



## **CITY OF COLTON**

### **City Hall**

650 N. La Cadena Drive  
Colton, CA 92324

Website: [www.coltonca.gov](http://www.coltonca.gov)

**Mayor Richard A. DeLaRosa**

**Council Members:**

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Ernest R. Cisneros – District 2

Frank J. Navarro – District 3

Dr. Luis S. González – District 4

Jack R. Woods – District 5

Isaac T. Suchil – District 6

City Treasurer Aurelio De La Torre

City Manager William R. Smith

City Attorney Carlos Campos

City Clerk Carolina R. Padilla

## **AGENDA**

### **SPECIAL MEETING**

#### **CITY COUNCIL,**

**SUCCESSOR AGENCY TO THE REDEVELOPMENT AGENCY FOR THE CITY OF COLTON,**

**COLTON UTILITY AUTHORITY, COLTON PUBLIC FINANCING AUTHORITY,**

**COLTON HOUSING AUTHORITY**

#### **REGULAR MEETING**

**TUESDAY, MAY 29, 2018 - 5:00 P.M.**

### **COUNCIL CHAMBER**

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Said Special Meeting shall be for the purpose of studying and/or taking action on the following matters:

#### **OPEN SESSION**

**5:00 P.M.**

**OPEN SESSION CALLED TO ORDER**

**ROLL CALL**

**MAYOR AND COUNCIL ITEMS**

#### **GIFT DISCLOSURES**

*Prior to rendering a decision in any proceeding involving a license, permit, contract or other entitlement pending before the city council, any council member who has received been promised a gift or gifts aggregating \$50.00 or more in value within the preceding twelve months from a party or participant in the proceeding shall disclose that fact either orally or in writing during open session. This disclosure shall be made part of the official public record of the proceeding, either as part of the minutes of the meeting or as a separate writing filed with the city. (CMC Section 2.04.030)*

**AB 1234 ORAL REPORTS**

*Members of the city council shall provide brief reports on meetings attended at the expense of the city. (GC Section 53232.3(d))*

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**PUBLIC COMMENT**

**Limit 3 Minutes**

*This is the portion of the meeting specifically set aside to invite your comments regarding Consent Calendar items and any matters within the jurisdiction of the City Council; however, any matter that requires action will be referred to staff for investigation and report at a subsequent Council meeting. The Council is prohibited by law from discussing or taking immediate action on items during this public comment period.*

*Persons desiring to submit paperwork to the City Council Members shall provide copy of any paperwork to the City Clerk for the Official Record.*

*Speakers will be limited to 3 minutes; provided, however, that the presiding officer shall have certain discretion to extend or limit time as provided for in the City Council Manual of Procedure.*  
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**DISCUSSION ITEMS**

- (1) Informational Report on General Fund Fiscal Stability and Recommendations for Financial Sustainability Report by Urban Futures, Inc. **[Staff Person: S. Dabbs]**

**ADJOURNMENT**

**POSTING STATEMENT:**

I, Dawn Miller, Deputy City Clerk or my designee, hereby certify that a true and correct, accurate copy of the foregoing agenda was posted Thursday, May 24, 2018, at least twenty-four (24) hours prior to the meeting per Government Code 54954.2, at the following locations:

City of Colton City Hall 650 N. La Cadena Drive  
City of Colton Website, [www.coltonca.gov](http://www.coltonca.gov)

**PROCEDURES FOR ADDRESSING CITY COUNCIL**

For the Official Record, it is requested that you obtain a card from the City Clerk and complete it by noting a specific item number on the Agenda, if applicable, or you can identify the subject that you wish to address under the Public Comment portion of the Agenda. The City Council encourages public input on all City issues within the Rules of Decorum. Speakers will be limited to the time periods provided on the Agenda; provided, however, that the presiding officer shall have certain discretion to extend or limit time as provided for in the City Council Manual of Procedure.

## **RULES OF DECORUM**

To help conduct the business of the City Council in an orderly fashion, the City Council has adopted rules pertaining to decorum and order, as provided for in the City Council Manual of Procedure. The City Council will strictly enforce these rules in order to allow full expression of ideas and opinions by councilmembers, staff and the public. Generally, the City's rules of decorum prohibit comments or actions which willfully disrupt the meeting. All remarks and questions shall be addressed to the Council as a whole and not to any particular member. No individual Councilmember or member of the City staff shall be questioned without first obtaining permission from the Presiding Officer. The City Council asks that all persons - including councilmembers, staff and the public - act and speak respectfully.

## **NOTICE TO PUBLIC**

Staff reports or other written documentation relating to each item referred to, on the Agenda, are available for public inspection at the following locations: Office of the City Clerk, 650 N. La Cadena Drive, Colton, CA; City of Colton Public Library, 656 9<sup>th</sup> St., Colton, CA; or the City of Colton Internet Website, [www.coltonca.gov](http://www.coltonca.gov). Any person having questions concerning any item on the Agenda may call the City Clerk at 370-5191 to make inquiry concerning the nature of the item described on the Agenda. The City Clerk shall direct inquiries to the appropriate office.

All matters listed under the Consent Calendar are considered by the City Council to be routine and will all be enacted by one motion. There will be no separate discussion of these items prior to the time the City Council votes on the motion, unless councilmembers, staff or the public request that specific items be discussed and/or removed for separate discussions or action.

In compliance with the American with Disabilities Act, if you need special assistance to participate in a City Meeting, please contact the City Clerk's Office at 909-370-5001. Notification 48 hours prior to the meeting will enable the City to make reasonable arrangements to ensure accessibility to this meeting.

## **LEGAL CHALLENGES**

If you challenge in court any discussion or action taken concerning an item on this Agenda, you may be limited to raising only those issues you or someone else raised during the meeting or in written correspondence delivered to the City at or prior to the City's consideration of the item at the meeting.

## **MANUAL OF PROCEDURE**

The City Council adopted its Manual of Procedure (MOP) pursuant to Resolution No. R-150-07; Amended by Minute Action on December 2, 2014 and adopted by Resolution No. R-03-15 on January 20, 2015. The MOP was amended by Minute Action on April 17, 2018 and adopted by Resolution No. R-41-18 on May 15, 2018. Copies are available in the Office of the City Clerk.

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## STAFF REPORT

DATE: MAY 29, 2018  
TO: HONORABLE MAYOR AND CITY COUNCIL MEMBERS  
FROM: BILL SMITH, CITY MANAGER  
PREPARED BY: STACEY DABBS, FINANCE DIRECTOR *SMD*  
SUBJECT: INFORMATIONAL REPORT ON GENERAL FUND FISCAL STABILITY AND RECOMMENDATIONS FOR FINANCIAL SUSTAINABILITY REPORT BY URBAN FUTURES, INC.

### BACKGROUND

At the March 20, 2018 City Council meeting, Finance Department staff presented an informational report on fiscal strategies to maintain City service levels and to address the sunset of Measure D. The report addressed the various challenges affecting the City's long-term financial sustainability and explored several revenue options to replace Measure D. Additionally, through the FY17/18 mid-year budget review process, the Finance Committee recommended the inclusion of funding for a consultant to evaluate the City's options for financial sustainability through revenue measures and expenditure reductions. On April 3, 2018, City Council approved a Professional Services Agreement with Urban Futures, Inc. to: 1. Establish a ten-year baseline financial forecast model for the General Fund and 2. Provide a revenue and expenditure analysis, which identifies opportunities for revenue restructuring and/or ballot measure options as well as an assessment of General Fund expenditure categories.

### ISSUES/ANALYSIS

The report outlines a summary financial forecast for the City's General Fund by first developing a summary baseline financial forecast of the General Fund. The baseline forecast makes certain assumptions and does not assume a recessionary period. Additionally, the consultant stress-tested the baseline forecast by applying a mild recessionary period to evaluate the impact, or volatility, of General Fund revenues. Further, revenue replacement measures were clearly examined to close the anticipated budget deficit absent Measure D. Among the recommendations for structural and service solvency, include adopting labor cost containment strategies, implementation of strong core financial policies, priority-based budgeting, and develop and maintain a Comprehensive Asset Management Program.

Given the assumptions prepared within the report, which include the anticipated increases to the General Fund's portion of the City's pension obligation and the loss of Measure D revenues at the conclusion of Fiscal Year 2020-21, absent any substantial changes the City will become budget insolvent beginning in Fiscal Year 2021-22 and cash flow insolvent in Fiscal Year 2023-24. The

report concluded that, “In order to achieve fiscal stability of financial sustainability for the General Fund, the City will need to take bold, decisive action to implement changes.”

### **FISCAL IMPACTS**

The General Fund stability and recommendations to ensure the long-term financial sustainability of the City are discussed at length in the report.

### **ATTACHMENTS**

1. Report on General Fund Fiscal Stability and Recommendations for Financial Sustainability prepared by Urban Futures, Inc.



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Public Finance Group

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# City of Colton

## REPORT ON GENERAL FUND FISCAL STABILITY AND FINANCIAL SUSTAINABILITY



Urban Futures, Inc.  
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## **I. INTRODUCTION**

In February 2016, the City Council of the City of Colton (“City”) approved placing a local initiative on the ballot to increase from 12.39% to a maximum of 20% the amount of surplus electric utility revenue the City Council may annually transfer to the General Fund (“Measure D”). Measure D was approved by 76.2% of the voters in June 2016 and was implemented beginning in fiscal year (FY) 2017. Measure D sunsets at the conclusion of FY 2021.

At the 20% threshold, the additional annual transfer from the Electric System Surplus Revenue Fund to the General Fund (“GFT”) is approximately \$4.8 million. With the sunset of Measure D at the end of FY 2021, the City’s General Fund faces a sudden decline in revenue of approximately \$4.8 million annually. Additionally, like most cities in California, the City is facing steep increases over the next five to seven years in its annual pension obligations due to a multitude of factors discussed in this report.

Urban Futures, Inc. (UFI) was engaged by the City to provide a high-level assessment of the fiscal health and stability of the City’s General Fund in light of foregoing considerations, and to provide recommendations for actions that address the fiscal impacts from the sunset of Measure D and improve the General Fund’s long-term financial stability. To prepare this report and analysis, UFI worked with city staff in the Finance Department and relied on the City’s historical data, published financial documents, CalPERS reports and projections, comprehensive annual financial reports (CAFR), and the City’s labor costing data. UFI also used the data to develop a very summary baseline ten-year financial forecast for the General Fund.

The results of the forecast and analysis, along with the development of findings and recommendations, is presented in this report for use by city staff and elected officials. This report provides measurements and findings as to the General Fund’s fiscal health (based on the forecast) and recommendations for financial and operational changes that can improve the solvency and sustainability of the General Fund.

## **II. SUMMARY FINANCIAL FORECAST FOR GENERAL FUND**

### **A. Development of a Summary Baseline Forecast**

We began our engagement with building a summary high-level ten-year baseline financial forecast for the General Fund (“Baseline Forecast”). Given the time constraints with the engagement, the Baseline Forecast developed for this report and analysis was not the typical financial forecast model UFI builds from a city’s general ledger and chart of accounts (a process of several months) which can be used for ongoing decision-making and financial impact assessment. Instead, the Baseline Forecast UFI developed for this report is intended to serve as an initial assessment tool of the General Fund’s fiscal stability and to provide a basis for making

recommendations upon which the City Council can take immediate action to address its known financial challenges from the sunset of Measure D.<sup>1</sup>

A “baseline forecast” is designed to be a politically neutral, fiscal assessment that establishes an agreed-upon common understanding of the status quo: if the city makes no changes to its organization or operations, and there are no significant external economic impacts to the city, what is the predicted financial condition of the General Fund over the next ten years? Working with staff, we collected the necessary data required to summarily understand, aggregate and model the rolled-up budget revenue and expenditure categories for the City’s General Fund. We worked to ensure a general level of reconciliation between the financial data as reported in the rolled-up budget categories and the financial data reported for the General Fund in the City’s CAFRs. We also looked to isolate one-time revenues that can distort an accurate picture of the current financial position of the General Fund, and to disaggregate several general expenditure data categories that contain costs driven by different inflationary indices.

Next, we developed and applied variables and indices for each general budget revenue and expense category to enable the Baseline Forecast to produce a very summary ten-year projection of the General Fund’s baseline financial condition given its current structure, operations, service delivery methods, debt structure, future obligations and fiscal realities. Finally, UFI developed several graphical outputs of basic measurements and metrics that help to tell the story of the General Fund’s projected financial condition in understandable terms to policy-makers, stakeholder groups and the general public.

## **B. Key Assumptions in Baseline Forecast**

The following are key assumptions for purposes of understanding the Baseline Forecast and the analysis that follows in this report. These assumptions are explained in detail because they either (1) contain some inherent risks or unknown factors that are not accounted for in the Baseline Forecast, that if true, could significantly impact the City’s future financial condition and solvency, and/or (2) assume a status quo condition that may be untenable over the forecast time period. While these assumptions can be “stress-tested” through in the model (as explained below), the City needs to be fully aware of these dynamic factors and inherent risks:

- **Revenue and expense assumptions in the Baseline Forecast are considered moderate.** The indices and variables used to drive the various categories of General Fund revenues and expenses are primarily derived from regional economic indicators, adjusted where

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<sup>1</sup> UFI would strongly recommend the City consider developing a financial forecast model that can be continually updated with the capacity to adjust assumptions and variables, and to iterate various future scenarios or potential decisions. A long-term financial forecast model would enable to the City to conduct rigorous fiscal analysis and provide immediate feedback on the short-and long-term impact of strategic choices and operational decisions, and to engage stakeholders and decision-makers in quantitatively-supported discussions and consensus-building exercises that help the City address any structural operating deficit and/or future financial obligations.

appropriate for the City's own revenue and expense history (if there was strong correlation between the data and trendline) or other local considerations. Under or over performance of the regional, state or national economy can affect these assumptions.

- **The Baseline Forecast does not assume any recessionary period over the ten years.** There is no rational method to accurately predict the timing, magnitude, duration and consequence of the next economic contraction or recession and the impact to various local revenue streams. Recessions, however, are cyclical and have occurred on average every 6.5 years since 1928. Recessions occurring after 1945 have peak-to-trough declines in the Gross Domestic Product (GDP) ranging from a low of 0.3% to the Great Recession's 4.3% decline, with an average of 2.21%. These declines have had varying impacts on local government revenues (and expenditures). Some revenues like the sales tax (monthly revenues, trued-up quarterly) reflect an immediate impact, while others like the property tax (with an annual lien date) have an effective one-year lag in recognizing economic impacts. For long-term liabilities like pensions or adjustable debt, the full impact can take even longer to appear because of amortization or "ramping" provisions. While the Baseline Forecast does not contain a recessionary assumption, it is prudent to expect there will likely be some period of economic contraction during the ten-year forecast period. As such, we did model a mild recessionary period for purposes of "stress-testing" the General Fund's fiscal stability which is discussed below.
- **Revenue and expense assumptions in the Baseline Forecast become less reliable in years three to five and are simply trend-based predictions or static constants in years five through ten.** Most economists are reticent to look much beyond 24 to 36 months in their fiscal predications about the factors that drive the economy and the impact to local revenues and expenses. Many economists refuse to make assumptions beyond 12 months. Despite these reluctances among researchers and academia, it is imperative for cities to develop and maintain long-term financial forecasts because government organizations have historically proven to be unable of effectuating substantive fiscal change or reform in the near-term (two to three years). Fiscal change, either through revenue augmentation, expenditure reduction or organizational restructuring, often takes years to accomplish and see the financial results. Thus, it is important for cities maintain a long-term financial perspective when making strategic decisions, so slower moving changes can be fully implemented before fiscal cliffs are reached.
- **The Baseline Forecast assumes no salary increases or benefit adjustments during the ten-year period.** The salary growth assumption in the Baseline Forecast is set at 0% and all benefit levels are assumed to remain the same. The only adjustments impacting labor costs are inflationary effects to existing benefits such as increased costs for employer-provided health benefits or actuarial adjustments to pension and OPEB liabilities. This

allows the City to more clearly understand the impact of any proposed adjustment to employee compensation.

- **For City pension liabilities, the Baseline Forecast incorporates the six years of projected costs provided by California Public Employee Retirement System (PERS) but assumes a flattening or stabilizing of pension costs for the final four years of the forecast.** The most recent PERS actuarial reports provide cities with projected pension costs for six years. For Colton (as with almost all local government agencies in California), PERS projects significant annual increases over the next six years with the rate of increase diminishing slightly in the later years.

The City's pension is a "defined benefit" plan, which means when an employee retires, the retiree is entitled to receive the benefit for the remainder of his or her life (and survivor benefits if applicable). PERS is the administrator and trustee for the City's pension plan. The assets of the City's pension plan have a market value of approximately \$215 million that PERS invests and holds in trust for payment to retirees (beneficiaries). Because the City's pension is a defined benefit plan, PERS uses actuarial assumptions to ensure the plan has sufficient funds to pay all retirees their defined benefit. These actuarial assumptions are subject to change by action of the PERS Board to account for changing conditions which in turn affects the City's future contribution rates. In particular, the City should consider the following risks inherent in actuarial assumptions used for defined benefit pension plans:

- ✓ **Adopted Rate of Return (Discount Rate).** Pension contributions made by the City and its employees to the City's pension plan are invested by PERS, the trustee for the plan. PERS establishes an annual expected "rate of return" for its investment portfolio (also referred to as the "discount rate"). If actual returns on the PERS investment portfolio are lower or higher than the established rate of return, the loss or gain is realized by the City's pension plan through an amortization schedule that adjusts future contribution amounts over time (see below for amortization explanation). Higher than expected returns on PERS investments means lower future City contributions. Lower than expected returns means higher future City contributions. Between 2000 and 2012, the average annual return on the PERS investment portfolio was lower than expected. The resulting losses were amortized for all PERS plans and are a factor driving the sharp rise in contribution amounts over the next five years. As a result of this long-term experience, and to lower the risk of future losses, the PERS Board has steadily lowered its expected rate of return from 8.25% in 2000, to 7.38% currently and then to 7% beginning in FY 2019-20. Each lowering of PERS expected rate of return also increases the City's future contribution rates (while lowering the risk of future losses the City would be required to fund).

- ✓ **Longevity of Beneficiaries (Mortality Rate).** As noted above, the City’s pension plan provides a “defined benefit” for a retiree’s remaining life (plus survivor benefits if applicable). To ensure the City’s pension plan remains financially viable, PERS must make assumptions about the longevity of pension beneficiaries – how long PERS will be obligated to pay the defined retirement benefit to beneficiaries. This is often referred to as a “mortality rate.” Due to improving health outcomes and increasing longevity across population groups, PERS has needed to periodically adjust its mortality rate assumptions. Continuing increases to the longevity of pension beneficiaries means higher future City contributions.
- ✓ **Amortization Policy.** When actuarial assumptions used by PERS differ from actual experience (e.g., lower returns on PERS investment portfolio, beneficiaries living longer, etc.), the City’s pension plan and future contribution rates must be adjusted to account for the resulting gain or loss in plan value. To avoid sharp increases or decreases in City contribution amounts, and to improve long-term financial planning and overall stability, PERS “amortizes” any annual gain or loss over a defined period of time. Longer amortization periods reduce the volatility of City contribution rates but increase overall pension plan costs when there is a loss. Shorter amortization periods increase contribution volatility but reduce overall pension plan costs from losses. Recently PERS changed its policy to create a level amortization period of 20 years for future gains and losses (previously it was 30 years, with a five-year ramp up and down period). The new amortization policy goes into effect in FY 2021-22 and will increase the amount of future City contributions if there is a loss in plan value, but it will also reduce the overall cost to the City from that future loss.

### C. Stress-Testing - Mild Recession Scenario in FY 2021 to FY 2023

A baseline financial forecast is constructed to monitor typical risk outcomes of status quo conditions projected into the future. A baseline forecast is a statistical simplification of reality and is not intended to fully capture every element of future risk. Thus, a growing best practice is to incorporate with forecast models a mechanism for understanding the impact of possible future events (such as those discussed in the prior subsection) on the city’s future financial condition. This is often referred to as the capacity to “stress-test” the baseline forecast model by evaluating the impact on a city’s future financial condition from possible future events, scenarios or changes in key assumptions or variables.

Stress-testing techniques fall into two general categories: sensitivity tests and scenario tests. Sensitivity tests assess the impact of significant movements in assumptions or variables that drive the forecast model without specifying the reasons for such movements. An example would be evaluating the impact from potential fluctuations in the revenue and expenditure indices by a

hundred basis points in either direction. Scenario tests are constructed either within the context of a city’s specific experience (historical fluctuations in a particular revenue or expense categories) or possible future events (service-level or capital asset conditions that need addressing, potential adjustments in compensation, etc.), or in light of historical or possible future events that commonly affect cities across a region, state or nation (economic recessions, state budget adjustments, changes in PERS actuarials, etc.). Hybrid scenarios are commonly used to construct potential events that are informed by historical experience but customized to address a city’s particular circumstances, needs and projected future actions.

While UFI’s typical fully-developed forecast model contains a module that provides the opportunity to stress-test the baseline forecast with both sensitivity and scenario analysis, with the summary Baseline Forecast prepared for this report is very limited in this capacity. As such, UFI developed a very simplified recession scenario test that adjusted major forecasted General Fund tax revenues, and affected inflationary indices for expenditures, for a period in which GDP growth slows by half during FY 2021, followed by a net decline in GDP of 2% in FY 2022, with recovery during FY 2023. We used some generally applicable estimated tax buoyancy and error correction factors to determine the resulting impact on the City’s major tax revenue sources during this period.<sup>2</sup> The impacts of this mild recession scenario on the City’s financial future are discussed in Section III.

### **III. SUMMARY OF FINDINGS**

#### **A. Defining Fiscal Stability and Financial Sustainability**

A public agency’s inability to provide essential services is a strong indication of fiscal instability and possible fiscal emergency. As noted by the Governmental Accounting Standards Board (GASB), common themes that have been formalized or are working definitions of fiscal stability and financial sustainability include the ability to continue public services and/or existing programs. This comports with the definition of “financial condition” adopted by the International City/County Management Association (ICMA). In particular, ICMA defines a municipality’s financial condition as the ability to: (1) maintain existing service levels, (2) withstand local and regional economic disruptions, and (3) meet the demands of natural growth, decline, and change.

A primary goal of the City in commissioning this work is to stabilize the General Fund’s fiscal condition and develop increasing financial sustainability in the General Fund. Achieving these twin goals requires the City to recognize the impact of its near-term decisions on the long-term General Fund finances. Using guidance from GASB and ICMA, UFI evaluated the General Fund’s fiscal stability and financial sustainability on four basic measurements of solvency:

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<sup>2</sup> “Property, Income and Sales Tax Performance Through Economic Fluctuations,” by John E. Anderson and Lincoln Institute of Land Policy, December 15, 2015

- **Cash Flow Solvency (no fiscal stability).** Ability to generate sufficient cash over a 30- to 60-day period to meet obligations.
- **Budget Solvency (basic fiscal stability).** Ability within the normal budgetary period to (1) generate sufficient revenues to meet expenditures, (2) avoid an operating deficit and (3) maintain minimum operating reserve required to for annual cash flow requirements.
- **Structural Solvency (good fiscal stability and basic financial sustainability).** Ability over multiple years to (1) maintain basic municipal service-levels and recommended minimum reserve levels without incurring operating deficits, (2) fund long-term liabilities such as pension, retiree healthcare, etc., and (3) fund maintenance of existing capital assets (government facilities, infrastructure, equipment and networks) to ensure basic operational condition.
- **Service Solvency (good financial sustainability).** Ability over time to (1) achieve and sustain the municipal service-levels desired by the community to meet its goals, (2) set-aside sufficient funding for the replacement (asset recapitalization) or enhancement of public infrastructure and facilities desired by the community, and (3) adequately respond to changing community preferences and needs, including local and regional economic and environmental stresses.

#### **B. Cash Flow Solvency Findings (no fiscal stability)**

Cash flow solvency is not a measurement of fiscal stability. Instead, it is an indicator of an entity's proximity to a fiscal cliff that leads to a downward fiscal spiral from which the entity may not recover. The City's General Fund will likely conclude this fiscal year with a fund balance of approximately \$11 million, about half of which has been assigned for purposes of addressing the General Fund's growing pension and OPEB liabilities, and the balance of which remains unassigned and available for general purposes. Thus, the General Fund is currently cash flow solvent and adequately positioned in the short-run to pay its obligations when due and withstand some economic uncertainty in the near-term.

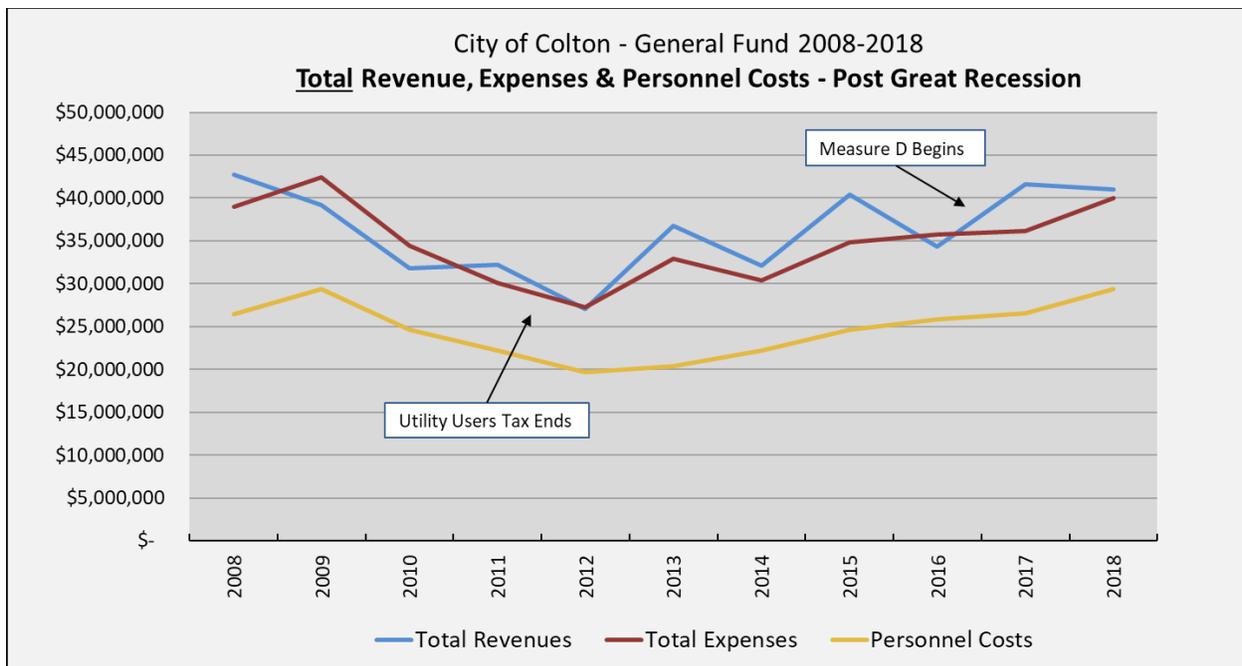
However, as discussed below, the Baseline Forecast shows the General Fund's current cash flow solvency increasingly deteriorating over the next six years due to two primary causes: the sunset of Measure D at the end of FY 2021 and rising pension costs. If no changes are made to reduce expenses or increase revenues in the General Fund, the General Fund is projected to become cash flow insolvent sometime in FY 2024.

#### **C. Budget Solvency Findings (basic fiscal stability)**

The Baseline Forecast reveals the General Fund will become budget insolvent within the next three fiscal years, and without substantial changes, the General Fund will remain budget insolvent for well-beyond the next ten years. The General Fund is facing a continuous significant

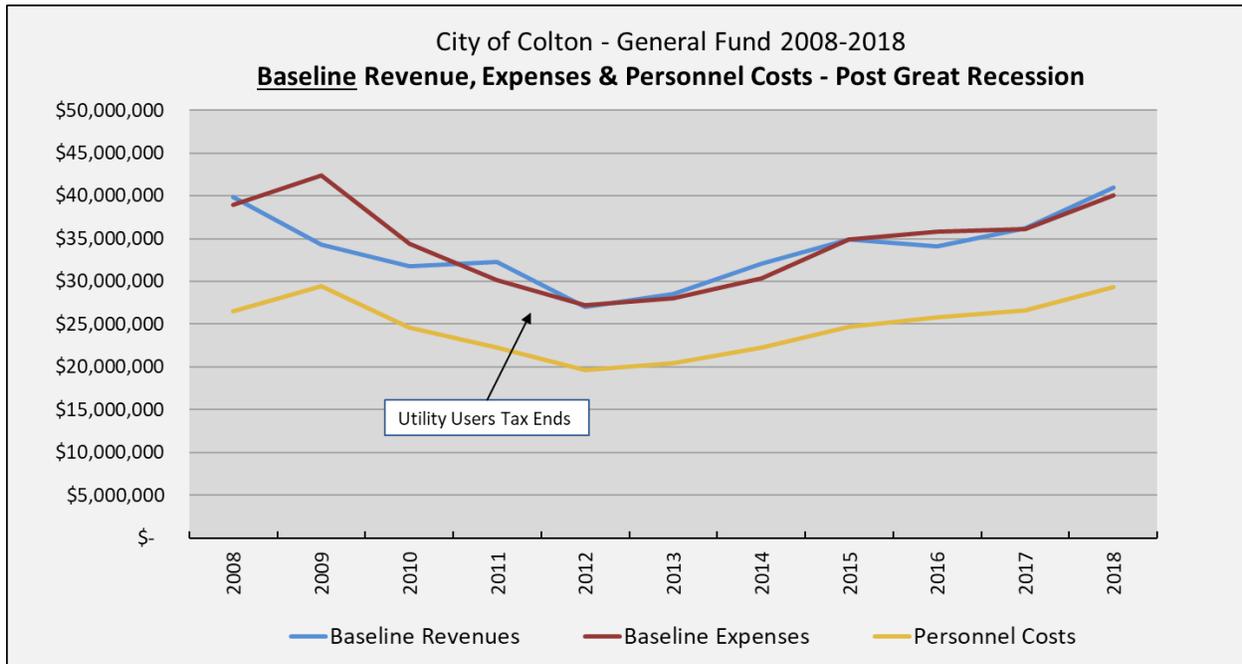
annual operating deficit of \$4 to \$6 million beginning in FY 2022. In other words, beginning in FY 2022 and continuing thereafter for the foreseeable future, assuming no changes, the General Fund is structured to spend \$4 to \$6 million more *per year* than it receives in revenue. At this rate, the General Fund will burn through its \$11 million in reserves in three years and likely become cash insolvent in FY 2024.

While baseline General Fund revenue levels have recovered from the Great Recession (2008 to 2011), annual revenue growth has slowed over the past several years from a high of 12% in FY 2014 to an expected growth of less than 1% for this fiscal year. The average annual growth rate for General Fund revenues during the last five years is approximately 5%. Fortunately, on other side of the General Fund ledger – expenditures – the growth rate has been roughly the same. Over the last five years the City has experienced an average annual growth in total expenses of 5.3%, roughly equivalent to the growth in revenues. Average annual growth in labor costs has been slightly higher at 6.4% over the past five years, but this is largely due to rising city pension costs (discussed below in detail). The data above is summarized in the following chart:

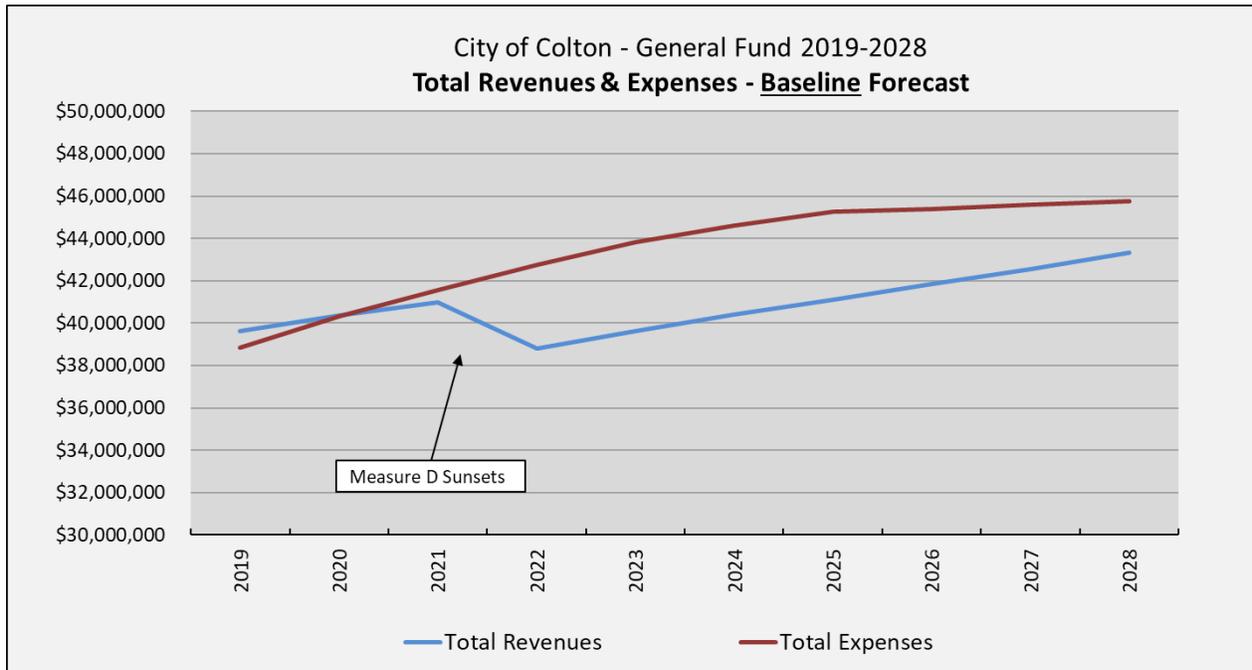


While the City has been able to maintain budget solvency in each year since FY 2012 (except one), it has relied on one-time and short-term revenues to maintain this solvency. In FY 2013 and 2015, the City received one-time revenues of approximately \$3.1 million and \$4.9 million respectively due to dissolution of the redevelopment agency and advanced wastewater facility lease payments. Additionally, in 2016, voters approved Measure D which increased the maximum authorized GFT for a period of five years, and in FY 2017 the General Fund began to realize the short-term increase in revenues of approximately \$4.8 million annually from the higher GFT. These one-time and short-term infusions of revenue in FY 2013, 2015 and 2017 can be visually

seen in the above chart and are responsible for the General Fund remaining budget solvent and developing a modest \$11 million reserve. If these one-time revenues and short-term revenues are removed, the General Fund’s financial condition looks much more precarious, constantly teetering on the edge of budget insolvency and unable to develop or maintain any reserves.



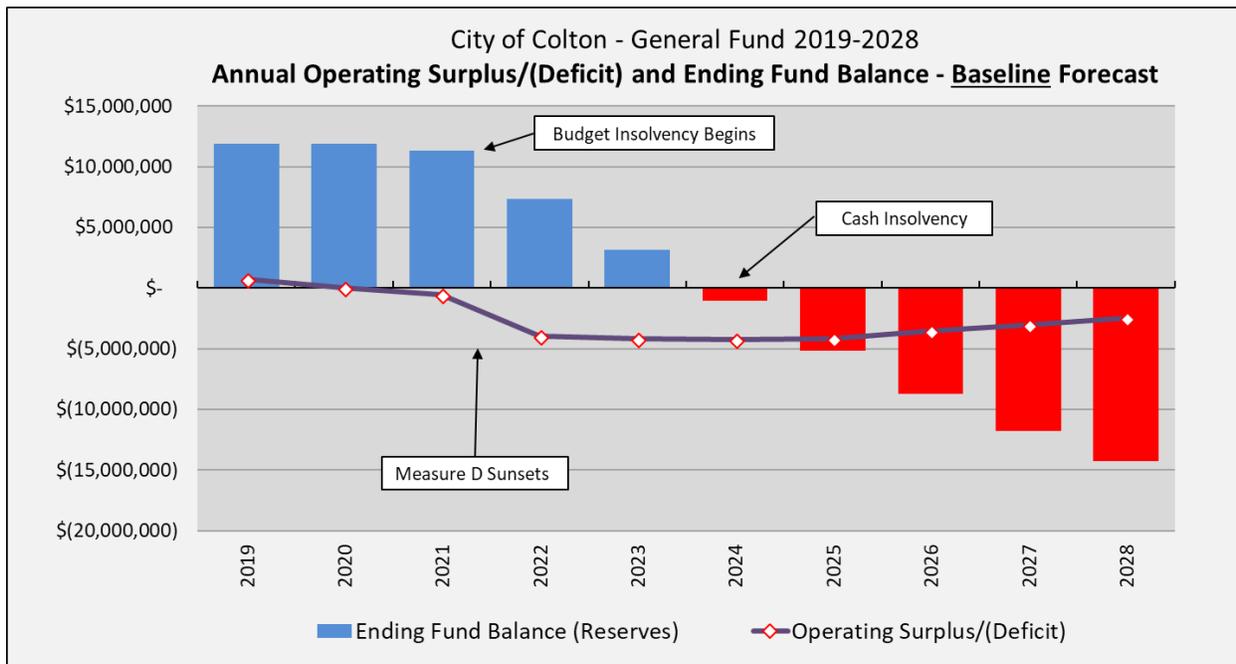
Use of one-time or short-term revenues to maintain budget solvency is a very precarious and fiscally unhealthy status quo. It is very unlikely the City will continue to periodically receive one-time revenues in the millions of dollars as occurred in FY 2013 and 2015. As discussed in Section IV, one-time revenues should never be relied on for operational costs, but instead should be used for one-time capital investments or augmentation of reserves. Similarly, while the use of short-term revenues like Measure D for operational costs may be temporarily acceptable, continued reliance creates a fiscal cliff that is virtually impossible to avoid because the increased baseline operational costs (staff, facilities and contracts) cannot be reduced fast enough when the short-term revenues end. The Baseline Forecast shows the City headed for this type of fiscal cliff in FY 2022 when Measure D sunsets. As shown in the chart below, the General Fund’s structural operating costs continue at current levels while the \$4.8 million in Measure D revenue abruptly stops.



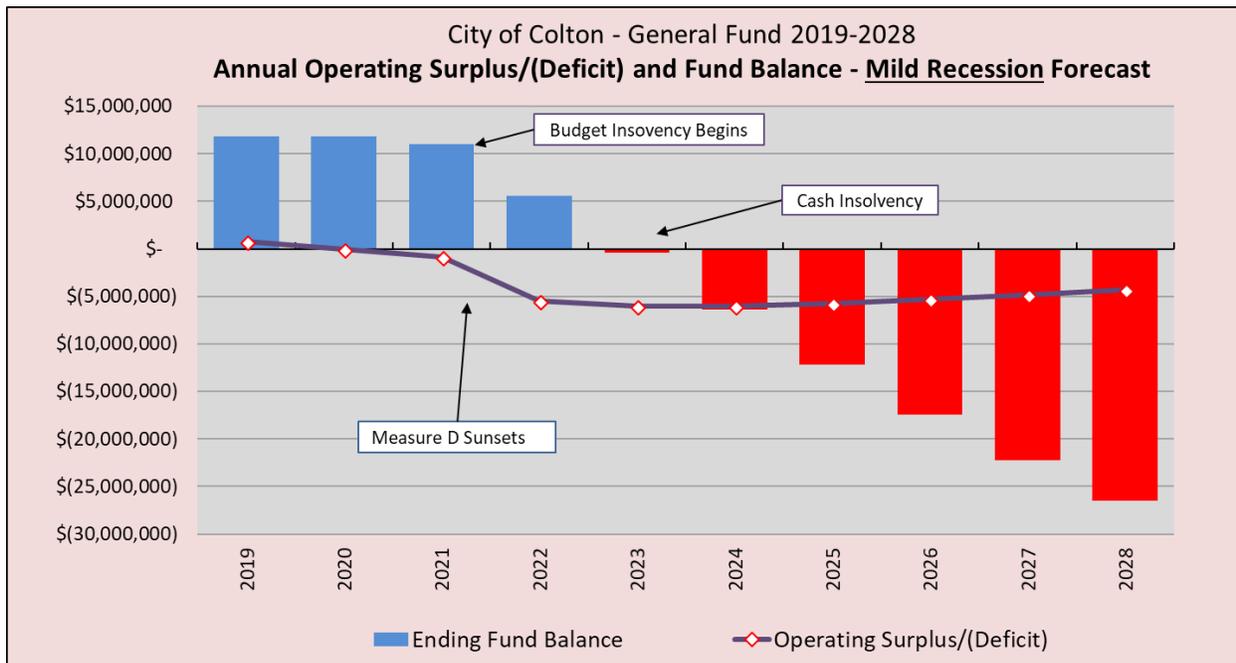
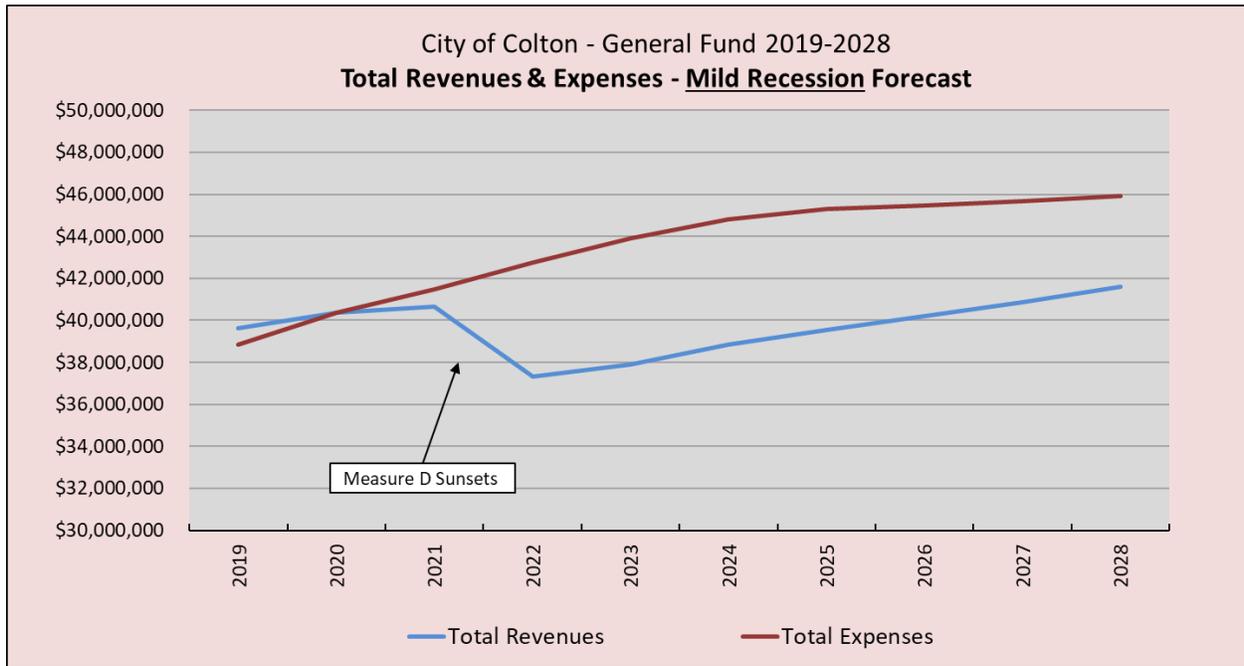
Because the fiscal cliff from the sunset of Measure D is steep and deep, an annual operating deficit of approximately \$4 million opens up in FY 2022 and plunges the City from budget insolvency to cash insolvency in less than three years. The next chart highlights the following two facts and underscores the urgency needed in the City’s response:

- the City has approximately 36 months to put in place a plan that would address the General Fund’s \$4 million annual operating deficit that begins in FY 2022; and
- once the General Fund operating deficit begins in FY 2022, the City has less than 36 months before it depletes all General Fund reserves and the General Fund faces a potential cash insolvency.

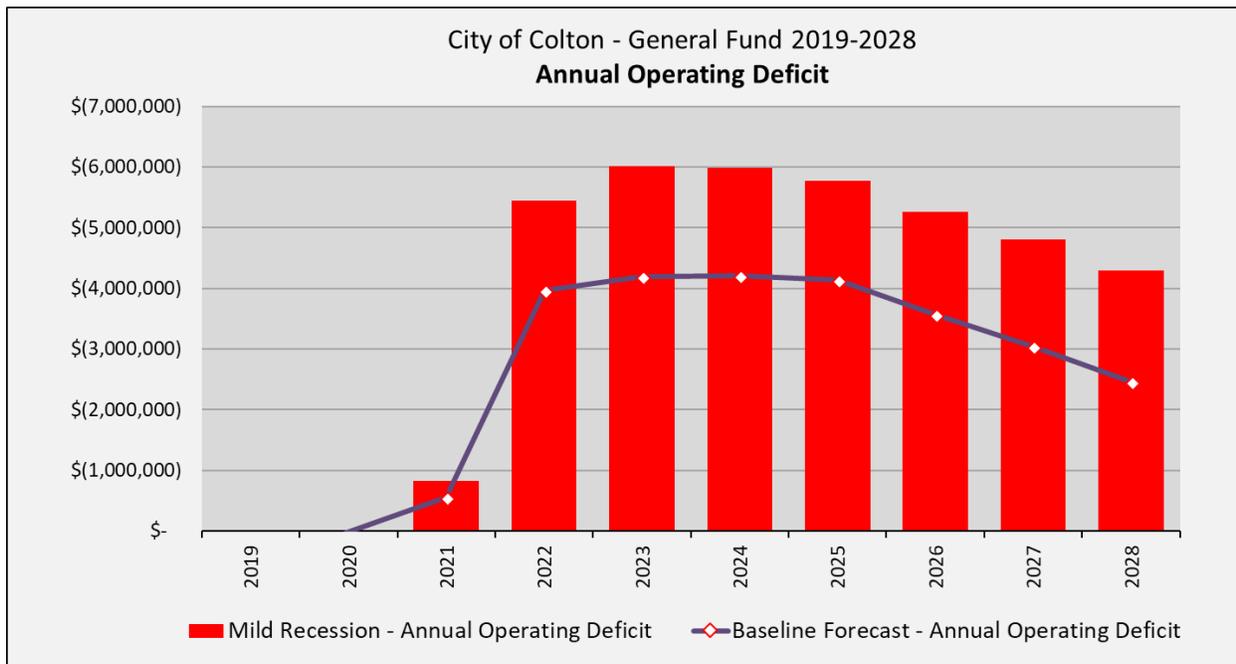
This is not a slow slide over a fiscal cliff; it’s a downhill run that must be addressed immediately with decisive and significant actions that can be fully executed in a very limited time frame.



The very tenuous and dangerous nature of the General Fund’s financial future in the Baseline Forecast is accentuated if a mild recession is added to the forecast in FY 2021 to FY 2023. The details of the mild recessionary scenario (a 2% decline in GDP) are discussed in Section II of this report. The negative impact to the General Fund’s fiscal stability from a likely recession is not surprising but important to understand. With a mild recession included in the forecast, the General Fund adds almost \$2 million to its annual operating deficit and accelerates the timeframe for the General Fund becoming cash insolvent to FY 2023. On average, the United States experiences a recession every seven years. The Great Recession ended in 2009-2010, so the likelihood of a recession occurring sometime in the next four to five years is very high, and if the recession is not mild, the impact to the General Fund’s solvency when Measure D sunsets in FY 2021 will be more dramatic and immediate.



The next chart provides a more graphic look at the forecasted annual operating deficit (the delta between expenses and revenues) over the ten-year Baseline Forecast period, including the additional impact from an expected mild recession.



The above chart also helps frame the financial challenge required to ensure the General Fund remains budget solvent during the forecast period: **the City must take action(s) that sustainably increase revenues and/or reduce expenses by a combined total of \$4 to \$6 million annually.** As discussed extensively in Section IV, fully addressing this significant financial challenge requires permanent new revenues or permanent program/service reductions, not one-time measures or temporary adjustments.

There are two primary drivers of the General Fund’s budget insolvency. The first driver is the loss of \$4.8 million in revenue from the sunset of Measure D at the end of FY 2021. The second driver is the City’s increasing pension obligations. Over the next six years, the General Fund’s total annual pension obligation will grow from approximately \$9.1 million to almost \$14 million. This equates to an annual growth rate of almost 8.7%, far outpacing any growth in General Fund revenues or other expenses. The General Fund pension obligation and its significant annual increases are comprised and driven by these components:

- 2007 Pension Obligation Bond. The City has an annual payment for a taxable pension obligation bond (POB) that was issued in 2007, the proceeds of which were used to pay unamortized, unfunded accrued actuarial liability in the City’s pension plan. Over the next six years, the General Fund’s share of the annual POB payment is approximately \$1.6 million to \$2.0 million. The POB payment is a decreasing share of the General Fund pension obligation. The bond issuance includes primarily term current interest bonds with some capital appreciation bonds payable at maturity. As a result, the amortized payment schedule for defeasance of the bonds periodically changes as the term bonds

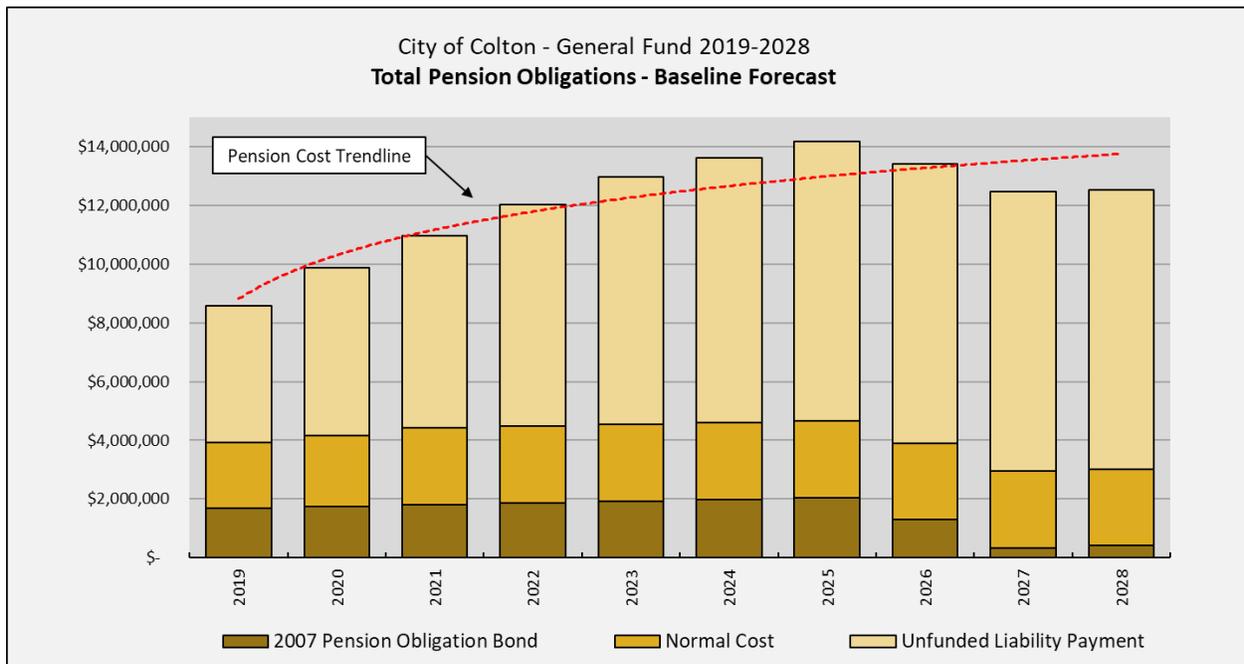
are retired and the capital appreciation bonds are repaid in the later years. As shown in the chart below, there is a significant decrease over two years of about \$1.6 million in the annual bond payment beginning in 2026, but seven years later the annual bond payment increases back to approximately \$1.8 million until the bonds are fully retired three years later in FY 2038.

- Normal Cost Contribution to PERS. The Normal Cost annual contribution is tied to actuarial assumptions that ensure funding of current city employee's vested pension benefits. The Normal Cost is a shared obligation of both the City and employees. In the Baseline Forecast, the annual Normal Cost contribution from the General Fund increases only marginally from approximately \$2.3 million to \$2.6 million. It is critical city leaders understand the reason for minimal forecasted growth in the Normal Cost is because the Baseline Forecast assumes no salary increases and no benefit changes – both of which are the primary determinants of the Normal Cost. If the City adjusts salaries, increases pensionable benefits or expands the city workforce, the Normal Cost will commensurately increase and could have a significant negative affect on the Baseline Forecast and the General Fund's solvency.
- Unfunded Actuarial Liability Contribution to PERS. The Unfunded Actuarial Liability (UAL) contribution is tied to actuarial assumptions that ensure funding of pension benefits of retired city employees. The UAL is an obligation solely of the City. In the Baseline Forecast, the annual UAL contribution from the General Fund increases from \$4.6 million to \$9.5 million. The UAL is both the largest component of the General Fund's total pension obligation and almost entirely responsible for the steep increases in pension contributions over the next six years. Moreover, PERS has not forecasted the projected growth of UAL contributions beyond six years. As such, the UAL growth rate slows in years six through ten of the Baseline Forecast because PERS has not provided any long-term projections. As discussed in Sections II and IV of the report, UFI strongly believes expected changes to PERS actuarial assumptions and likely market returns over the next ten years will continue to increase the General Fund's total annual pension contribution.

Finally, as discussed in the detail in Sections II and IV of this report, it is critical city leaders understand the following factors are expected to continue escalating both the General Fund's UAL portion and the Normal Cost portion of the total pension obligation:

- PERS new shortened amortization period for future investment gains and losses;
- continuing growth in longevity rates for pension beneficiaries; and
- losses that will be incurred if the expected recession materializes in the near future.

The chart below shows the General Fund’s portion of the City’s total annual pension obligation through FY 2028. As discussed above, the total annual obligation flattens in the out-years of the forecast because PERS only provides a six-year projection, and then it drops because of the POB payment schedule. But based on the other considerations mentioned above and discussed in Section IV, UFI strongly believes the City’s pension costs will at-least continue along the dotted trendline and will experience steeper growth assuming PERS investment portfolio does not meet the adopted rate of return (currently at 7.38% but dropping to 7.25% this coming fiscal year and then 7% in FY 2019-20) during an expected recessionary period in the near future.



Section IV presents the strategies and recommendations the City needs to immediately evaluate and execute to ensure ongoing budget solvency for the General Fund.

**D. Structural Solvency Findings (good fiscal stability and basic financial sustainability)**

Given the City’s significant General Fund budget solvency challenge outlined above, it’s unsurprising to find the City is likely years away from being able to see significant progress towards structural solvency. As defined by UFI, achieving structural solvency requires the financial capacity to maintain basic municipal service levels and existing infrastructure and capital assets in basic operational condition.

The City’s near-term challenge of restoring budget solvency to the General Fund, however, should not prevent the City from concurrently working on improving its structural solvency. The two levels of solvency should not be viewed as a linear process but rather a spectrum for measurement of the City’s fiscal and financial health. Actions that address structural solvency in

the General Fund will help the City prevent backsliding on budget solvency. The City's primary additional challenges to achieving structural solvency are as follows:

- a. **Containing Labor Costs.** Maintaining basic municipal service levels is a human resource challenge. At its core, municipal services are delivered by people. While some enterprise functions are more capital intensive (water, sewer and refuse), services delivered by the General Fund are largely labor-intensive (public safety, public works, community development, parks and recreation, libraries and internal services). Approximately 78% to 80% of the City's General Fund expenditures are for city workforce labor costs that support municipal service delivery.

As such, achieving and maintaining basic levels of municipal service is fundamentally a human resource and labor equation. If the City's labor cost structure is too high and growth of labor expenses continues to outpace revenue growth, then the number of employees must be reduced to maintain solvency thereby diminishing service levels to the community. Conversely, if the City does not periodically adjust labor costs and employee's real wages continually erode under rising living costs, employee morale, recruitment and retention can be severely compromised and the City's capacity to maintain basic service levels is significantly diminished.

The fact that labor costs dominate General Fund expenditures is expected. However, when labor costs increasingly crowd-out the ability to allocate resources to other critical inputs (facilities, tools, technology, fleet, materials and supplies, etc.), municipal-service levels can rapidly deteriorate because employee efficiency and effectiveness is diminished. Employees increasingly spend more time on less beneficial tasks, or doing activities in very inefficient ways to work-around or make-up for the lack of adequate or operational tools, continuing maintenance and deterioration of capital assets, etc. In essence, to avoid making hard personnel choices and minimize current expenses, the City is sub-optimizing expensive labor, implicitly placing higher value on the quantity of its workforce over its productivity and efficiency.

- b. **Investing in Capital Assets.** Adequate maintenance of existing infrastructure and capital assets requires disciplined financial planning to enable periodic investments. Performance and continued use of capital assets is essential to providing basic levels of municipal service. Capital assets describe General Fund assets used in municipal service operations and have initial useful lives extending over many years. Capital assets of the General Fund include major government facilities (buildings, community centers, libraries), infrastructure (roads, storm drains, parks) equipment, vehicles, technology, fixtures and other physical assets that enable the city's workforce to deliver municipal services.

The City Council's recent actions towards both labor cost containment and investing in capital assets are important to highlight and commend. In 2017, the City adopted two resolutions to strengthen its commitment to building critical reserves for the General Fund and to better define and restrict the use of reserves. First, the City increased its targeted reserve for the General Fund from 10% to 15% of operating expenditures. Second, the City authorized the Finance Director to allocate any year-end General Fund surplus to reserves and to commit such funds to the following priorities: 50% for pension obligations, 25% for OPEB liability, 10% transferred to the Building Maintenance Fund, 5% transferred to the Autoshops Fund, and 10% to remain unassigned.

Additionally, during recently concluded negotiations with employee bargaining units, the City Council held fast to a "last and best final offer" in which employees were presented a one-time compensation bonus rather than permanent increases to salaries or benefits. In light of the upcoming budget solvency challenge in the General Fund, this was an extremely prudent and fiscally responsible decision by the City Council. If the City Council had instead agreed to an increase in salaries or benefits, those permanent increases would have exacerbated the General Fund's annual operating deficit and accelerated the General Fund's downhill run towards potential cash insolvency.

Section IV presents additional strategies and recommendations the City should begin to evaluate and implement over time to progress towards helping the General Fund achieve structural solvency.

#### **E. Service Solvency Findings (good financial sustainability)**

Similar to achieving structural solvency, given the size of the General Fund's upcoming budget insolvency and the significant actions required to restore budget solvency, the City is years away from beginning to sustainably meet service solvency. As defined in the previous section, service solvency means achieving and sustaining service-levels desired by the community. Periodic improvements to a municipal service that are reversed or rapidly erode when revenues stagnate or decline, is not considered true service solvency. In fact, such actions usually have the opposite long-term effect on service levels. The increased labor and operational costs from temporarily boosting service levels continues after revenues decline or are diverted elsewhere, necessitating deeper cuts to service levels to address the growing operating deficit.

Achieving service solvency is premised on the City implementing the principles of priority-based budgeting, full-cost accounting for municipal services and other long-term cost containment/resource allocation strategies discussed in Section IV. In taking these steps, once the City has achieved budget and structural solvency, these principles and practices will help prevent the City from unexpectedly backsliding while moving towards sustainably improving service levels and capital assets desired by the community, even during periods of economic stagnation or recession.

#### **IV. FISCAL STABILIZATION AND FINANCIAL SUSTAINABILITY RECOMMENDATIONS**

This report and its recommendations are heavily focused on actions that can sufficiently impact the City’s looming General Fund budget insolvency. UFI did not consider it valuable to review the myriad of typical actions that can possibly save the City thousands or even tens of thousands of dollars. These actions are important and should be done, and there are dozens of resources available that identify how these practices can and should be implemented. But collectively, these small “best practices” will not add-up to the millions in annual savings and/or revenues required for the City to overcome the General Fund’s \$4 to \$6 million budget insolvency and begin moving it towards structural solvency.

It should be no surprise, most of the recommendations in this section are not easy to discuss, act upon or implement. They require policy creation, spending discipline, renewed and aggressive cost-sharing negotiations, and tough prioritizations that will result in decreased support for certain services and programs, and the potential elimination of others for some period of time. Every option and recommendation requires a collective show of political will amongst all stakeholders from city staff and City Council, to the residents and businesses of Colton.

Before discussing specific recommendations, UFI strongly urges the City to continue its current practice regarding the GFT increase authorized by Measure D. Based on discussions with city finance staff, we understand the General Fund budget does not include the full projected amount of authorized GFT for the fiscal year. This is done to help ensure there is a year-end budget surplus when the GFT amount is trued-up after the prior year audit is received in December. The resulting year-end General Fund surplus created by this practice automatically flows into the General Fund reserves in accordance with the City’s new reserve policy.

This is a very prudent and fiscally responsible approach to the GFT and will have multiple benefits for the General Fund. First, it will prevent the City from increasing structural operating costs up to the full amount of the GFT and not exacerbate the pending General Fund budget insolvency. Second, it could result in another \$5 to \$7 million being placed into the General Fund reserve by end of FY 2021. These increased reserves could be used to either slow down the impact of the General Fund budget insolvency in FY 2022, or more hopefully, if solutions to the General Fund budget solvency are implemented, the increased reserves can be used to proactively mitigate the City’s rising pension obligations and begin to address the City’s significant capital asset investment needs.

##### **A. Recommendations for Budget Solvency**

The ten-year Baseline Forecast that includes a strong likelihood of a mild recession, shows the General Fund will develop an annual operating deficit \$4 to \$6 million beginning in FY 2022 and continues through the remaining forecast years. This is not a one-year or short-term dip. The General Fund is facing a long-term sustained budget insolvency that if unaddressed will quickly

deplete its reserves in potentially less than two years and put the General Fund at-risk of cash insolvency possibly by the end of FY 2023.

To ensure the General Fund remains budget solvent and avoids the looming fiscal cliff, the City realistically has only three options:

1. Increase base General Fund revenues by \$4 to \$6 million annually;
2. Reduce General Fund operating expenses by \$4 to \$6 million annually; or
3. A combination of #1 and #2.

The primary reason the City has only three stark options is because the City has very little time. Three fiscal years is simply too little time to achieve \$4 to \$6 million in savings and/or revenues from other types of changes. While other actions (many of which are discussed below) can contribute to the budget solvency solution, the City needs to focus on developing the collective political and community resolve among all stakeholders for actions that can truly close a \$4 to \$6 million annual operating deficit. This process requires communication, education and sufficient time to ensure all affected parties thoroughly understand the General Fund’s fiscal challenge, the limited range of options, and have the opportunity to provide input to the City Council’s decision-making. As emphasized below, the process needs to begin immediately, and multiple options must be concurrently evaluated and considered, so the City has time to execute whatever strategies are selected and begin realizing the revenues and/or savings no later than the beginning of FY 2022.

**1. Revenue Increases of \$4 to \$6 million**

To ensure the City has the capacity to generate an additional \$4 to \$6 million annually in General Fund revenue prior to the beginning FY 2022, there are a limited number of options. Due to the short-time and high need, the following revenue actions are not recommended as potential budget solvency fixes for the following reasons:

| <b>Revenue Options <u>Not</u> Recommended to Address the \$4 to \$6 Million General Fund Budget Solvency Problem</b> | <b>Reason</b>                                                                                                                                                                                                                                                                                                                                          |
|----------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| General Fund Cost Recovery from Services/Benefits to Other City Funds                                                | The City recently completed an update of its cost allocation plan (CAP) which will be implemented beginning in FY 2019. With a recently updated CAP, any future updates will only marginally adjust the amount of cost recovery in accordance with actual costs and applied inflationary indices, resulting in little new revenue to the General Fund. |

|                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|--------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Update Existing or Adopt New User Fees</p>                                        | <p>The City has tended to consistently update its existing user fees for municipal services (e.g., recreation services, development services, permits, etc.). While regular updates should continue, the amount of additional new revenue resulting from these periodic updates is likely in the tens or hundreds of thousands of dollars, not the millions needed for budget solvency. Additionally, the City’s current range of user fees is broad, and any new user fees that could be legally imposed would add only de minimis revenues to the General Fund.</p>                                                                                                                                                                                       |
| <p>Economic Development Activities and Projects that Improve the City’s Tax Base</p> | <p>This is a long-term revenue augmentation strategy. Any particular project or set of activities is simply unable to quickly translate into a significant increase in the City tax base. Even for large-scale hospitality developments that raise property, sales, utility and transient occupancy taxes, the full tax benefits of these projects are not realized immediately and ultimately still represent only a small fraction of the existing tax base.</p>                                                                                                                                                                                                                                                                                          |
| <p>Benefit Assessment District</p>                                                   | <p>A benefit assessment district requires that every parcel within the district must be identified as receiving a “special benefit” over and above the benefit the public generally enjoys from use of the revenue. Historically, assessment districts have been used for landscape, medians, parks and lighting. Requires weighted-voter approval. Very few established since laws changed in 1996 to make process difficult and complex. Due to City’s relatively small General Fund expenditures for landscape, medians, parks and lighting, projected revenue from an assessment district would be insufficient compared to the General Fund need, and difficult to obtain since the public is already enjoying these assets without an assessment.</p> |
| <p>Community-wide Benefit Assessment</p>                                             | <p>This assessment requires that revenues derived from the assessment be used to fund only <u>new levels</u> of service; the funds cannot be used to supplant funding for current service levels. Thus, funds from this revenue measure could not be used to address the General Fund’s budget insolvency.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                              |

By necessity, the revenue options that can substantively address the General Fund budget solvency problem are new or increased local taxes. The City already exercises several local tax options at rates similar to surrounding communities. Below is a summary of the City’s existing local taxes (excluding the city’s share of the state sales and local property taxes). UFI is not recommending marginal adjustments to these existing local taxes because either the additional amount of revenue would be insufficient compared to the General Fund’s need, or adjustments would create a tax rate that is significantly higher than surrounding communities:

| Existing Local Tax Measures              | City Rate                                                            | Surrounding Communities                                                                                                                  |
|------------------------------------------|----------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|
| Transient Occupancy Tax (hotel guests)   | 10.0%                                                                | 8.0% to 10.0%                                                                                                                            |
| Real Estate and Documentary Transfer Tax | \$0.55 per \$1,000 in sales price (increase requires voter approval) | all cities in San Bernardino County at \$0.55 per \$1,000 in sales price                                                                 |
| Business License Tax                     | either % of gross receipts or flat tax rate                          | rates and methods vary by city and business type, but are typically based on % of gross receipts and generally similar to Colton’s rates |

Thus, the following are the recommended local tax options the City could use to generate new significant annual General Fund revenues by FY 2022 to help maintain its budget solvency. Before discussing the specific recommendations, the City should be aware that an initiative is circulating for the November 2018 statewide ballot that would require any new local tax measure be approved by a two-thirds vote of the electorate. The initiative would also make the new voter approval threshold retroactive to January 2018, potentially invalidating local tax measures approved on the November 2018 ballot by less than a two-thirds vote (the constitutionality of this retroactive provision has been questioned). UFI recommends the City continue to monitor this potential initiative and whether it qualifies for the November 2018 ballot, which should be known by the end of June 2018.

#### a. Transaction and Use Tax

The Transactions and Use Tax (TUT) was created by the State of California in 1969, authorizing cities and counties to adopt a local "transactions and use tax" that is added to the combined state and local sales and use tax rate. Prior to 2003, the most common TUT measures were for a specific countywide need, most commonly transportation. After the law was amended in 2003, cities and counties began to adopt TUTs for general fund purposes. Over 170 cities and counties in California have adopted a TUT, most of which are for general fund purposes.

Currently, the base statewide sales and use rate is at 7.25 percent (“State Sales Tax”). The State Sales Tax rate includes portions that go to the state general fund, specific state and local

programs, and 1% to the cities and counties based on the location of the purchase (often referred to as the Bradley-Burns portion of the State Sales Tax). In practice, the tax application and allocation for most retail sales will not differ between a TUT and the State Sales Tax. The TUT, however, applies to merchandise delivered into the jurisdiction that imposes the TUT (and conversely does not apply to merchandise delivered outside the jurisdiction). For example, in the case of a sale or lease of a vehicle, vessel, or aircraft, a TUT is charged and allocated based on the location in which the property is registered.

In 1989 and again in 2004, voters in San Bernardino County approved Measure I to increase by 0.50% percent the countywide sales tax for various transportation improvements. Measure I raised the base sales tax rate in San Bernardino County to 7.75% and remains in effect until 2040. Every county in Southern California (except Ventura) has similarly adopted a 0.50% percent sales tax measure for transportation, effectively raising the base sales tax rate in Southern California to 7.75%, except for Los Angeles County which has approved additional measures raising its base rate to 9.50%.

A citywide TUT in Colton would be added to the 7.75% countywide sales tax rate. Currently, two cities in San Bernardino County -- San Bernardino and Montclair – have adopted a 0.25% percent TUT, while Yucca Valley recently adopted a 1.00% TUT. In Riverside County, nine cities have adopted a 1.00% TUT, including the City of Riverside, and Palm Springs adopted a 0.50% TUT. In Los Angeles and Orange counties, a combined twenty-three cities have adopted a TUT, with rates of either 0.50% or 1.00%. Under current law, the combined rate of all local sales tax measures cannot exceed 2.00% (Rev. and Tax Code sec. 7251.1). Thus, the maximum amount Colton could adopt for a TUT is 1.50% percent, which would create a total sales tax rate in Colton of 9.25%.

While the tax application and allocation for TUTs is fairly similar to the statewide sales tax, TUTs typically generate somewhat less revenue. For purposes of estimating potential revenue from a TUT, most tax consultants recommend conservatively discounting the city's current sales tax revenues by 20% to 30%. However, UFI believes the composition of Colton's sales tax base requires further discounting. The City's sales tax base is disproportionately reliant on transactions involving trailers and recreational vehicles, building materials, construction equipment, and home furnishings compared to the countywide and state sales tax base. These sales tax categories are more susceptible to variance based on the overall economy and involve a higher percentage of transactions that occur outside the TUT district (vehicle registrations and merchandise delivered outside city boundaries). Based on these factors, UFI recommends discounting the city's current sales tax revenue by 30% to 40% to estimate TUT revenue.<sup>3</sup> The

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<sup>3</sup> The estimates provided in this report of potential revenues from a TUT in the City of Colton are simplified and general estimates that should only be used for purposes of evaluating the option of seeking voter approval of the TUT. For purposes of estimating actual revenues, UFI strongly recommends the City engage a sales tax consultant to review the City's sales tax revenue base, appropriately discount the sales tax components that would be different from a TUT and provide the City a detailed and refined revenue estimate.

following is a table of estimated annual revenues that could be generated from various TUT rates based on discounting the city’s forecasted total sales tax receipts in FY 2019 by 30% to 40%:

| City TUT Rate | City Total Sales Tax Rate | Potential Additional Annual Revenue |
|---------------|---------------------------|-------------------------------------|
| 0.25%         | 8.00%                     | \$1.5 to \$1.7 million              |
| 0.50%         | 8.25%                     | \$3.0 to \$3.5 million              |
| 0.75%         | 8.50%                     | \$4.5 to \$5.2 million              |
| 1.00%         | 8.75%                     | \$6.0 to \$7.0 million              |
| 1.25%         | 9.00%                     | \$7.4 to \$8.72 million             |
| 1.50%         | 9.25%                     | \$9.0 to \$10.4 million             |

State law requires voter approval of a TUT. Under current law, a TUT for unrestricted General Fund purposes needs approval by majority of the electorate, but if the TUT is restricted to specific purposes, it needs approval by two-thirds of the electorate. State law also requires TUT measures to be placed on the ballot at the general election of the city (November 2018 or November 2020). The only exception to this timing requirement is if the City Council unanimously makes the findings required to declare a fiscal emergency and calls for a special election to be conducted in the city.

**Pros:**

- ✓ TUT of at least 0.75% to 1.00% likely sufficient to maintain General Fund budget solvency, with the opportunity to seek a higher rate after discussion with the community of benefits that would flow from additional actions that create structural and service solvency in the General Fund.
- ✓ Tax burden spread across both city residents and businesses on a consumption basis and includes many sales transactions conducted by city visitors.
- ✓ Sales tax revenue growth continues to be strong within the city (but see below).

**Cons:**

- ✓ Statewide initiative may increase required voter approval to two-thirds.
- ✓ TUT rate higher than 1.00% would distinguish Colton as having the highest sales tax rate in the Inland Empire.
- ✓ Sales tax revenues are strongly correlated with overall economic growth such that a 1.00% decline in gross domestic product is expected to result in 0.90% decline in sales tax revenue. This factor is likely even higher for Colton because the city’s sales tax base is overly dependent on more volatile categories such as trailers and recreational vehicles, building materials, construction equipment, and home furnishings.

## b. Utility User Tax

Utility Users Tax (UUT) is a percentage tax based on the consumption of utility services, which can potentially include some or all of the following services: electricity, gas, water, sewer, refuse, telephone (including mobile phone and long distance), and cable television. Utility companies collect the UUT from customers as part of their regular billing and remit the funds to the City.

Over 150 cities throughout the state have adopted a UUT ranging in rates from 1% to 11%. The UUT often provides as much as 15% to 20% of General Fund revenues for these jurisdictions. In San Bernardino and Riverside counties, thirteen cities have a UUT with rates ranging from 3% to 8% in the City of Rialto (currently on the June 2018 ballot for extension). In Los Angeles and Orange counties, 56 cities have a UUT with rates ranging from 1% to 11%. The City previously had a UUT that expired in 2011.

The City's previous UUT was 4% on residential utility services and 6% on commercial/industrial utility services. In 2011, the approximate revenue from the UUT was \$4.8 million. Without a comprehensive study of the full utility service billings for all customers within Colton, it would be difficult to estimate with any precision the amount of revenue that could be derived from various UUT rates. Moreover, growth in municipal utility collections has slowed due to various conservation measures for both electric and water use, and while mobile phone and data services continue to see strong growth, the growth in online consumption of video and media continues to erode cable utility services. A very rough estimate of UUT revenue was derived based on growth in utility service revenues reported by city-provided utilities between 2011 and 2017 (9.79%). If the same 2011 UUT rates were adopted today (4% residential and 6% commercial/industrial), it is estimated the UUT could generate revenues of approximately \$5 to \$5.3 million annually. If the 2011 rates are raised by 25% (5% for residential and 7.5% for commercial/industrial), the estimated annual UUT could be \$6.3 to \$6.6 million.

State law requires voter approval of a UUT. The same timing and voter approval requirements as discussed with the TUT are applicable with the UUT.

### Pros:

- ✓ Re-adoption of 2011 UUT rates (4% and 6%) is likely sufficient to maintain General Fund budget solvency if coupled with some cost reduction strategies
- ✓ Tax burden is spread across both residents and businesses on a consumption basis
- ✓ UUT revenues less impacted by overall economic trends and more buoyant during economic downturns.

### Cons:

- ✓ Statewide initiative may increase required voter approval to two-thirds.

- ✓ The long-term trend for UUT revenue appears to be slow growth (average of 1.6% annual growth over last six years), and UUT revenue growth is less likely to keep pace with the growth of key expense drivers.
- ✓ Not significant opportunity to use UUT to seek additional revenues that could address structural and service solvency issues. A 25% increase in the 2011 UUT rates generates an additional \$1.3 million and any additional increase in rates would distinguish Colton as having some of the highest UUT rates in the Inland Empire.

### c. Parcel Tax

UFI is hesitant to include a parcel tax in the list of possible options due to its two-thirds voter approval requirement, the fact that non-school parcel taxes fail more often than local tax measures, the regressive nature of the tax, and the significant per parcel imposition that would be required to generate \$4 to \$6 million. Most parcel taxes are flat-rates and are relatively small. In 2015, the median was \$60 per parcel for cities, \$96 for school districts, and \$68 for special districts. Nonetheless, we felt it was important to include this option because it was previously included in a staff presentation to the City Council in March 2018.

A parcel tax (otherwise known as a property tax override) is a special non-ad valorem (non-value based) tax on parcels of property. The tax is generally based on either a flat per-parcel rate or a variable rate depending on the size, use, or number of units on the parcel. Because a parcel tax is not based on the value of the property, it is considered a "fixed tax." A parcel tax, however, may provide for an inflationary index that annually adjusts the tax such as the Consumer Price Index. Parcel taxes require two-thirds voter approval and are imposed for any number of purposes, including funding police and fire services, and neighborhood improvement and revitalization. Parcel taxes may be placed on the ballot for voter approval on any date allowed under state law or the City's charter.

City staff previously did some analysis on the estimated revenue that could be generated by a parcel tax. In order to compare the parcel tax to other revenue strategies presented in this report, we examined rates that would be required to generate \$4 to \$6 million annually to ensure General Fund budget solvency. Using the City's parcel data, the following is an example of the required rates and estimated revenues:

| Parcel Type     | Number of Parcels/Units | Parcel Tax Rate | Potential Additional Annual Revenue |
|-----------------|-------------------------|-----------------|-------------------------------------|
| Residential     | 10,410                  | \$400           | \$4.1 million                       |
| Multi-Family    | 573                     | \$200           | \$115,000                           |
| Non-residential | 1,871                   | \$800           | \$1.4 million                       |
|                 |                         | Total           | <b>\$5.6 million</b>                |

**Pros:**

- ✓ Because parcel tax requires two-thirds approval of electorate, City can define specific General Fund purposes to which revenues would be dedicated to generate public support. In addition, if it passes, the parcel tax would be insulated from potential conflict with possible upcoming state initiative.
- ✓ Because parcel tax is non-ad valorem, tax revenue is not impacted by overall economic trends, and if an inflationary index is included, long-term growth would generally keep pace with rising costs.

**Cons:**

- ✓ Requires two-thirds approval of electorate.
- ✓ Very uncommon in Southern California for cities to have parcel tax (whereas many special districts have adopted parcel taxes).
- ✓ Amount of tax required to generate \$4 to \$6 million annually (\$400 for residential parcels and \$800 for non-residential parcels) is very rare in California except in wealthy communities and school districts.
- ✓ Parcel taxes are often considered a very regressive tax because most often they establish a fixed amount per parcel, so the owner of small unimproved parcel pays the same amount as owner of very large, valuable and highly developed parcel. Scaling the parcel tax based on size (per square foot) can help make the tax less regressive, but it still does not consider the value of property improvements.

**d. Permanent Increase to GFT**

Finally, although this option is not technically a tax, seeking voter approval of a permanent increase to General Fund Transfer (GFT) provides the opportunity to continue a significant existing revenue stream that can help the General Fund avoid budget insolvency and create a stronger foundation upon which to build structural solvency. In 2016, 76.2% of the voters approved Measure D which temporarily increased the GFT from a maximum of 12.39% to a maximum of 20% for five years. The result is an approximate \$4.8 million annual increase in revenue to the General Fund transferred from the Electric Fund. As documented in the Baseline Forecast and Section III of this report, when Measure D sunsets at the end of FY 2021, the fiscal impact to the General Fund is immediate budget insolvency and potential cash insolvency within 18 to 24 months (assuming no changes in current expenditure levels).

In evaluating a permanent GFT increase as a potential component to avoiding the fiscal cliff in FY 2022, UFI strongly urges the City Council to consider several important provisions: (1) at a minimum, the maximum authorized GFT should be sufficient to ensure budget solvency for the General Fund, (2) the increased GFT should be permanent with no sunset clause and would continue in effect just like a local tax, subject only to repeal by the voters, and (3) there should

be no accompanying freeze on electric rates. The Baseline Forecast makes clear the General Fund operating deficit that begins in FY 2022 must be viewed as a permanent gap which can only be closed by permanent increases in revenue or permanent decreases in expenses. Any revenue measure that is temporary or sunsets is simply pushing the fiscal cliff back for future generations to address. And because the GFT needs to be permanent, it would be impossible for the Electric Fund to stay solvent if a freeze on electric rates continues. To sustain a permanent increased GFT, the cost of the GFT will need to be absorbed within the rate structure for electricity. Finally, the City has been previously advised that the ballot procedures and requirements for seeking voter approval of either a GFT increase or local general tax are effectively the same.<sup>4</sup>

As proposed, the impact of a permanent increased GFT is effectively the same as a UUT imposed on electricity charges. The surcharge is spread across all utility customers – both residents and businesses – and the amount paid is consumption based – the more electricity consumed, the greater the surcharge (the GFT would be a component of electric rates whereas the UUT would appear separately itemized on electric bill). There are, however, some differences in the pros and cons for the City Council to consider:

Pros:

- ✓ GFT provides a maximum transfer (as opposed to a fixed tax rate), providing flexibility and discretion in future years to adjust the amount transferred accordance with community needs and objectives, and changing financial circumstances.
- ✓ Time and cost to properly administer a GFT are significantly less than a local tax.
- ✓ Unlike consumption and property taxes, the GFT is not correlated with the economic trends because rates can be adjusted to ensure continuity of the GFT revenue stream. This provides a potential level of revenue certainty that helps staff and leadership focus on executing strategic initiatives instead of developing contingency plans (or being reactionary) if tax revenues fall short of projections.

Cons:

- ✓ Because a permanent increase in the GFT must necessarily be incorporated in future electric rates, this General Fund revenue structure may be less transparent than local taxes to residents and businesses. For taxes, the payor sees the tax listed as a separate charge on their bill or receipt (although a local TUT is combined with the state sales tax rate and not separately identified). To address

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<sup>4</sup> The resolution of the City Council placing Measure D on the ballot in 2016 (Resolution No. R-14-16) contained the following recital: “the City Attorney’s Office has advised that, pursuant to Proposition 26, approved by the voters on November 2, 2010 (California Constitution Article XIII C, Section 1(e)), an increase in the General Fund Transfer as proposed in this Measure is equivalent to a general tax increase.”

this issue, the City may want to consider a methodology by which the GFT component of future electric rates is separately identified on ratepayer bills.

- ✓ The GFT will only be spread across electric ratepayers. While this burdened group likely represents almost all city residents and businesses (and nearly identical to UUT payors), it would disproportionately affect persons or businesses that are large consumers of electricity (in comparison to other services or goods that could be taxed).

## **2. Cost Reductions of \$4 to \$6 million**

This report is not intended to provide a full explication of the process and intricacies of how the City can sustainably reduce \$4 to \$6 million in General Fund costs by FY 2022. Instead, the report looks to frame the challenge and guide leadership on where it needs to focus in order to realistically help accomplish this difficult task.

Over the past number of years, the City has continued to cut and reduce its non-personnel operational expenditures to very minimal levels. In 2008, the General Fund had approximately the same levels of expenditures as is budgeted for this coming year FY 2019. The proportion of General Fund expenses for labor costs (salaries and benefits), however, has risen from 68% in 2008 to 78% in 2019. When including contracted labor and labor related to internal services, the percentage of department budgets going to labor costs can be upwards of 85% to 90%. With so little General Fund monies being spent on non-personnel expenses (materials, equipment, facilities, and other capital assets), the City can realistically only focus on labor cost reduction strategies to address a \$4 to \$6 million annual operating deficit in the General Fund. The City cannot expect significant savings can be achieved looking elsewhere given the long-term deferred maintenance, repair and replacement of capital resources and other non-personnel inputs.

There are two basic strategies the City can pursue to reduce its labor costs by millions of dollars before the fiscal cliff in FY 2022. If the City fails to adopt any of the revenue strategies discussed above, it will almost assuredly need to utilize both cost reduction strategies to achieve a \$4 to \$6 million savings within this period. UFI has not attempted to place cost savings estimates on these strategies as each involves a series of staff evaluations, negotiations, recommendations and City Council approvals, each of which can significantly affect the amount of potential savings.

### **a. Restructure Delivery Model of One or More General Fund Services**

Traditionally, cities have delivered municipal services to their residents and businesses through personnel directly employed by the city. Many older cities have continued to rely on this more traditional service delivery model, including the City of Colton. While changing the service delivery structure has certain risks and contingencies limiting the amount of savings that can be achieved (especially over the long-term), when facing the alternative of cutting current staffing

and service levels, this strategy deserves exploration. Below are two alternative models for delivering municipal services that could potentially be activated to some level within the City's three-year window of opportunity.

- **Consolidate or Regionalize Service Delivery.** By cooperating jointly with other entities to deliver a municipal service to a broader populace or region, there is potential to achieve savings from scaled-economies of service inputs (both labor and capital), more rational geographic scope and scale for delivering the service, and broader spreading of administrative overhead. The City already takes advantage of this cost-reduction strategy in its joint fire service arrangement with the City of Loma Linda. Extending this type of arrangement to other core municipal services requires staff to investigate whether there is mutual interest from adjacent agencies, and more importantly, whether there are any opportunities to create the aforementioned efficiencies. Some California agencies have found success in the consolidated regional delivery of the following municipal services which the City provides: parks and recreation, human services, code enforcement and library services.
- **Contract with Private Sector.** Since the 1980's, city governments in the United States and California have increasingly turned to the private sector for municipal service delivery in an effort to increase economic efficiencies, reduce transaction costs and achieve overall savings while maintaining service levels. In some cases, the private sector may be better poised to leverage assets compared to local governments, and to be more flexible and responsive to changes in labor demands and costing. On the other hand, cities do not make a profit or pay taxes, and they can typically access capital at lower rates than the private sector. While assessments are mixed of whether greater efficiency and savings has been achieved through private sector contracting, this strategy is worth examination when the alternative is cutting staff and service levels.

While the private sector provides opportunity to contract for almost all municipal services except public safety, there are some important considerations in evaluating which opportunities (if any) can potentially result in significant and sustained savings.

- ✓ The City must have a good understanding of the total inputs and costs it incurs to provide the municipal service. This clear understanding is important for evaluating any potential savings and determining whether the City will continue to incur any non-contract costs. For example, the City will likely need some personnel to manage the private sector contractor and to review the quality and performance of the work. Fixed facility costs will also likely remain with the City. Additionally, unfunded retirement liabilities will remain with the City after contracting but the City's retirement contributions for active employees (the normal costs) will diminish.

- ✓ The City must evaluate whether there is an active and competitive market of private sector providers of the particular municipal service. One of the primary reasons private contracting can help reduce costs while maintaining services levels is because it introduces competition into an otherwise monopolistic system of public service delivery. If, however, the marketplace of potential service providers is non-competitive because there are too few providers, then there is increased risk that initial low prices will simply continue an upward trajectory without the check of competitive market forces and possibly obviate any savings over the long-term.
- ✓ The City must be capable of establishing good performance measurements for the municipal service and holding the private sector contractors accountable to the performance goals. Studies have found that as a municipal service involves more asset specificity and more measurement difficulty, the likelihood that municipalities contract this service out is lower. Performance-based contracts should be used as much as possible to place the emphasis on obtaining the results the City wants achieved, rather than focusing merely on inputs and trying to dictate precisely how the service should be performed.
- ✓ Finally, the City must be realistic on the overall cost savings that can be achieved through contracting with the private sector for municipal services. For example, UFI performed a cursory analysis of three major General Fund departments -- Community Services, Development Services and Public Works (excluding utilities) – to determine the total expenses in these departments that could be subject to savings from contracting with the private sector. In FY 2019, the proposed total budgets of these departments is approximately \$8.7 million. The following departmental expenses were removed from potential savings because they would remain with the General Fund, even if all department services were contracted (“retained costs”): existing contracted services, management required to oversee the contractors, capital costs assigned to the departments, City pension liability and retiree health expenses allocated to the departments, and allocated costs that are reallocated to other departments because they relate to fixed costs that do not scale/adjust with staffing levels (estimated 20% for Development Services and Public Works and 80% for Community Services). When “retained costs” were removed, the estimated total expenses in these three departments that could be subject to savings from contracting was approximately \$5.7 million. If private contractors could perform all the services in these departments for 20% less than the City currently spends (a significant cost differential), the total savings would be approximately \$1.1 million annually.

Finally, if the City chooses to explore contracting out some services, a strategic place to begin may be some of the internal services currently provided by the City: facility and equipment maintenance, information services, and automotive repairs. These are services for which there is a broad market of private sector providers and for which the above criteria can more easily be applied to evaluate the opportunity and potential savings.

**b. Seek or Impose Labor Cost Concessions**

Although this strategy is burdened with significant procedural requirements, legal limitations and potential pitfalls, it is important to evaluate whether certain existing labor cost components can be reduced through renegotiation and agreement with labor groups, or potentially through unilateral action by the City if necessary. Like all municipalities, the City attempts to provide a competitive package of salary and benefits to its employees. To attract and retain quality employees, it is important for city compensation levels to remain competitive in the labor-market. But the total cost of employee compensation must also be examined within the context of both what the City can sustainably afford currently and prospectively, and the broader total available labor pool in both the public and private sectors.

There are a number of components that make-up an employee's total compensation and some components are protected as "vested rights" from being reduced or eliminated without an off-setting benefit (e.g., city pension plan, accrued vacation or leave, and other "contractual" terms and conditions). Nonetheless, the City should consult with legal and labor counsel regarding options it may have within the next three years for potentially reducing the cost of the current total compensation it provides to employees. In the absence of such cost reductions or increased tax burdens on citizens (discussed above), the City may be left with the least-favored recommendation discussed below.

**c. Permanently Reduce General Fund Staffing and Municipal Service Levels.**

In the hierarchy of cost reduction strategies, this recommendation is clearly at the bottom because of its high impact to both the community (which has already suffered under service insolvency for many years) and the affected city employees. If the \$4 to \$6 million budget insolvency cannot be resolved through some combination of the cost reduction and revenue strategies discussed above, the City will be left with only the strategy of permanently reducing staffing and municipal services to close the remaining gap.

It is beyond the scope of this report to make specific recommendations on the staffing and service cuts that would be required to achieve savings of \$4 to \$ 6 million annually prior to FY 2022. The various options and permutations require careful evaluation by city staff, with input from elected leadership and the community, that balances various factors such as feasibility, timing, impacts to residents and businesses, and estimated savings. Below, however, are several recommendations and considerations to help guide this process:

- **Start Evaluating this Option Now.** If this option might be necessary as a last-resort by the City to solve its General Fund budget insolvency problem in FY 2022, the City should presently begin evaluating and making a contingency plan of employee and service reductions even though its pursuing other preferred options. Not only is the process for identifying and assessing cuts potentially lengthy, by the time other options/recommendations are evaluated and attempted, there will likely be insufficient time to evaluate and successfully implement the cuts before the General Fund arrives at the point of cash insolvency.
- **Priority-Based Budgeting.** To assist in evaluating potential impacts and savings from various staffing and service reductions, the City should consider moving to priority-based budgeting. Priority-based budgeting and its benefits are discussed in more detail in the next section. While full adoption of priority-based budgeting may not be achievable before the City needs to finalize its plan of cuts, the process of moving towards this goal will help the City formulate a more thoughtful and sustainable plan of cuts, as well as a roadmap for potentially restoring service levels.
- **Scope of Required Cuts.** While the amount of cost reductions and/or new revenues obtained through other strategies will determine the extent to which staff and service reductions are required, it is important to understand the scope of cuts required to obtain significant cost reductions. While UFI had limited capacity to develop an independent understanding of various programmatic costs in the General Fund, the FY 2018 budget allowed us to make some rough estimated savings that can help contextualize the impacts of aggregating \$4 to \$6 million in annual savings through staff and service reductions:
  - ✓ \$2.0 to \$2.5 million – eliminate General Fund monies for parks, recreation and community facilities, requiring closure of most parks and community facilities without maintenance or upkeep;
  - ✓ \$1.3 to \$2.2 million – close Fire Station;
  - ✓ \$575,000 – eliminate all Code Enforcement and Weed Abatement activities;
  - ✓ \$550,000 – eliminate all Library services and close facilities; and
  - ✓ \$100,000 – reduced demand for Internal Service Departments (IT, vehicle maintenance and administration) due to staffing and municipal service cuts.

## **B. Recommendations for Structural and Service Solvency**

Structural solvency is the City's financial capacity to maintain basic levels of municipal service and to adequately fund existing infrastructure to ensure basic operational condition. Service solvency builds upon this structural stability of adequate service-levels and operational assets. Service solvency moves the City towards augmenting the services and assets most valued by the community and ensuring these improvements can be sustained. As discussed in the findings

section of this report, the biggest challenges to the City obtaining structural and service solvency are:

- Balancing projected continued growth in labor costs with maintaining and augmenting the services most valued by the community;
- Dedicating sufficient funds to keep existing infrastructure and assets properly maintained and operational, and eventually funding improvements, enhancements or full replacement of facilities most desired by the community; and
- Developing sufficient operational reserves and capital capacity so improvements to services and facilities can be maintained and sustained through periods of economic and revenue stagnation and recession.

At its core, achieving structural and service solvency requires the City to develop and adhere to strong financial and budgeting policies and principals designed to optimize services that best meet the communities needs and priorities. Below are the recommendations that if implemented will help the City achieve structural solvency and progress towards service solvency.

### **1. Implement Strong Core Financial Policies**

Progress towards structural solvency is difficult if not impossible if the City is continually struggling to maintain General Fund budget solvency. The following core financial policies are important to ensure that when the City has restored budget solvency to the General Fund, it continues to follow practices and procedures in budgeting and decision-making that prevent unwanted “backsliding” during periods of economic stagnation or recession that are anticipated to occur during the Baseline Forecast.

- **Reserve Policy.** Most cities maintain multiple funds based on different revenue sources and requirements. Because there are risks (both known and unknown), it is important that reserve levels in all funds be maintained as a hedge against such risks. Without proper reserves, there can be major disruptions in services when unforeseen financial demands emerge that require immediate diversion of resources. For the General Fund, different types of reserves should be maintained, including an economic uncertainty reserve (sometimes called a contingency) to provide a cushion for unexpectedly low revenues in any given year and for other emergency needs that arise.

As discussed above, the City is to be commended for its progress in this area. The recent update of the General Fund reserve policy is a good start. Assuming the City is able to maintain budget solvency in the General Fund, it should consider strengthening its reserve policy even further to ensure the General Fund budget includes an intended year-end surplus that is flows into the reserve. We understand the City is essentially applying

this methodology by budgeting a percentage of expected GFT revenues, but formalizing this operating procedure into a definitive policy will help ensure long-term commitment to intentionally growing and maintaining city reserves at recommended levels appropriate for their purpose.

- **Use of One-Time Resources.** Periodically, the General Fund is the beneficiary of one-time resources from revenue spikes, budget savings, sale of surplus equipment and/or property or other similar nonrecurring events. It is recommended the City adopt a policy to prevent the use of one-time resources for current or new operating expenses, and instead dedicate one-time resources to building reserves, retiring debt early, prepaying long-term liabilities, capital expenditures that do not increase operating costs or other nonrecurring expenditures.
- **Continually Update Fees and Cost Recoveries.** It is also recommended the City adopt a policy that ensures consistent updates at regular intervals of the General Fund’s administrative cost allocation plan and cost recovery methodologies. This policy should include all fees (including development impact fees) and where appropriate ensure the use of appropriate inflationary indices and variables to prevent under-collecting and subsidy between updates. As a general rule, if appropriate indices and variables are used, the time period between updates should not be greater than three to five years.
- **Multi-Year Financial Forecasting.** To ensure current budget decisions consider future financial implications, the City should consider creating a long-term financial forecast that is utilized by city staff and City Council as a continual decision-making tool. Any proposal for new or major changes to services or programs, or any budget revisions, should include an analysis of the impact to the baseline forecast. If a revision creates a negative impact on the forecast, a funding plan should be developed and approved to offset the impact. The baseline forecast should be updated semi-annually to reflect changes in revenues and expenditures. The forecast should be regularly presented to the City Council for discussion and public input.

## 2. Move to Priority-Based Budgeting

In periods of fiscal constraint or revenue decline, the traditional budget process typically continues funding the same services it funded last year, albeit at the same or reduced level (e.g. across-the-board budget cuts). Similarly, during periods of revenue growth or receipt of one-time revenues, traditional budgeting allocates increased funding to various departments, often to “restore” previous across-the-board cuts. The result is a continuing see-saw of municipal finance expansion and contraction, disconnected from why the municipal services exist, the full cost of the services, and consequently, what relative value the services provide to the community.

The underlying goal of priority-based budgeting is simple: to help a city invest its available resources to best meet the community’s stated objectives. To achieve this goal, priority-based budgeting provides elected officials with better and more relevant data for informed decision-making, meaningfully engages citizens in the budgeting process, and avoids the pitfalls of basing the "new" budget on revisions to the "old" budget. This holistic approach to municipal finance helps the community identify and enhance the services it most values. The principles associated with priority-based budgeting are as follows:

- **Fund Services Based on Community Needs and Priorities.** Priority-based budgeting starts with identifying core community needs and priorities, and then evaluates the relative benefit/value each municipal service (rather than an entire department) provides towards meeting the community needs and priorities.
- **Spend Within the City’s Means.** Priority-based budgeting begins with the total revenue available to the city, rather than last year’s expenditures, as the basis for decision-making. It focuses on ensuring funding decisions are based on the true cost of providing a service.
- **Do the Important Things Well; Cut Back on the Rest.** In identifying the services most needed and valued by the community, priority-based budgeting emphasizes continued strong funding for those services, while reducing service levels or potentially eliminating lower-value services.
- **Transparency of Community Priorities and Accountability for Service Results.** By basing budget decisions on well-defined community priorities, city spending decisions are less open to interpretation. By focusing city services on how well they advance community priorities, accountability for results is easier to ascertain and support.

The above principles were adapted from materials and information provided by the Center for Priority Based Budgeting and the Government Finance Officers Association (GFOA), both of which can provide the City strong guidance and steps for moving to priority-based budgeting.

### 3. Adopt Labor Cost Containment Strategies

At the outset, we again want to highlight the City Council’s recent progress towards labor cost containment by (1) committing specific percentages of any General Fund surplus to mitigate the City’s rising pension costs and OPEB liabilities, and (2) its decision to make a “last and best final offer” in which city employees were presented a one-time compensation bonus rather than permanent increases to salaries or benefits. These are good initial steps towards establishing a foundation and policy framework needed for structural solvency, which can be strengthened with the following recommended strategies:

- **Total Compensation Approach to Labor Costing.** Negotiations for any increase or change to employee compensation should utilize “total compensation” bargaining concepts that examine and include all components of compensation, including “salary equivalent”

compensation. These compensation components include: base salaries, step increases, special pay, vacation and leave allowances, cash-out policies, health benefits, employer pension contributions, and built-in cost adjustments. As an example, the City's recent commitment of General Fund reserves to ensuring the financial viability of the City's pension plan should be firmly represented and acknowledged for what it is – an economic benefit to the employees because it helps ensure the bargained for defined benefit retirement will be delivered throughout their full retirement. With municipal pension plans experiencing swiftly rising unfunded liabilities, the City Council's decision to allocate funds that help ensure the financial integrity of employee pensions is a valuable future benefit with a present value that needs to be recognized at the bargaining table. The City should also evaluate and consider how to "monetize" the value of non-economic improvements to employee working conditions as part of the total compensation approach. Finally, any potential changes to any form of compensation should be modeled through a baseline financial forecast to ascertain its current and long-term affordability. In particular, attention should be given to fully-costing any proposed adjustments to compensation that are pensionable (salaries, special pay, etc.), and priority should be given to adjustments or improvements to compensation components that are not pensionable.

- **Modernize Salary Step Adjustments.** Traditional public agency salary schedules with an average of five or six steps within each employment classification range were developed before the onset of widespread collective bargaining. These steps were intended to provide an opportunity to reward employees annually for their performance and for the growth of their experience and productivity as they become more effective on the job. The increases are often known as merit increases, but many are implemented automatically. Often it takes less than four years for an employee to get to the top step of their current salary range. During this period the employee is typically awarded a step increase, if available, and cost of living adjustments negotiated by their bargaining group. Because of this practice, new employees often receive significant pay increases in the first few years of employment with the City.

Currently, the City has only five steps within each salary range. Consequently, almost 65% of city employees are at the top-step of their salary range, which creates pressure to adjust salary ranges. A 10 to 15 step range for management and non-management employees would reduce the City's costs and could spread the opportunity for performance increases over six to nine years rather than the current three to four years. Such a change in the salary schedule would need to be negotiated with each of the City's bargaining units and would be considered by both sides as part of the total compensation package during negotiations.

- **Pension Cost Containment.** There are two cost drivers in the City’s annual pension contribution payment: (1) the “normal cost” which is the amount required for proper funding of the retirement benefit provided to current employees, and (2) the “unfunded actuarial liability” (UAL) cost which is the amount required to ensure the City’s pension plan can pay all obligations to all retirees when due. The normal cost portion of the City’s pension contribution is a function of the City’s current payroll and the terms of its pension plan. The more employees and higher salaries paid, the greater the City’s normal cost. Thus, while working to stabilize and improve services, the City can control its normal cost by optimizing its employees’ productivity, and more importantly, adhering to the total compensation principles discussed above, including minimizing pensionable components of compensation for current employees and ensuring pension plan terms are included as part of the City’s total compensation approach (especially for new employees).

For the UAL component of the City’s contribution, the City has less control because actuarial assumptions largely drive the UAL (see discussion in Section II of this report). To help cost-contain the UAL, the City has several options it should evaluate and consider. First, as discussed in Section II, every time the City’s pension plan experiences a loss in value, the City’s payment to restore the value is spread over a period of time – called an “amortization period.” Amortization of the loss helps avoid dramatic swings in the City’s annual pension contribution. But this stability comes with a long-term cost. Just like a home mortgage, the total cost of a 15-year mortgage is always significantly less expensive than a 30-year mortgage because of the time value of money. Similarly, if the City is able to pay for an amortized loss in its pension plan more quickly, it will save on overall costs. Prepayment of the pension UAL is often a good use of one-time revenues and/or use of the General Fund reserves the City has committed to addressing pension costs. In addition, prepayment of the pension UAL should be considered a component of “total compensation” for employees, as it helps secure the future integrity of the employees’ retirement benefit.

#### **4. Develop and Maintain Comprehensive Asset Management Program**

Structural and service solvency require a growing commitment to ensure adequate funding is dedicated to keep existing infrastructure and assets operational, while also implementing appropriate long-term financial plans for the full replacement and improvement of capital assets identified as most needed and valued by the community. While the City currently annually updates a Five-Year Capital Improvement Plan (CIP), this document is focused on the funding and status of capital construction projects across all funds in the city. Missing from the City’s current CIP process is a regular holistic (citywide) capital needs assessment and costing, and prioritization of capital investments in alignment with community identified objectives and values.

To this end, the City should annually prepare a Citywide Capital Asset Management Report for presentation and consideration by the City Council prior to the annual budget and CIP discussions. The report would provide a "city-as-a-whole" perspective for capital assets and would include the physical assets of all services and programs that rely on capital assets for service delivery. The report would provide an accounting of the number, condition and replacement-value of existing capital assets, and an assessment of current service levels supported by the capital assets, and the costs of unmet needs. The report would also identify the amount of funding needed on an annual basis to keep the capital assets from deteriorating or becoming non-operational, and the annual funding gap over current service levels needed to bring assets up to a sustainable level of maintenance, repair and replacement.

The timing and delivery of this report should enable the City Council to consider how to address prioritized capital funding needs when adopting the annual General Fund budget. This Citywide Capital Asset Management Report is especially integral to implementing the priority-based budgeting process discussed above, because it allows funding for community-valued services and assets to be optimized.

## **V. CONCLUSION**

In order to achieve fiscal stability and financial sustainability for the General Fund, the City will need to take bold, decisive action to implement changes. The City has only three years before the General Fund faces a fiscal cliff in FY 2022. If the fiscal cliff is not avoided, the General Fund will fall into a state of budget insolvency and quickly slide into potential cash insolvency. The recommendations in this report will assist the City in realigning General Fund annual revenues with annual expenditures to restore budget solvency and to establish a basic level of fiscal stability. Moving the City beyond basic fiscal stability, however, must be the City's long-term goal. The recommendations in this report that can help the City achieve long-term financial sustainability and economic resiliency will require a shared culture of partnership and commitment to engagement, transparency and fiscal discipline among the City Council, staff and community.