as follows:

February 2005	Council Budget Workshop
March 2005	Council Project Priority-Setting
April 2005	Council Master Fee Schedule
May 2005	Council FY2005-06 Budget Adoption

FY2006-07 Budget Process and Timeline

Staff recommends an entirely new approach to developing the City’s budget for FY2006-07. In order to build the budget “from the ground up” and with full community participation and regular Council input, staff has developed a process that spans the next 12-15 months. During this period, every City service and result measure will be examined in light of documented community priorities and willingness to pay. Rather than continue to focus attention on the “cuts”, the new approach and emphasis is on the “keeps”; namely, determine those services to be provided by the City of Menlo Park that are necessary to achieve the results or outcomes identified by the community.

First, staff proposes that a five-step process of building the FY2006-07 begin in April 2005 with a rigorous assessment of the economic conditions facing the City of Menlo Park in light of the current state-local financial structure in California. This information will be presented to the community in workshops intended to educate residents about the serious long-term structural budget issues that preclude further reliance on short-term, stop gap solutions.

The second step is to determine in specific terms what the community is willing to spend for government-provided services. It is clear that there is a limit above which people are unwilling to pay more, irrespective of whether it is in the form of a tax or a special purpose fee. A community survey will enable Council to make informed decisions about various options that are available to augment existing revenues. The timing would be planned to allow for consideration of potential ballot measures as an option.

Once the “price of government” has been set, the third step is to clearly set the priorities for the City in terms of desired results or outcomes and with clear indicators of success or metrics. The establishment of community priorities would, of course, involve resident input.

Next, the fourth step is the allocation of available resources, as defined in step two, to the priorities set in step three. If where the line is ultimately drawn results in too severe

a reduction in services, then the choice becomes how to augment what is available either through revenue raising (taxes and/or fees) or future transfers. The fifth and final step is to then layout a detailed “purchasing plan” or budget for each planned outcome (result) that delineates precisely how much is to be spent.

In addition to community outreach and regular Council updates on meeting agendas, staff proposes that a Council subcommittee of two members be designated to work with staff on a weekly basis. The subcommittee would serve as a sounding board for ideas related to citizen participation strategies, participate in community outreach efforts, work with staff on interpreting feedback, and analyze service-level costs, revenues and results measures. The commitment of time would be substantial over the next year.

April 2005	Community Survey and Outreach
June 2005	Council Direction on Expenditure Levels
August 2005	Council Identification of Service Priorities
November 2005	Council Service-Level Allocations
February 2006	Council Budget Workshop
March 2006	Council Project Priority-Setting
April 2006	Council Master Fee Schedule
May 2006	Council Budget Public Hearing
June 2006	Council FY2006-2007 Budget Adoption

Next Steps

This new approach requires an almost immediate focus on the long-term financial health of the City. In order to undertake the comprehensive process of defining sustainable service priorities, staff is recommending an abbreviated process leading to the adoption of a “hold-over” budget for FY2005-06. On Saturday, March 5, the Council will discuss and rank its project priorities. In April, the Council will approve the Master Fee Schedule. Then in May this year, the Council will be in a position to approve the Budget for the coming 2005-06 fiscal year.

Commencing in April 2005, the staff and Council will launch the new “focus on priorities” budgeting process of building the FY2006-07 Budget from the ground up. The new process will take approximately one year, with preliminary recommendations for Council review in early 2006, and following the normal budget adoption timeline through June.

Prior to the kick-off of the process, staff will return to Council with a more detailed workplan, a request for an appropriation of funds for a community survey and outreach and the appointment of two Council Members to serve as a budget committee.

IMPACT ON CITY RESOURCES

Ultimately, the choices that the City Council makes about service levels and projects will determine where City resources are budgeted. The budgeting process for FY2005-06 as proposed, leading to adoption in May, represents a change from past practice. The goal is to recognize that real choices in the short-term are limited and that to take a more comprehensive, bottom-up approach will require additional time, effort and focus.

POLICY ISSUES

Embedded within its service levels and project priorities reflected in the adopted budget are the goals and policies of the City Council.

David Boesch, City Manager

PUBLIC NOTICE: Public Notification was achieved by posting the agenda, with this agenda item being listed, at least 72 hours prior to the meeting.

ATTACHMENTS

- A. Ten-Year Financial Forecast ([Attached](#))
- B. Graph of Total Revenues and Expenses ([Attached](#))
- C. Graph of Sales Tax Revenue ([Attached](#))
- D. Summary of Budget Balancing Measures and Impacts
([Attached](#)) ([Attached](#))