



MEMORANDUM

DATE: May 30, 2007

TO: Mayor Reilly and Members of the City Council

FROM: City Manager

SUBJECT: PROPOSED BUDGET FOR FISCAL YEAR 2008

The City's Economy and the City's General Fund Budget

Those who work with and depend on the City's budget know that since the high-tech bubble burst in 2001, the City of Santa Cruz has struggled. The five-year period from Fiscal Year 2001 through Fiscal Year 2005 was probably the most financially challenging period that the City ever experienced. Fortunately, that exceptionally difficult period is behind us. It seems that "normal" economic conditions have returned.

It is therefore appropriate to ask two questions. The first is: "What is 'normal' for the City of Santa Cruz?" The second is: "What does the answer to the first question mean for the City's future?"

The answer to the question, "What is normal for the City?" is clear. In most years, the City's tax receipts will grow very modestly. More often than not, the City's tax receipts will grow at about the rate of inflation, give or take a little. The last time we experienced noteworthy growth above the inflation rate was when the Gateway Plaza came on line; prior to that it was when Costco came to the City. As these examples make clear, we do not experience noteworthy real growth very often.

This may not sound like such a bad thing for the City. How difficult could it be to hold expenditure increases to the rate of inflation over the long term? The answer turns out to be that it is impossible to hold the City's spending increases to the rate of inflation without cutting services at the same time. Economic reality dictates that no institution can keep doing the same things year after year and hold overall spending increases to the rate of inflation.

There are many reasons why City spending always has outpaced and always will outpace inflation, including the following: 1) the total cost of compensation for most cities, and most employers, increases at a rate that exceeds the rate of inflation over the long term.¹ This reflects real growth in the larger economy over time; 2) the cost of health benefits continues to increase by much more than the rate of inflation; 3) it is widely anticipated that the cost of fuel and energy will continue to increase by more than the rate of inflation, and many of the City's services are fuel-intensive; 4) workers' compensation and retiree health care benefits represent additional financial challenges that will require funding above the rate

¹ That does not mean that most employees in the workforce enjoy raises that exceed the rate of inflation; that has not been the case in recent years.

of inflation; 5) the City still processes its land use applications, parking fines, and a host of other activities on its antiquated HP 3000 mainframe computer. We have no choice but to transfer these activities to a modern environment and to expand our Information Technology staff to accomplish this; 6) there is a long list of things that fall in the same category as Item (5) above; 7) the City engages in construction activities of all kinds, and will always be engaged in those activities. Construction costs are increasing at triple the rate of inflation or more, and are expected to continue to do so; and 8) in making cuts over the past seven years, the City cut or postponed any number of expenditures that cannot be forever dispensed with.

Even absent the above pressures, we also want more of almost everything. That is, we want real spending to increase. We want (and need) a larger Police Department, one that has the resources to dedicate special patrols to the downtown and the beach area and to address street crime, gangs, and other situations. We want a Fire Department that will continue to provide paramedic as well as fire suppression and safety services in the face of increasing demands. We want our streets to be passable, our streetlights to be on, and our storm drains to flow. We want lifeguards on the beach. We want our extensive parks system to be well-maintained. We want our 2,500 acres of greenbelt to be protected. We want the Louden Nelson Community Center, Civic Auditorium, Harvey West Pool, Teen Center, Beach Flats Community Center, and other facilities to be open. We want not only to continue, but to expand, our support of social services. This list goes on and on.

These spending pressures are not unique to the City of Santa Cruz. How do other cities expect to address them? The answer is that most cities plan for, and expect to experience, real growth, rather than just nominal or inflationary growth.

It is easy for growing cities to experience real economic gains; it is more challenging for cities that are "built-out." Recognizing that it is harder to sustain a built-out city than a growing city, most built-out cities still plan for and expect to achieve real economic growth, as new economic activities replace older activities, and as new developments replace older developments. Witness San Francisco's breathtakingly ambitious plans; San Francisco may be built-out, but it is planning to be re-built. The same kind of planning is being done almost everywhere. Other cities may or may not achieve what they seek, but the fact is that most seek to achieve real economic growth.

Santa Cruz is an exception to this generalization. The dominant theme for Santa Cruz is the desire to maintain the positive attributes the City has long enjoyed. The City does not, by and large, desire to cultivate real economic growth and vitality. That is a legitimate choice, so long as the financial consequences of such an approach are recognized and dealt with. It has, after all, been the City's choice for a long time.

Translated into "budget-speak," the City's historic planning goals translate into a revenue goal, albeit an unacknowledged one: for tax revenues to increase at about the rate of inflation, reflective of maintaining existing conditions in the City. The City's budget dilemma is that real economic growth is required to keep doing the things that the City government does, but the City's built environment, in the absence of continuous rebuilding, remodeling, and re-use, will produce nominal growth instead.

Suppose for the sake of contemplation that participants in a graduate city planning seminar were assigned the task of proposing services for a city whose highest value was the

preservation of its existing environment. That is, the city being contemplated desired, as its highest value, to avoid the activity, congestion, pollution, and other conditions that result from more intensive economic activity. What would be said about the services that city should undertake? The answer is clear: that city should take a minimalist approach to city services. That city should do what is essential, but avoid doing what is optional. That city should not have an extensive list of city services.

If a group of savvy local government professionals were shown only the amenities provided by the City of Santa Cruz and asked to describe the City's tax base, they would say, "This City provides wonderful services. It must be a very well-off city indeed." They would be shocked to find that it is not so.

Our City is not going to compromise either its determination to maintain its present economic environment or its support for the amenities it values. Instead, the City will struggle to make ends meet. We are like a family that has acquired its dream house and is planning its dream vacation, but whose breadwinners are committed to working part-time; each is a fine choice, but they do not fit together very well.

The hard-working citizens preparing the City's next General Plan are coming to grips with this issue. They cannot solve it. But the language being proposed at this time recognizes two important points. The first point is that the well-being of the larger economy and the financial well-being of the City itself are two different things. The larger economy will perform reasonably well, because it is broad; the City's tax base will not perform as well, because it is narrow. The second point is that in the absence of real growth in tax receipts over the years, the City government will continue to experience financial distress.

For better or worse, there are two keys to the prosperity of cities in California. They are retail sales and hotels. These revenue sources are critical for two reasons. First, they have the potential to grow more quickly than inflation. Second, they are relatively independent of demands for municipal services. As the other sources of municipal revenues grow, so do demands for municipal expenditures. That is why other sources of revenue are considerably less attractive, from the city hall point of view, than sales and hotel taxes.

There is good reason for the fierce competition that is waged among cities to attract sales tax and hotel tax generators. The winners will achieve real economic growth of their tax base, which will enable them to pay for the things they want. Jurisdictions that do not obtain sales and hotel tax winnings will not achieve real economic growth of their tax base, and will struggle to meet their growing expenditure obligations. This is the way things are in California. It is the way things have been for a long time. There is no sign that they will ever be any other way.

The City's Employee Compensation Dilemma

The City of Santa Cruz is next door to one of the most dynamic employment markets in the world, and to cities that have extraordinarily productive tax bases. Northern California as a whole is one of the most prosperous areas of our country. We are in competition with many of the most successful local governments and private companies anywhere. We do not like being in competition with them, but there is nothing that we can do about it. We cannot hope to match them, and have always said so flat out. But we cannot escape the pressure to trail

them by some reasonable differential. This is not a matter of values or theory; it is simply a matter of practical reality.

Despite trailing “over-the-hill” jurisdictions, historically the City has compared favorably with other government employers in Santa Cruz and Monterey counties. Now even that is starting to change, as jurisdictions in our region individually address their own compensation challenges. For example, the County of Santa Cruz has made a commitment to pay its highest-ranking managerial and professional employees at a rate that is 95% of an eight-county average, which includes Santa Clara County. Santa Cruz County will accomplish this over an eighteen-month period. It remains to be seen how the County will address compensation issues for the remainder of its workforce. The City of Monterey has approved a package much like Santa Cruz County’s for its management and professional employees, and has also granted large increases to law enforcement. As a result, instead of being roughly comparable with the County of Santa Cruz and the City of Monterey, as has long been the case, the City of Santa Cruz will trail those jurisdictions for many managerial and professional positions, often by very substantial amounts. Nor are those the only positions where this situation applies; such positions can be found throughout the workforce.

Moreover, even comparatively rich cities are experiencing difficulty recruiting for a wide range of positions, especially managerial, professional, and technical, highly skilled employees. The City of San Jose has announced that it must increase compensation of selected positions despite the fact that its revenues will not grow at a pace to cover the cost.

It is tempting to think that there is a new economic reality out there. But it is not so. What has happened is that many jurisdictions have witnessed but not responded to the labor market over the past seven years. These cities, Santa Cruz among them, had more than they could cope with already. They were in no position over the past seven years to make modest, regular adjustments. On the other hand, cities and other employers that could afford to do so did make a series of smaller adjustments over the past seven years, and remain in a strong position. Those who could not and did not keep up are now facing a serious problem.

The labor market in law enforcement is an excellent example of what is now happening in other areas, too. Over the past twenty-five years, the City has hired every single police officer candidate who met the City’s standards and agreed to come to work here. If ten or twenty such people had appeared at one time, we would have immediately gone to the City Council and proposed to hire them all, knowing that the Police Department would not be over-staffed for long. It has never happened. Under these circumstances, the City of Santa Cruz is obliged to pay what the labor market dictates, not what the tax base can support.² The same is true for police sergeants, lieutenants, deputy chiefs, and the police chief.

Fortunately, the City meets with a high degree of success in attracting candidates for most of its jobs, especially those that are more reflective of local economic conditions and less reflective of what happens elsewhere. For other positions, the City of Santa Cruz must compete in the larger labor market for people with skills that are in high demand. Such positions include numerous technical specialties throughout the workforce, as well as accountants, engineers, planners, and others. Many departments report that they are having more difficulty than ever before finding qualified applicants.

² It is estimated that there are between 12,000 and 15,000 police officer vacancies in California.

The cost of benefits is also a serious matter. Health care costs routinely increase by much more than the rate of inflation. Pension costs continue to be a burden. The City's share of retirement for police and fire employees is 35% and 39.7% of salary, respectively. In addition to those employer contributions, police and fire employees contribute an additional 9% of salary, making the total cost of retirement 44% of salary for police and 48.7% of salary for fire. As police and fire salaries increase, as they inevitably will, the cost of retirement benefits will increase proportionately. These costs are, and will continue to be, staggering.

The total cost of retirement for non-public safety employees, who are referred to by the CalPERS retirement system as "miscellaneous employees," is less than half that for public safety employees, but still far from inexpensive. The City's share of that cost, however, is dramatically less. The major issue for miscellaneous employees has to do with the share paid by the City and the share paid by employees. When the current plan was established in July of 1997, employee bargaining units agreed that employees would bear the cost of the program for ten years. That period has now passed, and the issue is open for discussion.

The total cost of retirement for miscellaneous employees is 20% of payroll. Pursuant to the 1997 agreement, employees are paying about two-thirds of that cost while the City pays the remaining third. The cost of retirement for non-public safety employees, then, could well become but is not yet a significant problem for the City.

Retirement reform seems to have stalled in Sacramento. Those who advocate maintaining defined benefit pensions for the long term, but at reduced levels of cost and benefits, have met with little success. Those who want to end defined benefit pensions altogether are biding their time, or so it seems; they have certainly not withdrawn. Those who desire to protect the current level of benefits continue to be in a controlling position.

Many local governments are improving retirement benefits despite the costs, the cities of Scotts Valley and Capitola among them. On the other hand, a handful of local governments have established two-tiered retirement systems, with reduced benefits for new employees, but they are in a very small minority. Ultimately, that would seem to be the most likely means of reform, probably on a mandated basis from Sacramento. In any event, cost relief does not appear to be on the way.

The cost of retiree health care benefits will be as problematic for many public agencies as the cost of pensions. The City of Santa Cruz will be better off than most in this regard, as the City has not made the kinds of promises so many others have. An updated actuarial estimate of the obligations the City does have will be produced in the course of the next year. It is a serious issue, and the cost will not be small, but it will be a manageable number in comparison with the other issues noted above.

In sum, the City's compensation dilemma is that, if history is any guide at all, the City's revenues are not going to grow at a pace sufficient to keep up with the labor market of which the City is a part. This means that, from time to time, the City will need to reduce the number of people it employs, which means reducing the services it provides.

Most organizations, the City among them, can benefit from budget pressures. Budget pressures force organizations to address inefficient practices and focus on performance and

results. It is often beneficial to re-think, re-organize, and re-prioritize. On the other hand, organizations have minimum requirements reflective of legal mandates, round-the-clock operations, physical plant and equipment, and other exigencies. At this point, having experienced a five-year period of making reductions, there are many more places where the City needs to employ more people and spend more money than there are opportunities for further cuts. The consequences of being understaffed are evident in many places, from police to building maintenance to parks. A complete list of services that are inadequately staffed would be lengthy.

While long-term realities are clear, we are happy to report that it is not necessary to make cuts this year. Our difficulty in hiring has produced short-term budget savings this year, as it did last year and the year before. We are also seeing tax receipts grow modestly, which is a good thing and a nice departure from recent experience. As we succeed in hiring the people we need, especially in the Police Department, the one-time savings that the City has realized will diminish and the budget situation that we have defined above and have come to know so well will again apply.

Those of us who help shape the City's organizational structure are constantly asking ourselves how we could function with fewer employees. When we can get by with vacancies, we do so. When temporary employment will suffice, we take that approach. The fact of the matter is that the City needs full-time employees to do most of the things the City does. We constantly face problems that we must attend to, and the attending requires people and money.

In sum, the City has never before experienced on such a broad scale the compensation challenges it now faces. There have always been a few positions that required special attention, and there will always be a few. The number of positions that now require special attention is at an all-time high. The actions being taken by other agencies show that the City of Santa Cruz is not alone in facing this situation. This is certain to be one of the most important and most difficult issues the City Council will be called on to address in the next period of time.

What to Expect in Fiscal Year 2008

When Fiscal Year 2007 concludes on June 30, 2007, the City will still have an abundance of unfilled positions, especially in the Police Department, which will contribute to one-time savings. This will be the third year in a row that we have been unable to hire the people we wanted to hire, indeed, the people the City Council directed us to hire. This is good for the General Fund balance, which will be somewhere between \$11 million and \$12 million, but not good in any other respect.

The City's General Fund budget for Fiscal Year 2008 would be only slightly in deficit—that is, forecast spending would exceed forecast revenues by \$500,000 to \$1,000,000—if there were no pay increases for City employees. As discussed above, that is not a possibility. Instead, the City will, because it must, address its compensation issues. Not incidentally, five bargaining unit agreements will be up for renegotiation in Fiscal Year 2008: the mid-management/professional employees' unit, the supervisors' unit, SEIU, police, and police management. Fire and fire management follow in July of 2008, so the City will bargain with all seven bargaining units during the next fiscal year.

Inevitably then, the forecast deficit for next year will become substantially larger than \$1,000,000. At some point in Fiscal Year 2008—we cannot predict exactly when the turn will take place—the City will cease adding to and begin to draw down its General Fund balance. We hope that the turn will come later rather than sooner and given our recent experience, that may be. It will be reasonable to have some draw-down, given the budget savings of the past three years. But in three years or so the City can expect that it will, once again, have to balance revenues and spending in the General Fund. It is not a pleasant prospect. Rather than make extensive cuts at one time, we will want to anticipate where we are heading, and try to engineer a “soft landing,” if possible.

Two More Financial Risks

Two grave financial risks to cities in general and to the City of Santa Cruz in particular are being addressed in the courts.

First, several cities that levy a 9-1-1 fee to support the cost of emergency dispatch services have had that fee challenged. Should the 9-1-1 fee be declared to be a tax, every jurisdiction that has such a fee would have to eliminate it or place it before the voters.

Second, the application of utility users’ taxes to long-distance and other telephone services is also under challenge in the courts. Moreover, Congress has taken up numerous bills that would eliminate or limit such taxes. The City of Santa Cruz collects about \$1.5 million from its 9-1-1 fee and about \$3 million from the application of utility users’ tax to telephone services. Santa Cruz will not be alone if judicial outcomes are adverse, but remedies would have to be found.

What is the Potential for a Better Economic Future?

We can define the financial big picture with reasonable confidence for the short and medium term, but what about the long term? Several observations can be made.

On the positive side from a financial point of view, the City’s supremely wonderful location guarantees that there will always be parties ready to undertake one economic development project or another. Most cities want to be rich, but lack any way of reaching that goal. The City of Santa Cruz will never lack for possibilities. Santa Cruz’ challenge is to find economic development projects that work for both applicants and the City.

As noted, retail sales and hotel stays are the revenue cream for local government. The development of new motel rooms along Ocean Street, already underway, will contribute to the City’s tax base, but not nearly as much as a quality hotel would do. The proposal for the La Bahia has the potential to provide an excellent boost in tax revenues if it proves to be a project the community wants. The new owners of the West Coast Hotel are contemplating what to do in the long term. In the short term they are making interior modifications that may increase the economic contribution the property makes to the City.

The interest in the sale of the Sentinel property is encouraging in terms of the value prospective owners place in downtown property. The potential for retail sales or even hotel use on the property remains to be seen. Clearly downtown property is at a premium, even given the uncertainties in the broader real estate market. Investors believe the City’s future will be good for them. That is a hopeful sign.

One could argue that the City of Santa Cruz has skipped a generation of development. It is quite possible that this approach, while it has made for tough times for the City's budget, has preserved opportunities for the future that would not otherwise have been preserved. Perhaps the next generation of opportunities will be more compatible with Santa Cruz values than the last one. Perhaps one or more retailers of stature will want to locate in the Harvey West area, which would not produce the impacts that so often cause projects to be rejected. Perhaps new opportunities for the visitor sector will emerge that will enable the City to capitalize on its superb location in an acceptable manner. Perhaps the rebuilding of the downtown will be followed by the rebuilding of other commercial centers, to the City's economic advantage.

There are lots of cities in this world that would do anything to improve their economic circumstances. Santa Cruz is not among them. Santa Cruz will continue to be highly selective. In the long run, perhaps that will work out just fine. From our current vantage point, it is hard to see how that might be. A small number of significant economic gains could make a huge difference.

The City Council, sitting as the Redevelopment Agency, has renamed it the Department of Economic Development and Redevelopment and added an economic development manager position to its staff. The Council recognizes, and has long recognized, that the City needs to supplement its tax base. The Council is doing its best to prepare for the long-term economic future. From an economic point of view, the City's foremost challenge is to add a small number of significant economic gains to the picture.

Repairing the City's Streets

The passage of Measure H will enable the Public Works Department to begin the long-needed process of repairing the City's streets. For the next four years the Public Works Department will dedicate over \$6 million per year to street repairs. Residential streets, as well as collectors and arterials, will be repaired. This will be the largest amount of concentrated pavement work the City has ever done. Significant work will be done in each quadrant of the City in each of the next four years.

Because the backlog of needed repairs is about \$42 million, not every street can be attended to. A second plan will be needed four years hence to address the remaining streets. But huge progress will be made, and the City's streets will be in much better overall condition than they are today. At this writing we are still working on a borrowing plan that will enable us to make the best use of funds for the City's streets.

Police

The passage of Measure H has enabled the Police Department to create a Parks Unit. Working together, the Police and Parks and Recreation Departments are dedicating a team of police officers, community service officers, and park rangers to improving conditions in the City's parks and open spaces.

The Police Department has also established a Street Crimes Unit, which is a highly mobile team focused on narcotics and gang issues. The Police Department is also utilizing overtime, in cooperation with other law enforcement agencies, to address gang issues. Despite those countywide efforts, there is a need to dedicate considerably more attention to the gang problem.

We hope to reduce the number of vacancies in the Police Department over the coming year. Much depends on being able to do this. Unfortunately, accomplishing this goal will also have the effect of reducing the City's budget savings.

Fire

The Fire Department has assumed management responsibility for the City's Marine Rescue and Beach Lifeguard programs. The programs will be supervised by a fire captain. This reorganization places water-oriented emergency responses and citywide fire and emergency medical responses in the same department, which we believe will serve the public well. The Marine Rescue and Beach Lifeguard programs had historically been managed by the Parks and Recreation Department, which set the bar very high. The new approach is the product of an enthusiastic and cooperative effort between the Fire and Parks and Recreation Departments.

A deputy fire marshal position is being reclassified to fire marshal division chief. Also, a fire and life safety inspector position is being added to the Fire Prevention Division. These changes will enable the Fire Department to improve its life safety services to the City's businesses. The costs of these measures will be offset by inspection, building permit, and plan check fees.

Parks and Recreation

As mentioned, the approval of Measure H has enabled us to create a Parks Unit. It is now in operation but not yet fully staffed. When fully staffed, it will consist of a chief ranger, three park rangers, a police sergeant, four community service officers, and the homeless resource officer. This Parks Unit will make a significant contribution to the safety and environmental condition of the City's parks and open spaces.

Three new facilities opened in 2007, and will be part of the Parks and Recreation Department's ongoing maintenance program: the Ken Wormhoudt Skate Park at Mike Fox Park, the Bicycle Trip Bike Park at the Fun Spot, and the new synthetic turf Bowling Green at San Lorenzo Park.

After five years of significant cuts, no budget cuts are proposed this year. The Parks and Recreation Department remains short-staffed after years of cuts, and full restoration will never be possible. At this writing we are still deliberating about how many of the Parks and Recreation Department's vacant positions can be filled on a regular basis.

Refuse and Recycling

Same-day refuse and recycling service is now in place throughout the City. A new \$2.5 million single-stream recycling sorting system has the capacity to sort five days of recyclable materials in four days. This efficiency enables recycling staff to deal with materials that require special handling. The recycling program is processing and selling 94% of the recyclables collected at the curb.

The next two projects at the Resource Recovery Facility will be the replacement of the north leachate pond and the design and construction of the next lined cell.

Water

Intensive capital improvements will be underway for the next ten to fifteen years in the Water Department. The major projects are the replacement of the Bay Street Reservoir and the development of a desalination plant, but the complete list of projects is long indeed. The Water Department is requesting an additional assistant engineer and an additional associate engineer to help manage these projects.

The Water Department's revenues are performing as expected. Capital projects are being paid for with a mix of pay-as-you-go and debt financing. This year's drought conditions will have a negative impact on revenues, but we do not expect that it will be necessary to utilize the rate stabilization reserves.

Conclusion

In conclusion, I wish to extend my thanks to Mayor Reilly and the City Council for your inexhaustible interest in and commitment to the work of the City, and for the seriousness of purpose you bring to your custodianship of the City's financial affairs. You have led the City through some perilous times. The future will no doubt be equally challenging.

Richard C. Wilson
City Manager