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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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# Consideration of Three Budgetary Principles Consistent with Citizens' Fiscal Sustainability Task Force Analysis of Proposition D

## OVERVIEW

On Monday, October 7, 2010 the City Council will consider adoption of a statement of budgetary principles consistent with three principles called for in the "Citizen's Fiscal Sustainability Task Force Analysis of Proposition D- Reform Impact". This report discusses the three proposed principles and identifies issues that warrant further discussion and clarification. The concepts in the three principles mirror several of the Council-adopted "Guiding Principles for Eliminating the Structural Budget Deficit" as well as many elements of the City's adopted Budget Policy. They differ in their specificity regarding the City's reforms savings and future expenditures; and it is important that all parties have a common understanding of intent and expectations.

## REVIEW OF TASK FORCE PRINCIPLES

**Principle #1- Enactment of operational reforms, efficiencies and other budget reductions that produce an average annual savings of \$73 million as verified by the Mayor, Independent Budget Analyst and Independent City Auditor.**

We agree that aiming for strong reforms of \$73 million average annual savings may be achievable based on the reforms that are underway and the potential savings associated with their implementation. However, this should be viewed as a goal as such savings cannot be guaranteed. There are numerous variables and circumstances that could impact this projection. This principle could be restated as a commitment by the City to maximize reforms savings to the extent possible, and the City will aim to achieve a target of \$73 million or more in average annual savings.

In discussions with the Task Force Chair, Vince Mudd, we have confirmed that the Task Force recognizes that it could take up to two years to ramp up to achieve annual savings in the range of the \$73 million target and that actual savings could vary year by year from this amount. The Task Force scenarios reflect this with the assumption of \$31 million of reform savings for FY 2012, \$56 million in reform savings for FY 2013 ramping up to \$77 million by FY 2016.

We caution that 1) the City should not be locked in to a hard number for any given year or time period; 2) the average annual savings of \$73 million be restated as a commitment to a target; and 3) the savings calculation not be limited to the results of the ten reforms tied to Proposition D. Other viable savings and reforms options exist including reorganizations, debt refinancings, business process reengineering studies and multicity cooperative agreements. Any savings from these and other future reforms should be recognized and accounted for as well.

We recommend discussing and clarifying these points prior to adoption of this principle. The expectation for when the verification of savings is to take place by the Mayor, IBA and City Auditor should also be clarified.

**Principle # 2 –Implementation of a spending freeze that permits no more than \$20 million per year from the temporary sales tax, adjusted annually for inflation, of critical service level restorations above the levels contemplated in the current Five-Year Outlook.**

The current Five-Year Outlook serves as the baseline for future revenue and expenditure projections. It is important to be aware that the Mayor’s “Revised Five-Year Financial Outlook”, issued April 19, 2010, includes no restorations of past budget reductions; no new programs or service level increases; minimal costs to operate and maintain new facilities; and no consideration of restoring any portion of the 6% salary reductions put into place two years ago. It also includes annual retirement ARC payments less than those projected by the SDCERS actuary.

It should be clarified by all parties whether the \$20 million spending limit applies only to service level restorations as stated in Principle #2 or whether it is intended to apply to all new spending as stated in the Task Force report and reflected in their financial scenarios. The Task Force financial scenarios add \$20 million annually for all new spending to the April 2010 Outlook baseline numbers. The only other allowances in the Task Force scenarios for new spending are payment of the full OPEB ARC and slight increases to the pension ARC to more closely match SDCER’s actuarial projection. Page 3 of the report states the following:

“Budget discipline freezes new spending at \$20 million per year. Council to agree to freeze annual budgeted expenditures above the Mayor’s current five-year budget outlook at no more than \$20 million per year.”

This is an extremely conservative spending limit if intended to apply to all new spending. The Task Force scenarios show that this limitation is necessary in order to avoid a deficit situation upon expiration of the sales tax increase. Any restorations or new spending should be approached very cautiously.

The Task Force scenarios are restricted by their revenue and reform assumptions, however, these assumptions could be significantly altered by the economy, emergency situations, and pursuit of other revenue sources and reforms. The principle as worded does not allow for any spending flexibility in the event of increased revenues or increased savings from reforms above and beyond those assumed by the Task Force. Prior to adoption of Principle #2, it is important to clarify that the \$20 million figure represents a commitment to a target and not a hard and fast spending cap.

While the Task Force has applied the recommended \$20 million spending freeze (with inflation) through FY 2021 in their scenarios, the Council may want to consider clarifying that this principle is intended to be in effect during the years that the sales tax is in effect as the Task Force Report noted for Principle #3.

**Principle #3-In the event of any future budget surpluses, a minimum of 50% of the surplus will be utilized for expenditures on critical infrastructure requirements or important one-time expenditures that do not impact future budget year expense run rates.**

We concur with this principle but would clarify as noted on page 3 of the Task Force report that this applies during the years that the sales tax is in effect. Additionally we would clarify that 50% is a target and not a hard and fast percentage. We also suggest replacing “that do not impact future budget year expense run rates” with “that do not result in annual recurring costs.”

## CONCLUSION

As mentioned earlier, the concepts in the three principles mirror several elements of the City’s adopted Budget Policy as well as the Council-adopted “Guiding Principles for Eliminating the Structural Budget Deficit.” The Guiding Principles are provided as an attachment to this report.

The proposed budgetary principles attempt to include greater specificity by assigning dollar values (either minimums or maximums) for specific elements of the budget equation, in terms of both savings and spending, for a specified period of time. Clarification is necessary in order to manage expectations. The Budget Policy and Guiding Principles focus on concepts, grounded in accepted best practices, that are timeless budget goals that the City should strive to achieve, now and in the future.

In November 2009, the City Council adopted the City Budget Policy (000-02). The Budget Policy outlines the City’s guidelines for budgetary decision making and set standards for sound budgetary practices and fiscal performance, and if consistently followed, will assist the City in achieving its current and future goals in a fiscally responsible and sustainable manner.

The adopted Budget Policy outlines fundamental budget principles, including:

- The City shall adopt and maintain a balanced annual operating budget.
- It shall be a goal of the City to achieve a long-term structurally balanced budget through efficiencies, permanent reductions to the expenditure base, and/or revenue enhancements.

A structurally balanced budget is defined as a budget that does not rely on reserves or the use of one-time revenues for ongoing expenditures.

- The use of one-time revenues should be limited to one-time expenditures; and, ongoing expenses should be funded with ongoing revenue sources.
- The City's budget shall fully fund the Annual Required Contribution (ARC) as determined by the San Diego City Employees' Retirement System (SDCERS) actuarial valuation report.
- Funding of retiree health or Other Post-Employment Benefits (OPEB) shall be a priority of the City's budget. The policy outlines a minimum payment formula to ensure the budget in future years contains funding for OPEB of at least the current level.

In February 2010, following study of best practices and the deficit elimination plans of other cities, the IBA recommended and the City Council adopted eleven Guiding Principles for Structural Budget Deficit Elimination.

The eleven principles reinforce and underscore the many areas outlined in the City Budget Policy, and provided greater specificity to achieve fiscal stability, including:

- Eliminate the General Fund structural budget deficit through a balanced approach of ongoing expenditure reductions and revenue generation, including identifying new revenue sources.
- Actively pursue alternative service delivery methods, including managed competition, efficiency improvements and elimination of service duplications.
- Reduce pension and retiree health care liability and annual City costs through the meet and confer process.
- Develop a plan to fully fund the Retiree Health (OPEB) ARC.
- Develop a plan to fund deferred capital infrastructure and maintenance needs.

The Council should carefully consider if the three proposed budgetary principles are consistent with and complement the already approved Budget Policy and adopted Guiding Principles. It is important that the adoption of additional budgetary commitments truly assist the City in achieving its goal to permanently eliminate the structural budget deficit.

**[SIGNED]**

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Attachment: Structural Budget Deficit Elimination Guiding Principles