



**PAINFUL BUT NECESSARY CUTS:
ONE COMMENT THAT SHOULD BE MADE AND NINE
QUESTIONS THAT NEED TO BE ASKED ABOUT THE CITY OF
SAN DIEGO'S MID-YEAR FISCAL YEAR 2009 BUDGET
AMENDMENT REPORT**

NOVEMBER 2008

In October 2008, Mayor Jerry Sanders announced that slowing revenues had opened up a \$40+ million deficit in the City of San Diego's FY 2009 General Fund Budget. SDI subsequently showed that if revenues significantly slow and the City's expenses increase at the rate projected in the last Five Year Fiscal Forecast, the FY 2010 deficit could be over \$100 million. We released a subsequent report that identified more than 3 dozen cost cutting ideas put forward during the month of October by more than 30 different municipal and state governments.

On November 5, 2008 the Mayor authored a detailed report (FY 2009 Budget Amendment Report, #08-166 revised) that updated the projected deficit (now standing at an estimated \$31 million – revised downward largely as a result of cost-controls instituted to slow departmental expenditures) and laid out a series of reductions designed to bring the City's FY 2009 budget into balance.

In this latest SDI report we offer one comment, acknowledging the Mayor for the continued efforts to fund the City's long-term liabilities, and raise nine questions that we feel must be asked if policy makers and the public are to make informed decisions during this fiscal crisis.

Steve Francis
Chairman
San Diego Institute for Policy Research

ONE COMMENT

Mayor Jerry Sanders should be acknowledged for continuing to invest in the “eight significant areas.”

Addressing the under funding of the City’s pension system, increasing contributions to the employee health care fund, and increasing investments to deal with the deferred maintenance backlog are all vitally important to stabilizing the city’s long term fiscal outlook. Mayor Sanders deserves credit for continuing to make these investments and it is important that the City Council not backtrack, as “borrowing” against these commitments robs, with interest, future taxpayers.

NINE QUESTIONS

1. What are the projections for FY 2010 Revenues?

The Council will enter its FY 2010 budget cycle in five months. The public needs to recognize that this round of reductions is likely not the last. This is particularly true if growth in General Fund revenues do not keep pace with escalating fixed costs.

SDI looked to the narrative in the report to determine the projected rate of growth in various revenue categories. If we did not find one, we used the revised FY 08 to FY 09 projected growth rate. If that was indiscernible from the report, we relied upon the growth rate used in the Five Year Forecast. Finally, if that wasn’t clear, we used the FY 2009 budget to calculate a revised growth rate.

Revenue Source	Year End Projection (\$M)	Projected Rate of Growth/(Decline)	FY 2010 Forecast
Property Tax	396.6	2.0	404.6
Sales Tax	216.2	(0.2)	215.8
TOT	82.2	0.0 ⁱ	82.2
Franchises	68.2	7.5 ⁱⁱ	73.3
Property Transfer Tax	6.4	2.0 ⁱⁱⁱ	6.5
Safety Sales Tax	7.4	(0.2)	7.3
MLVF	6.0	0.0 ^{iv}	6.0
Other Major Revenue	72.0	3.0 ^v	74.2
Departmental Revenue	<u>289.4</u>	3.0 ^v	<u>298.1</u>
TOTAL	1144.5		1168.0

If these projections are correct, FY 2010 General Fund revenues would grow only 2.1%, one of the lowest growth rates in San Diego’s history, and would mean that additional cuts would be required to balance the City’s FY 2010 budget.

According to a November 5, 2008 Memo from the Independent Budget Analyst (IBA) to the City Council, the Mayor will be releasing his Five Year Forecast on November 12th.

This should reflect newly updated revenue projections and we would suggest that policymakers and the public pay close attention to the projected overall growth rate in General Fund revenues forecasted for FY 2010. At the very best, we believe, the updated forecast should project revenue growth no higher than 2.1%.

2. What other factors not detailed in the report could further hurt revenues?

In the Mid-Year report the narrative discusses in broad terms the trends in property, sales and TOT taxes, which account for 60.7% of the projected FY 2009 General Fund revenues. While most economists predict this recession will impact every sector of the economy, it is clear that some are going to suffer much more than others. We believe it is prudent for the Council to ask management for their opinions on at least three specific risks that could negatively impact the City's General Fund.

First, it is clear that the credit crunch and plummeting consumer confidence are having a negative impact on automobile sales and other major durable goods purchases. On November 7th Ford Motor Company announced that U.S. sales were down 30% in October. According to the California Department of Motor Vehicles, auto registrations in San Diego County were 6.3% lower in 2007 than in calendar year 2006. All indications are that 2008 will be even worse. On November 10th Circuit City filed for Chapter 11 protection, citing declining sales in major electronic goods. Given the importance of durable goods to overall sales tax revenues, it is critical that the Council understand how much downside risk there is to the City's sales tax numbers if auto sales and other major durables remain at such dismal levels.

Second, in addition to delinquent property tax receipts, the Council should inquire as to how at risk the City is from property owners asking for re-assessments of their property values. According to DataQuick Information Services, 28,000 residential properties were bought between 2006 and 2007 with a *combined* assessed value of \$13.6 billion. Since then, the median price of homes in the City of San Diego has fallen 29.8%. Under California Proposition 8, nearly ALL of these property owners are eligible to seek a reassessment from the county and, if they exert their legal rights to seek lower assessments, it could impact revenues. Though the County reports that it has only 15,000 Prop 8 applications for reassessment currently pending, a recent report estimated that 200,000 properties in the County could be eligible!^{vi}

Third, the Council should understand the risks to transient occupancy tax (TOT) that could result from a slow down in business travel and conventions. As outlined last year in an SDI report on the economic impact of the visitors industry, in 2007 23% of those staying at a hotel indicated that their principal reason to visit San Diego was business. Last month, the Travel Industry Association released its forecast for 2009 that forecast a 2.9% decline in business travel. The Council needs to understand, if these forecasts hold, how it would impact the City's General Fund.

3. Which budget cuts yield on-going savings, which provide only one-time savings, while give multi-year savings but which will eventually have to be restored, and which cuts lack enough information in the report to classify?

It is important for the City Council to understand which cuts close the gap in FY 2010, which are one time savings that will not be available to meet next year's fiscal challenges and which, while having some "out-year savings" cannot be permanently sustained and thus which will end. That is because, all things being equal, we believe it is better to make cuts that not only help in closing the current gap but also help address the FY 2010 challenge. While possibly more politically painful, the City is better able able to adjust to a single deep set of service reductions than an on-going multi-year process of scaling back operations.

Unfortunately it is difficult to classify cuts in this fashion from the information in the Mid-Year budget report. Some of the biggest uncertainty is with the \$17 million in projected expenditure savings^{vii} as it is unknown whether this represents one-time reductions (achieved, for example, by putting off non-salary expenditures off until June 2009) or on-going savings (such as keeping a position open and successfully redistributing workload). *Without understanding this difference, the Council lacks an important tool in picking between cuts that only impact only the FY 2009 situation and similar sized reductions that would also positively impact the out-year budget problem.*

4. What assumptions are being made about the timing of these cuts (and thus when the City will realize the savings?)

The report projects \$40.3 million in savings. It is important for the Council to know what assumptions are being made about when those cuts are approved and the timing of any processes, such as meet-and-confer, severance notifications, "bumping rights," etc. that are being made in calculating the fiscal impact of the cuts.

5. What risks exist to the City from actions that the State of California could take as it tries to closes its \$11 billion shortfall?

As of November 7, 2008 the Governor had not indicated his support for budget cuts that would dramatically impact local government. However, since Proposition 1A does have provisions that would allow the state to "borrow" local revenues, it is important that the Council get the most current and up-to-date estimate for how big that reduction could be and, at the absolute earliest, when it could take effect if enacted during the current special session.

6. Are there other risks to General Fund revenue and expenses from the County and other government agencies?

As the report detailed, part of the problem that the City faces is the result of actions of other local entities. For example, the county government's unanticipated increase in the cost of processing property tax receipts has increased City costs by \$1 million. The Council should ask for a report from the Mayor on any other risks the City could face from other local and regional actors which would impact the City's revenues and costs. We suggest, unfortunately not in jest, that the Council may want to take this question up in closed session as to not give other government agencies any ideas.

7. How could the downturn impact non-General Fund departments?

While many non-General Fund departments and functions have more flexibility in respect to revenues, some do not. We believe the Council should ask, if they have not already received reports, about plans in place to deal with:

- A. Revenue declines in the TOT Fund (used to support Arts and Culture, Economic Development, etc.).
- B. Impact on Development Services from the continued slump in construction. In addition, the Council should ask about what plans are in place to both reduce expenditures as revenues decline but retain core competencies so as to minimize long-term damage to the organization during the reduction in staff.
- C. Downside risks to the Stadium Fund if revenues decline as consumers cut back on discretionary expenditures.
- D. Downside risk to the Airport Fund and experiences in that fund during past recessions.
- E. Any other funds that could be significant impacted by a reduction in consumer spending and slumping construction activity.

8. Does the Council have adequate information about how citizens prioritize popular programs?

If the projections made by the Mayor prove accurate, the Council will need to cut \$43 million this year and potentially another \$30+ million next year. If more pessimistic revenue projections hold, the cuts in FY 2010 would have to be even deeper. As the administration has pointed out, given the magnitude of the deficit it is inevitable that popular programs will be cut.

Needing to make very hard tradeoffs, the Council may wish to consider gather more data on how citizens rank particular programs. The June 2004 issue of Government Finance Review details, for example, how the City of Eugene used surveys, focus groups, and a constrained prioritization system to better understand how citizens prioritized core city services.^{viii}

9. How are Performance Measures being used to inform management’s decisions on what to cut and how to restructure?

Some of the cuts being proposed have the feel of triage. Given the fast moving nature of the problem, this is somewhat understandable. Moving forward, however, the Council should inquire as to how management is using performance measures to evaluate which particular services and locations are cost-effective and which are not. If the current performance measures do not help the City in making hard choices when tax dollars are scarce, it is an indication that the measures need further refinement.

ⁱ . The Mid-Year Report does NOT make a forecast of TOT Revenues. Rather the report states, “All of the above factors indicate that a recover is not anticipated until the second half of 2009 at the earliest indicating that in the near term, flat to slight growth in TOT revenue should be expected.” (pg. 19) Comparing FY 08 actuals (\$83.7 million – pg. 16) and the FY 09 projections (\$82.1 million) indicates a projected 1.8% DECLINE in TOT revenues. Given the shortfall and the lag typically seen between economic recovery and increased spending on business travel, A MODERATELY conservative forecast would be for TOT to be flat in FY 2010.

ⁱⁱ . There is no FY 2010 projection in the mid-year document. Given the information provided we took an AGGRESSIVE approach, using the growth rate used in the Five Year Forecast

ⁱⁱⁱ . There is no FY 2010 projection in the mid-year document. We used the same growth rate for Property Tax.

^{iv} . While the report is not clear on this point, if (see page 20) the FY 2009 VLF budget was 6.9 million and that assumed a 3.4% growth rate, it means that the revised projections of \$6.0 million in FY 2009 represent a 10% DECLINE from FY 2008 levels. We have MODERATELY assumed that FY 2010 will see VLF revenues remain flat. Given falling consumer confidence and financial problems, this may be an overly optimistic assumption.

^v . The Mid-Year document provides neither a forecast for FY 2010 nor the FY 2008 number so that the revised 2009 growth rate could be calculated. We somewhat arbitrarily assumed a 3.0% growth rate.

^{vi} . It should be noted that cutting against the Proposition 8 reassessments are properties which change ownership and are subject to Proposition 13 reassessments as well as the general 2% increase in assessed value which will impact many San Diego homes. We believe that, however, given the number of properties that could be subject to Proposition 8 reassessments the Council would be wise to ask management to assess the risks to FY 2010 revenues if reassessment requests dramatically increase OR if, as did Riverside County, the County of San Diego undertakes a reassessment on its own.

^{vii} . Pg. 5

^{viii} . “Bringing Rigor to Cutback Management: Eugene’s Constrained Prioritization Process”, Government Finance Review, June 2004