

Pension Plan: A Strategy for Action

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Executive Summary

For several years, the City of San Diego has been immersed in what has often been labeled a pension crisis. This crisis has resulted in the reduced financial strength of the City and the Retirement System Trust Fund. It has also revealed and exacerbated administrative challenges for both entities. The Office of the Independent Budget Analyst (IBA) has developed this report to provide the City Council with a checklist of both administrative and financial reforms that should be addressed immediately to help restore the City's financial strength and prevent financial or administrative exposure in the future.

Some valuable reform has already begun. From a financial perspective, several initiatives over the last several years, some of which are still in progress, will control the liabilities the City incurs or increase the assets of the Retirement System. For instance, the City has infused \$107 million in additional assets into the System, a first step in complying with current labor contracts and pending legal settlements. In addition, potential liabilities in the system have been reduced by instituting salary and benefit freezes and eliminating benefits for new employees. Future efforts, such as Propositions B and C, and the Mayor's ongoing Business Process Re-engineering (BPR) efforts, may also help to control benefit increases and reduce system liabilities. We recognize these efforts in the first chapter of this report.

Despite these efforts, there are many financial and administrative reforms that have yet to be addressed. Most of these reforms should not be new, yet the IBA has seen little to no progress on them. We are alarmed by this apparent lack of action and are therefore bringing this report forward to provide a list of actions we recommend be taken expeditiously to comply with legal requirements and improve the financial status of the City with respect to the Retirement System.

Currently, there are five municipal code changes that should be brought forward to the City Council. Most of these changes will bring the City into compliance with new laws, legal settlements or labor contracts. Several of these changes are already past due, including changes necessary to comply with the Gleason settlement and the codification of the FY 2006 labor contracts. Others are no less urgent, including a technical tax compliance ordinance and an ordinance to comply with recent state domestic partner requirements. Finally, we again urge action on the "Waterfall," as codified in the Municipal Code.

Additionally, approximately half of the time has expired on the City's current contract with Local 127, which specifically requires an infusion of \$600 million into the Retirement System by June 30, 2008. Yet to date, only \$107 million has been deposited and no concrete or comprehensive plans have been announced regarding the remaining \$493 million. Although the City has been blocked from many financing opportunities over the past several years, this does not preclude the ability to plan for various actions that could be implemented eventually, nor does it preclude discussion of comprehensive

strategies. The City has just over 18 months to figure out how to infuse \$493 million into the Retirement System. In addition to developing strategies for complying with this cash infusion requirement, the City should determine what might happen if we cannot meet that obligation. The financial impacts of both scenarios should be evaluated for appropriate budgetary planning. Tentative legal settlements may further enforce the requirements for large cash infusions in coming years. Due to the length of time that will likely be required to complete any financing plans to satisfy these obligations, this should be addressed immediately.

Appropriate budgetary planning is the key to shepherding the City through the future challenging years. In the coming years, the City will see an increased ARC, notwithstanding the potential move to a 15 year amortization in FY 2009, as well as increased costs to address outstanding deferred maintenance and retiree health liabilities. This is in addition to the cost of providing basic services. The City cannot continue to hobble along year-to-year barely making its payments. The Mayor is preparing a multi-year forecast now, for presentation to the Budget & Finance Committee on November 29th. It is our expectation that this plan will forecast more challenging financial decisions in the City's near future. Now is the time to review a long-term financial forecast and make the difficult decisions that will ensure financial solvency in future years.

These issues are challenging and some may be esoteric, yet they merit immediate and continued discussion. It is critical that the City work now for reform, rather than waiting until it is too late.

Reforms Undertaken to Date

Although it is not within the scope of this report to discuss the history of the pension crisis, the reader may refer to reports issued by the Pension Reform Committee, Vinson and Elkins, Navigant, Mercer and Kroll for this level of detail. Prior to entertaining future reforms we must acknowledge the progress that has or is currently being undertaken to strengthen the Retirement System through fiscal and managerial reform. The City is currently pursuing several reforms that can be broadly categorized as cash infusion solutions, cost-cutting solutions, benefit adjustment solutions and benefit control solutions. Our discussion will begin with a brief description of the progress related to these categories.

Cash Infusion Solutions:

In the pursuit of cash infusion solutions, on June 21, 2006 the City deposited \$107 million from tobacco bond proceeds, 2006 tobacco settlement revenue receipts, and additional employee pick-up savings into the Retirement Fund to reduce the unfunded actuarial accrued liability (UAAL) (City of San Diego 2006h, City of San Diego 2006b and City of San Diego 2006a, 109). The impact of this infusion will be reflected in the SDCERS Actuarial Valuation of June 30, 2006, which will be completed by January 2007. This form of revenue securitization is part of a larger goal set forth in the Local 127 Labor Contract to “implement a leveraged mechanism to reduce the UAAL by a total of \$600 million or more... by June 30, 2008” (City of San Diego and Local 127 2005, 50). The implications of infusing an additional \$493 million into the Retirement System by June 30, 2008 will be addressed in the “Cash Infusion Obligations” section of this report.

Cost-cutting Solutions:

The Mayor’s office has voiced commitment to cost-cutting solutions through the mechanism of Business Process Re-engineering (BPR) and Proposition C, an upcoming ballot measure to institute Managed Competition Reform. The Mayor has stated that the “goal of managed competition will be a smaller, more responsive and more cost-efficient city government” (City of San Diego 2006f). Through the institution of BPR, the Mayor has projected a reduction of 500 City positions in Fiscal Year 2007 (City of San Diego 2006g). The concurrent processes of BPR and Management Competition seek to reduce City operating costs by streamlining operations and concentrating personnel resources to ensure that tasks are productively accomplished with the smallest expenditure of public resources. In addition to cost savings in the City budget, reduction in personnel and positions in the City will result in a reduction of future pension liabilities. When liabilities are reduced, the UAAL of the Retirement System is reduced as well.

Benefit Adjustment Solutions:

Collaboration between the City's unions and City Management has resulted in benefit adjustment solutions, providing the City with significant savings from a combination of salary freezes, benefit freezes, increased employee contributions, and an elimination of specific benefits to new employees. Pursuant to negotiations between the City and each labor union, the following benefits are no longer available to employees hired on or after July 1, 2005: Deferred Retirement Option Plan (DROP); the 13th Check; the purchase of service credits; and all formulae except 2.5% at age 55 and 3% at age 50 for General and Safety members respectively (City of San Diego and Local 127 2005, 42-44). In addition, the City's "pick-up" of employee pension contributions was reduced by 3% for the Municipal Employees' Association (MEA) and the International Association of Fire Fighters Local 145, along with a 3.2% reduction for the San Diego Police Officers Association (POA) and the Deputy City Attorney Association (DCAA) (City of San Diego 2005c, 13 and DCAA 2006, 3). Local 127 agreed to a 1.9% salary reduction and a benefit freeze in lieu of additional employee contributions (ibid).

After negotiations broke down between the City and the POA on May 1, 2006, the City Council imposed a continued pay freeze along with the 3.2% continued contribution to SDCERS and an additional 3.37% contribution since the Employee Contribution Reserve is depleted (SDPOA 2006a, 2). This equates to a 6.57% pay reduction to increase payments into the Retirement System (SDPOA 2006b). Not accounting for the 2006 POA pay cuts, negotiated wage and benefit freezes under the prior POA agreement along with agreements reached with MEA, Local 145, Local 127, and DCAA are projected to have a savings impact of approximately \$151 million for Fiscal Years 2006 and 2007 (City of San Diego 2005c, 17). Future liabilities, expressed as the UAAL, will thus reflect a savings of at least \$151 million due to these labor concessions.

Benefit Control Solutions:

Benefit control solutions apply to future benefit increases and seek to control the imposition of additional benefits. Proposition B, proposed by the Mayor and approved by the City Council, is to be placed on the November 2006 ballot. The proposition would mandate majority voter approval and an accompanying actuarial study of all benefit increases (City of San Diego 2006f). The City and County of San Francisco currently implements a similar system in which benefit increases must be approved by a vote of the public (Summers 2006). As of 2005, San Francisco's pension system was 104% funded (Schmidt 2005). In relation to the required actuarial study, the City of San Jose requires such a study prior to the implementation of benefit enhancements. The San Jose retirement system was 99% funded in 2005 (ibid). Although the benefit control reforms in these cities appear to be correlated with high funded ratios, this does not imply that the implementation of such reforms will cause the City of San Diego's funded ratio to improve. Nonetheless, reforms that place greater restrictions on the dispensing of retirement benefits may prevent the City from granting benefits that it does not have the ability to fund.

Reforms Undertaken to Date	
Solution Category	Reform
Cash Infusion	\$107 million deposited June 2006
Cost-cutting	BPR and Prop C Proposal
Benefit Adjustment	Salary freezes, benefit elimination, benefit freezes and increased employee contributions
Benefit Control	Prop B Proposal- voter approved benefit increases and actuarial study

The solutions described above have placed the City on a path of reform. Yet other actions must accompany our current progress. Reports issued by various outside consultants, along with internal reports issued by the IBA, have alerted the City to significant issues affecting the Retirement System that are in dire need of reform. As time continues to expire, the IBA urges the City to expediently address these issues. The following chapter will describe some of these pressing concerns.

Imperative Reforms Not Undertaken to Date

In this chapter, the IBA will address remedies that have yet to be implemented. Some of these recommendations echo those made by Kroll, the Pension Reform Committee (PRC), and prior IBA Reports. The issues addressed in this portion of the report require the City's immediate attention. Regardless of what form the final solution may take, the IBA is concerned that if these issues are not addressed in a timely manner, the City may not be able to take full advantage of opportunities for significant improvements and reform. The ensuing discussion will evaluate the following: (1) amendments to the San Diego Municipal Code; (2) cash infusion obligations; and (3) the City's long-term budgetary challenges. The purpose of this discussion is to urge the City to develop a strategic plan to improve the fiscal and administrative management of the City's Retirement System.

Imperative Reforms Not Undertaken to Date	
Section	Reform
Amendments to Municipal Code	Eliminate concept of surplus undistributed earnings in "Waterfall"
	Three pending ordinances
	FY 2006 Labor Contracts
Cash Infusion Obligations	Infuse \$493 million into Retirement System by June 30, 2008
	Tentative legal settlements
City's Financial Forecast	Reduce UAAL
	Cost Cutting
	Revenues

Amendments to Municipal Code

- **The "Waterfall:"**

The City must take immediate action to address overdue and imperative amendments to the San Diego Municipal Code (SDMC). During the Fiscal Year 2007 budget process various members of the executive and legislative branches lamented the reality that the "Waterfall" clause continues to divert "surplus earnings" away from the Retirement System's assets. To date no action has been taken to remedy this reality. The IBA is concerned that if this is not addressed, the fiscal soundness of the Retirement System will continue to be compromised. The IBA continues to recommend that the City, in coordination as necessary with the City's various labor unions and plan participants, address the elimination of the concept of surplus undistributed earnings with the greatest expediency. In addition to the "Waterfall" provisions of the Municipal Code, the

proceeding sections will discuss three ordinances relating to the administration of the Retirement System, and an ordinance codifying the benefits enacted by the Fiscal Year 2006 Memoranda of Understanding with the various labor unions.

In light of the extensive reforms the City of San Diego is poised to undergo this fiscal year, the City is presented with a most opportune time to eliminate the fallacious notion of “surplus undistributed earnings” embedded in the “Waterfall” section of the Municipal Code. This concept has been a key factor in compromising the fiscal soundness of the Retirement System. In IBA Report 06-18, entitled “Mayor’s Proposed Fiscal Year 2007 Budget,” issued April 28, 2006, it was noted that “ ‘The Waterfall,’ the mechanism by which retirement fund assets are diverted to other ‘contingent’ uses, is still codified in the City’s municipal code” (City of San Diego 2006d, 22) The PRC has proposed that “an amount equal to the value of the contingent benefits siphoned from the Plan earnings should be replaced by the City annually based on an estimate calculated at the beginning of the fiscal year for that fiscal year” (City of San Diego 2004a, 36). Kroll has also opined that:

For the purposes of calculating annual funding requirements, the UAAL should reflect a prudent view of economic reality, and include within it the costs of the Corbett settlement. We recommend against using the City’s contribution to pay for any benefits other than retirement benefits and the related costs of administering the Plan. Thus, no portion of the City’s annual contribution to SDCERS should be credited against the City’s obligation to pay for retiree healthcare costs, or for any other of the so-called ‘Waterfall’ payments, unless and until the City pays the required ARC. (Dahlberg, Levitt, and Turner 2006, 259)

In response to Kroll, the Mayor’s office stated that this particular remediation “may require an amendment to the City’s Municipal Code. Staff will work with the City Attorney to ensure that these changes are brought before City Council for action **by December 2006**” (City of San Diego 2006k, 29). Prior to this pronouncement, on June 13, 2006, Council President Peters issued a memo to the City Attorney requesting a legal analysis on eliminating the provisions of the Waterfall, urging that appropriate items be submitted “at the earliest possible date.” It is our understanding that the offices of the Mayor and the City Attorney are collaborating on this project and we respectfully suggest that the December 2006 date be reaffirmed in order to ensure that the issue may be addressed prior to the winter holidays.

· **Three Pending Ordinances:**

In addition to the elimination of the surplus undistributed earnings concept, the City must adopt three pending ordinances that affect the administration of the Retirement System. The following ordinances do not require a “meet and confer” or a vote of SDCERS’ members: Proposed Tax Compliance Ordinance; Proposed Ordinance to Comply with the Domestic Partner Act; and Proposed Ordinance to Comply with the Gleason Settlement Agreement (SDCERS 2006, 1).

- Technical Tax Compliance:

Per Mercer's 2004 recommendation to SDCERS, the Board pursued the receipt of a Tax Determination Letter (TDL) from the Internal Revenue Service (IRS) to confirm the status of the retirement plan under the Internal Revenue Code (IRC) (SDCERS 2006, 1). As a "necessary and integral part" of the TDL application, the City must adopt an ordinance to amend the Municipal Code to add specific references to the IRC (SDCERS 2006, 2). The "Technical Tax Compliance Ordinance" was prepared by SDCERS legal staff and tax counsel, but has yet to be adopted to amend Division 10, SDMC §24.1010 (ibid).

- Domestic Partner Compliance:

On January 5, 2005, the Domestic Partner Rights and Responsibilities Act of 2003 became effective in the State of California (SDCERS 2006, 2). The Act requires that employees with same-sex domestic partners, registered with the State of California, be provided with the same employment benefit granted to employees with spouses (ibid). An ordinance was finalized in December 2004, which would bring the City into compliance with the Act. Nearly two years later, this ordinance has yet to be adopted (ibid).

- Gleason Settlement Compliance:

Per the Gleason Settlement of July 2004, the City is required to "repeal those portions of the San Diego Municipal Code section 24.0801 enacted November 18, 2002, which specify the rates the City pays [to the Retirement Fund on behalf of City employees] are as agreed to in the governing Memorandum of Understanding between the City and SDCERS" (SDCERS 2006, 3). The deadline for this requirement was November 24, 2004 (ibid). As of this writing, the City has not complied with this settlement provision.

- **FY 2006 Labor Contracts:**

In addition to the three ordinances described above, the City Council has not adopted an ordinance codifying the alteration of benefits enacted by the Fiscal Year 2006 Memoranda of Understanding with the various labor unions (City of San Diego 2006l). The SDCERS Board has stated that it cannot carry out the intent of the FY 2006 and FY 2007 MOUs unless an ordinance is adopted to amend the Municipal Code (ibid). The Board will administer the plan as set forth in the Municipal Code until the terms of these MOUs are incorporated (ibid). For instance, although it was the intent of the City Council to eliminate the purchase of service credits as reflected in the labor agreements, the Municipal Code does not mirror this intent. This ambiguity is problematic. The IBA recommends that immediate action be taken to ensure that the Municipal Code affirms agreements between the City and the labor unions to prevent financial or legal impacts from being incurred.

In a memorandum issued on May 15, 2006 by Council President Scott Peters to City Attorney Michael Aguirre, Peters requested that the City Attorney provide the Council and Mayor a status update on a “proposed ordinance combining three of the pending ordinances” and “ordinance language related to the FY 2006 MOU” (City of San Diego 2006l). Additionally the memo asked the City Attorney to submit “items to be docketed at a City Council meeting at the earliest possible date” (ibid). A follow-up memorandum was issued by the Council President’s office on July 19, 2006 reiterating the concerns detailed in the May memorandum. On August 9, 2006, the Mayor issued a memorandum to the City Attorney referencing Peters’ two memoranda. The Mayor requested that he and the City Council be updated on the status of these items and that “any appropriate items” should be submitted “to be docketed at the September 11, 2006 City Council meeting” (City of San Diego 2006j). The IBA suggests that the codification of benefit changes resulting from Fiscal Year 2006 MOUs and the ordinance combining the three pending ordinances be brought before the City Council as soon as practicable.

Cash Infusion Obligations

The City of San Diego is obligated to infuse significant sums of cash into the Retirement System in the coming years. Due to current labor contracts with the unions, as well as potential settlements in the cases of *McGuigan v. City of San Diego* and *Newsome v. SDCERS and City of San Diego*, the City’s time to reduce the System’s UAAL is limited. Due to the tentative nature of these settlements, and reality that the labor contracts require the largest cash infusion, the following discussion will focus on fulfilling the City’s obligations as defined by current labor contracts. Specifically, this discussion will focus on the City’s labor contract with Local 127.

In negotiations with Local 127, the City agreed to infuse a total of \$600 million into the Retirement System within three years in exchange for certain labor concessions. The MOU with Local 127 states:

If the City does not implement a leveraged mechanism to reduce the UAAL by a total of \$600 million or more, including the amount achieved by leveraging employee salary reduction and pension contribution monies, by June 30, 2008, then these monies, plus interest, shall be deposited into the SDCERS Employee Contribution Rate Reserve and used to defray the pension contribution obligation of employees in Local 127-represented bargaining units. The City shall be excused from meeting the above obligation if the funded ratio reaches 100% by June 30, 2008. (City of San Diego and Local 127 2005, 50)

As stated earlier, on June 21, 2006 the City deposited \$107 million into the Retirement Fund from tobacco bond proceeds, tobacco settlement revenues and employee pick-up savings (City of San Diego 2006a, 109 and City of San Diego 2006b). This leaves \$493 million to be leveraged by June 30, 2008 in order to comply with the terms of the MOU. The IBA recommends evaluating the following cash infusion solutions: revenue securitization of franchise fees and/or lease revenues, city property sales, and the

issuance of Pension Obligation Bonds (POBs). These options were recommended in City Manager Report 05-190, *Options to Increase the Funded Ratio of the San Diego City Employees' Retirement System*, issued on September 8, 2005 (hereafter referred to as the "Manager's Report"). The following discussion is based on this report's analysis and numerical data, and is utilized to provide a forum for discussion as to how the City plans to comply with current labor agreements.

According to Fiscal Year 2006 budgeted estimates, franchise fee collections from Cox Communications and Time Warner Cable will equal approximately \$14.9 million per year over a five to ten year period (City of San Diego 2005c, 15-16). When securitized over five years it is estimated in the report that this revenue stream could generate approximately \$38-\$48 million in upfront proceeds and approximately \$66-84 million if securitized over ten years (ibid). An evaluation of this option must consider the impact of California Assembly Bill 2987 approved on September 29, 2006 (State of California 2006). It is unclear at this time how the transition to state issuance and administration of franchise fees will impact the ability of the City to securitize this revenue stream.

In addition, the Manager's Report further suggests that lease revenues from "blue chip" credit tenants equaling approximately \$23.8 million could be securitized over five to ten years (City of San Diego 2005c, 16). The report estimates that that this revenue stream could generate up-front proceeds of approximately \$51-\$65 million when securitized over five years and approximately \$88-112 million when securitized over ten years (ibid).

By conservative estimates, if both revenue streams were securitized, the City could generate upfront proceeds of \$89 million over five years or \$154 million over ten years.¹ If either of these leveraging mechanisms is utilized, however, the General Fund will need to be backfilled in order to maintain current service levels. Thus, the City must evaluate the availability of the employee offset savings and/or other revenues to backfill the General Fund to prevent reductions in City services.

Apart from various forms of revenue securitization, the City might consider City property sales as a way to infuse significant cash into the Retirement System. The Manager's Report argues that such properties would not encompass assets or public amenities described as open space land or dedicated park land, but properties held for investment purposes rather than the City's central mission (City of San Diego 2005c, 16). The Manager's Report estimates that such properties could have an estimated value potentially in excess of \$250 million; however the report suggests that only \$100 million in land sales could be transacted over a three year period (ibid). In addition the PRC recommends the following additional viable solutions: "borrow against real estate, using it as collateral;" or "allow the plan to hold a fully amortizing note carrying the actuarially assumed rate of 8% secured by specific City real estate" (City of San Diego 2004, 32).

¹ Liberal estimates would generate \$113 million in upfront proceeds over five years and \$196 million over ten years.

A City Charter provision regarding the Capital Outlay Fund presents a challenge to this potential strategy:

Into this fund each year there shall be placed all moneys derived from taxation required or needed for capital outlay expenditures and all proceeds received from the sale of city-owned real property. The moneys in the Capital Outlay Fund shall be used exclusively for the acquisition, construction and completion of permanent public improvements... (City of San Diego 2005b, §77)

This Charter provision further restricts the use of such moneys stating that the fund “shall not be used for any other purpose or transferred from said fund, except with the consent of two-thirds of the qualified electors of said City, voting at a general or special election” (ibid). The IBA suggests that the City Attorney evaluate the legal implications of this option. If property sales prove a legally viable option to infuse money into the Retirement System, the IBA suggests that the Mayor’s office update the City Council on the outlook of utilizing sales from investment properties.

The issuance of Pension Obligation Bonds (POBs) has been promulgated as an option by the PRC, the Manager’s Report and, most recently, the Mayor’s office. Once the City’s credit ratings are restored, the City may be able to borrow at interest rates below the Retirement System’s 8% assumed rate of return. IBA Report 06-18, dated April 28, 2006, clarified the crux of the POB issue: “Issuing POBs is... akin to refinancing debt. ***It must be emphasized that POBs neither create new debt, nor do they pay off debt that already exists.*** As such, the primary reason to issue POBs is for interest rate savings and/or arbitrage” (City of San Diego 2006d, 22). If interest rates do not remain favorable, then there is no economic reason to issue POBs. Yet the issuance of POBs may be a necessary and vital mechanism to generate the large cash infusion dictated by labor contracts. By creating such an issuance the debt does not disappear, but is transformed under conditions in which interest rates would result in savings. POBs are also viewed as a form of “hard debt,” which the City must recognize as an outstanding liability on the financial statements (City of San Diego 2006d, 22).² Many critics of POBs argue that they “shove the problem off into the future” (Schmidt 2005). Yet statements such as these must be evaluated carefully. If POBs are financed under the same period as the amortization of the current UAAL in the Retirement System, this debt is not actually prolonged any further.

In light of Kroll’s acerbic treatment of POBs, along with the uncertainty of savings from favorable interest rates, it is not clear if such an option will remain viable. Nevertheless, if interest rates are below 8%, there is no reason to summarily reject the POB option. The IBA suggests that the Mayor update the City Council on the prospect of cost savings from a POB issuance once the City’s credit ratings are restored.

It is unclear whether the full \$493 million can be infused into the Retirement System before June of 2008, even if all funding options discussed above are executed to the

² Whereas the UAAL is a footnote on statements.

fullest extent. The IBA strongly recommends that the issue of labor contract compliance be discussed by the City Council at the earliest possible date. The aim of such a discussion should result in the development of a strategic plan to infuse \$493 million into the Retirement System before June 30, 2008. Additionally, this discussion should address the costs the City could incur if these obligations are not met. The City should be aware of the cost of defaulting on labor contracts in order to adjudicate proposals to infuse additional funds above the ARC into the Retirement System.

City's Financial Forecast

The City's debt to the Retirement System, known as the Unfunded Actuarially Accrued Liability (UAAL), was estimated to be \$1.37 billion as of June 30, 2005. This presents a daunting challenge for the City of San Diego. Much discussion has focused on possible solutions to eliminate or reduce the UAAL. The final report by the Pension Reform Committee (PRC) suggested pension obligation bonds or real estate sales as possible options. The various lawsuits against the City and the current labor contract with the unions have also focused on reducing the UAAL by requiring additional cash infusions, such as the \$173 million required by the tentative *McGuigan* settlement or the \$600 million required by the MOU with Local 127.

Despite these required cash infusions, a sizeable UAAL will remain. Claims have been made that the City has no plan to pay down its debt to the Retirement System. These claims fail to realize, however, that the City is currently taking action to eliminate the UAAL in much the same way that one would pay off a mortgage debt: through amortization. Each year, the Retirement System presents the City with a "bill" for what it owes that year. This bill, known as the Annual Required Contribution or ARC, includes two distinct components. The first component is the amount that the City needs to pay in order to cover the liabilities that will accrue in that fiscal year. This component is known as the Normal Cost, and would have to be paid even if there were no UAAL. The second component of the ARC is the amount that the City needs to pay that year to amortize its debt -- the UAAL -- over an extended period of time. The ARC in FY 2007 is based on a 28-year amortization period for the June 30, 2005 valuation.

This method of amortization *is* the City's plan to eliminate the UAAL, regardless of any additional corrective action. This perspective has not been widely circulated. The problem with this plan, however, is that due to the magnitude of the UAAL, the annual payment that will be required by the City in future years for amortization may be so large that it will essentially cripple the General Fund. While the General Fund is not the only City fund that must contribute to the ARC, the General Fund faces the greatest constraints since it funds the City's most critical services such as public safety. Therefore, while all City funds must be carefully managed over the long-term, we will focus on the General Fund.

Over the past several years General Fund revenue growth has been significant, yet budget cuts have been required in each year, largely as a result of the City's obligations to the Retirement System. In addition, these annual payments will increase when and if

the City moves to a 15-year amortization in FY 2009. It should also be noted that this does not account for the growing costs of retiree health care and the City's need to address this additional unfunded actuarial liability.

Despite the substantial revenue growth and the reduction in services that has occurred over the past several years, the General Fund remains in a structural budget deficit. The FY 2007 budget was balanced without any service cuts as a result of several anomalous factors, such as a one-time increase in property tax revenue and the absence of any wage and salary increases. These factors cannot be counted on in future years. Given the General Fund's limited revenue streams, it is unlikely that the City will have the capacity to continue providing the current levels of service, much less any increase in services, and meet its obligation to the Retirement System.

Conceptually, the solution to this problem is straightforward. In order to relieve the structural budget deficit in the General Fund, the City must increase revenues, cut costs, or reduce the obligation to the Retirement System. It is likely that the optimal solution will include components of each option. The Mayor has already taken steps to cut costs through BPR and the Managed Competition ballot measure. Although, the actual cost savings to be realized from these efforts is unknown. Pending lawsuits may reduce some obligation to the Retirement System, but cannot and should not be counted on to reduce the City's burden. Additional solutions in the form of revenue increases, service cuts, or accelerated reductions in the UAAL may be necessary in order to achieve a structurally balanced General Fund. It is expected that many of these issues will be addressed when the Mayor presents his multi-year forecast on November 29th to the Budget & Finance Committee. In addition, the Council's Strategic Planning Process, currently scheduled for December 6th, will provide the opportunity for the Council to consider the range of potential solutions.

Once discussion begins on the multi-year forecast, the IBA recommends that the City revisit the plan on a quarterly basis and use all of the tools at its disposal to ensure a sound financial future for the General Fund, and all City funds. A quarterly review will include a discussion on the how the City plans to reduce obligations to the Retirement System by meeting the terms of current labor contracts, as well as an evaluation of the recommendations made by the PRC and reinforced by Kroll. It also includes discussion of cost savings measures from BPR and Managed Competition to identify core City services and align costs with those functions. It should further include the identification of new revenues. We have included an update on the issue of a Pension Tax here, as well as a brief review of revenues recommended for consideration in the past, as a starting point for this discussion.

Pension Tax: Charter section 76 states that "the Council, if necessary, shall levy annually a sum sufficient to meet the requirements of the pension funds herein provided..." (City of San Diego, 2005b). Proposition 13, approved by California voters in 1978, sharply limited local agencies' taxing power, but allowed certain flexibility for taxes to pay back indebtedness approved by voters prior to July 1, 1978. City Attorney Legal Opinion No. 82-3 issued on September 1, 1982 on the *Legality of the Property Tax*

Levy to Meet City Pension Plan Obligations found that a tax may be levied “in excess of the 1% limitation of Proposition 13 to meet City’s obligations to fund the Retirement System” (City of San Diego 2005c, 21).

While a pension tax would provide a reliable revenue source that could directly fund the pension deficit, a legal debate surrounds the issue of whether a pension tax can be imposed or if it requires a vote of the people (Donohue 2006). Although the City imposed a pension tax from 1961 to 1978, former City Attorney John Witt and current City Attorney Mike Aguirre contend that the re-imposition of the tax would require a vote of the people (Donohue 2006 and Hall 2006b). Proposition 218, approved in 1996, further strengthened the tax limitations imposed by Proposition 13. The IBA suggests that an updated legal opinion from the City Attorney may be warranted to address how Proposition 218 might impact the possible levy of a pension tax.

It should be noted that a Pension Research Council report found a negative correlation between a pension tax and the funded ratio of retirement systems. The report states that “a dedicated tax for contributions appears to reduce, rather than enhance, funding” (Yang 2005, 17). The report speculates that “this may be because state or local governments may assume that such taxes cover needed contributions so that they do not fill the gap when one arises” (ibid). However, this argument does not provide sufficient grounds for dismissing a pension tax wholesale as proper controls and regulations could be put in place to avoid such “contribution holidays.”

A recent response from both the Mayor and Council to MEA’s letter demanding the City levy a pension tax was not favorable to this option (Donohue 2006). The IBA suggests that the City make a formal decision to either pursue the issue of a pension tax or to concentrate energies on other reforms.

Trash Collection Fee: San Diego is the only major California city that does not charge for trash collection (Baxamusa 2005, 16). Although not subject to the voter requirement under Proposition 218, the City Charter requires free trash collection to single-family residences. Thus, a majority vote would be required to amend the City Charter.

Transient Occupancy Tax: According to a report entitled *The Bottom Line* by the Center on Policy Initiatives, San Diego has the lowest TOT rates among the top ten tourist destinations in California based on 1997 U.S. Census Bureau statistics (Baxamusa 2005, 8). Voter requirements vary depending on the design of the tax or fee.

Business License Tax: In proportion to gross business receipts, San Diego businesses pay the lowest Business License Taxes when compared to ten other large California cities (Baxamusa 2005, 12). A change in this structure would require a vote of the people, as mandated by Proposition 218 (LAO 1996).

The IBA again emphasizes that the Mayor and City Council should use a balanced approach for future planning in order to correct the structural deficit inherent in the General Fund. We urge the Budget & Finance Committee to docket the issue of long-term planning and reviews of the multi-year forecast on a quarterly basis, in order to make appropriate progress on potential remedies.

CONCLUSION

In summation, this report discussed several vital reform processes that should be docketed and addressed immediately by the City Council. Most of the items presented here are past due for City action, such as the municipal code modifications, or have a looming deadline, such as the labor contracts and tentative legal settlements. As we have stated, the Office of the IBA is alarmed at the lack of action on the various items listed here. Thus, we recommend the following:

1. The City Attorney should present a plan and a timeline for the expeditious advancement of all of the necessary ordinances to effect the Municipal Code changes discussed:
 - a. The “Waterfall”
 - b. Three Pending Ordinances:
 - i. Technical Tax Compliance
 - ii. Domestic Partner compliance
 - iii. Gleason settlement compliance
 - c. FY 2006 Labor Contracts
2. The Mayor should develop a plan and timeline for cash infusions as required by current labor contracts and legal settlements. This should be discussed regularly and comprehensively with the Council and developed over time. Items should not be brought forward on a piecemeal basis or at the last minute without a comprehensive plan that is presented and discussed in advance.
3. The Mayor and City Attorney should present financial and legal analyses on the possibilities and consequences of default on the contract with Local 127 and/or all contracts. The City Council must be aware of the consequences of default and be able to consider those consequences when weighing the costs and benefits of proposed cash infusion solutions.
4. The Multi-Year Plan, currently under development by the Mayor, should be discussed quarterly with the Budget & Finance Committee in order to adequately plan for future obligations and adjust for changing circumstances.

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