Salinas Study Progress Report

The City of Salinas has been battling budget deficits since the Great Recession and before. Over the years, it has reduced staff, cut programs, let building and park maintenance needs lag, neglected City street repair and maintenance, and reduced General Fund reserves. To counteract many of these measures, the City residents voted for two sales tax measures that are being used to restore staffing in the police and libraries, restore other services and fund major capital projects for the Police Department and the Library.

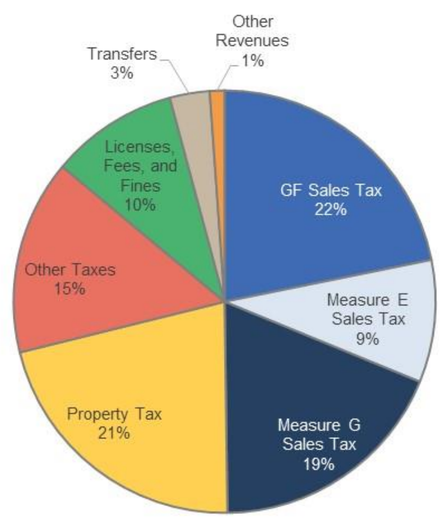
Even with all of these actions, the City is facing a growing structural budget deficit over the next ten years. The NRN team is putting together initiatives to address these issues and provide the City a plan to address future structural deficit issues.

Budget Overview

Key Revenue Drivers:

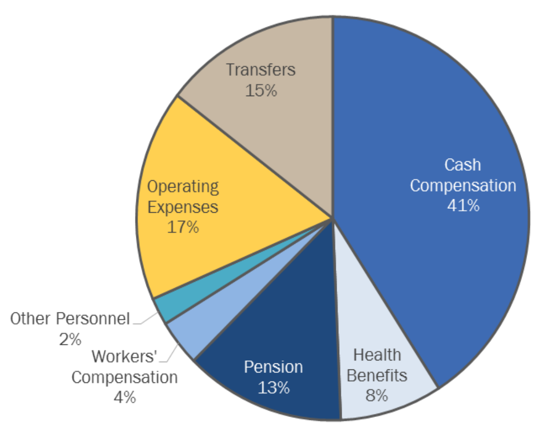
- Sales taxes (including two local tax measures) are half the budget. The Measure G revenue expires in FY2030. The Measure E sales tax will not expire
- Other taxes include Utility Users Tax, TOT, and business license tax
- Property tax rate is fixed—increases are subject to capped CPI growth, property turnover and new development
- Potential direct control over revenues is only from approximately $3.4 million in charges for service

GF Revenue Categories
FY 18 ($131.2M)



Key Expense Drivers:

GF Expenditure Categories
FY 18 ($133.2M)



- Personnel-related expenses are 68.5% of the FY18 budget, growing to 73% by FY28
- Operating expenditures cover basic operating costs for utilities, insurance, contracted services, etc.
- Transfers is primarily voter-approved sales tax transfers to non-GF programs, including capital and debt service. Transfers also includes GF support to "enterprise" funds

Budget Changes Over last Several Years

The City dropped from 630.00 FTE in FY07 to a low of 476.74 FTE in FY15 due to budget reductions caused by the Great Recession. In FY05 and again in FY15, voters passed add-on sales tax measures (Measures V and G) that allowed the City—as the economy improved—to add back 76.69 FTE while additionally underwriting the cost of an additional 91.11 existing positions. The sales tax measures are also being used to finance capital expenditures, including a new police station and library.

While the value of the sales tax measures are critical to the current balanced budget, the increased taxes also make it unlikely to get another major general tax measure passed in the near future. The fact that the budget deficit is growing with these tax measures puts the City in a very precarious revenue position. In California generally, there is little room to increase taxes with approval of the voters. In Salinas's position, it will be very difficult to increase revenues.

NRN Team Charge

The NRN team is charged with two major outcomes for the City of Salinas:

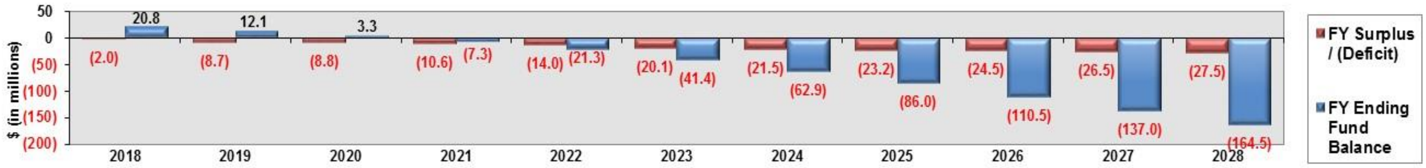
1. Provide a path to budget sustainability over the next ten years through:
    a. Budget out an updated model development to project fiscal balance and to test changes in the impact of new revenues or expense adjustments on the City's bottom line.
    b. Evaluate the City's organizational structure and recommend opportunities to continue critical City operations at a high level while identifying programs or services that can be restructured to achieve long-term savings.
    c. Evaluate the City's workforce pay and benefit structure to determine the ability to reduce expenses as well as make the City more attractive as an employer to future recruits to key City positions.
2. Evaluate the City's role in housing and homelessness
    a. Tools to address overcrowding in single- and multi-family housing that is exacerbating ongoing social and poverty issues and creating a public health crisis endangering many residents.
    b. Provide a template of actions the City can take to reduce the severe overcrowding, particularly in East Salinas (also known as the Alisal) and among farm workers, and creating opportunities for appropriate housing and wrap-around services.
    c. Identify partnerships for both housing and homelessness that the City can leverage in its role in with these issues.

Budget Model

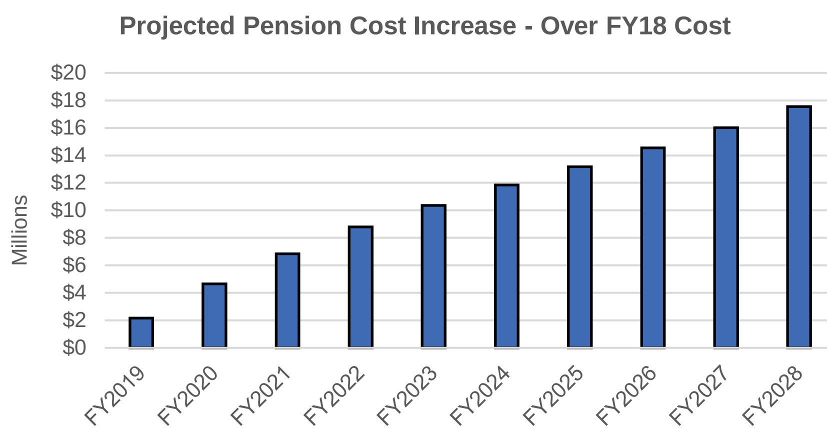
PFM is developing two budget forecast models: the typical Excel-based model and a Whitebirch model. The Baseline model is complete and signed-off by the Finance Director, but needs to be recalibrated to reflect the City's FY2019 budget once the budget is adopted.

Even with the expense reductions and the recent increase in sales tax rates, the City is facing growing budget deficits over the next 10 years, caused in large part by increases in pension costs, but also fed by recent increases in other labor costs. The Baseline budget forecast projects a budget deficit of $8.7 million in FY19 (not including any budget adjustments the City will present to Council with the FY19 proposed budget) with deficits then growing every year, reaching $20.1 million by FY23 and $27.5 million by FY28. In all, this leads to a cumulative fiscal shortfall of $171.9 million over the next ten years.

City of Salinas Baseline Budget Forecast

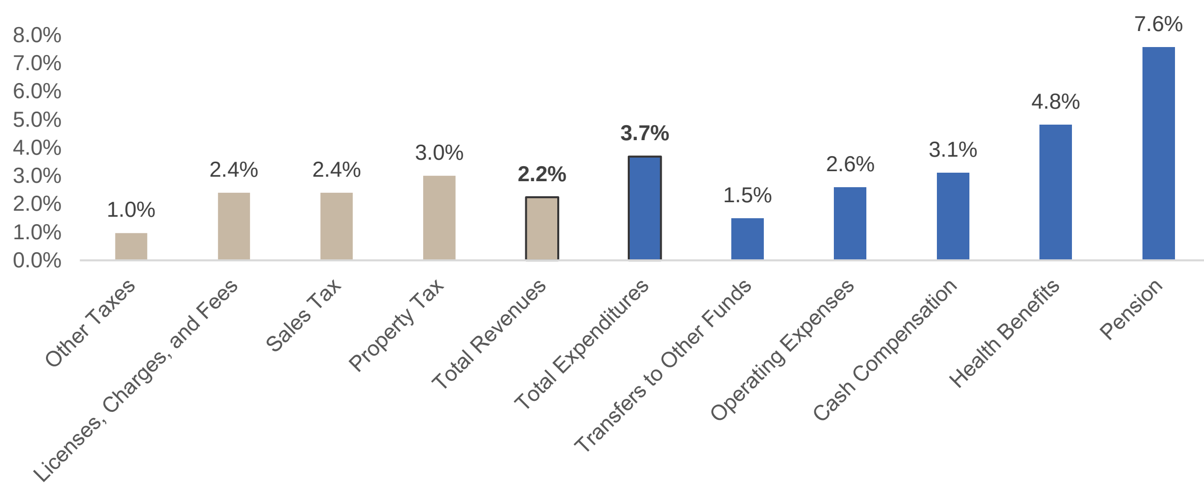


Revenue growth is conservative with a compounded annual growth rate (CAGR) of 2.2%; however, expenses grow with a CAGR of 3.7%. Personnel costs grow 4.4% per year and outside services grow 3.3% per year, led by expected growth in the County's 911 contract.



Personnel cost growth is driven by pension increases, which are projected to grow at a CAGR of 7.6%. The other major expenditure drivers are health benefits, which are projected to have a CAGR of 4.8%, and cash compensation that is driven by a 2.5% across-the-board assumed wage increases as well as steep increases and premium pays. These three expenditure drivers account for almost 80% of the total projected deficits.

Average Annual Growth of Fiscal Drivers, FY2018 – FY2028



PFM also stress-tested the baseline forecast to determine the size of the budget gap under alternative assumptions. In a recession scenario where revenues and inflation grow at a slower rate and pension costs further increase with lower investment returns, projected deficits would increase to $23.1 million by FY23 and to $31 million by FY2028. Even in the unlikely scenario where the current expansion phase continues through the projection period, the City's underlying structural deficit still totals almost $20 million by FY23 as a result of pension cost increases as well as other personnel cost growth that outpace revenue growth.

City of Salinas Budget Forecast, Recession Scenario

In addition to the structural deficit identified above, the City has a number of unfunded costs that do now show up in the budget and, if funded, would exacerbate the current budget forecast issues. These items are addressed below.

Addressing Structural Budget Issues

The City has conducted many operational studies in recent years, including those that review the City's animal services, fleet, parks, and public safety management. While these studies provide useful recommendations to help improve departmental efficiency and effectiveness, the City has been slow to implement changes, in part because the initial net costs and/or the long-term savings for implementing these recommendations are often unclear. Our goal is to develop a multi-year plan – with initiatives to close the projected budget gap, some of which may have already been recommended in previous studies – that outlines corrective actions the City needs to take in order to achieve long-term fiscal sustainability. There are three tracks being pursued to help close the projected budget gap:

Organizational Structural Changes

- Eliminating expenses that don't match with the City's core services
- Reducing services
- Reducing expenses that are tangential to the City's services
- Contracting out where cost effective

Workforce Cost Reductions

Workforce reductions can be difficult to implement, can affect staff morale and make recruitment and retention more difficult. At the same time, the City may not be able to avoid such reductions; therefore, PFM is evaluating options that will limit the impact on current and future employees to the extent practicable.

Budget Changes

Other budget changes may include tweaks to revenues or expenses

- Increasing fees to reflect actual costs of services

- Eliminate subsidies
- Revenue recovery policies
- Review contracts for cost/benefit to City
- Obtain value from new development

In addition to trying to fix the budget issues, it is clear that the City has additional budget structural issues (such as deferred building maintenance) that need to be acknowledged at a minimum. These issues will be cost-neutral at best, and significantly increase costs at worst. The importance of raising these issues is to assist the City in seeing the bigger picture of funding needs as they make spending decisions.

Also, in addition to the fiscal distress discussed previously, the initial City assessment identified significant issues in homelessness and scarce housing—leading to significant overcrowding in homes and apartments. The City has made efforts at both of these issues. While recognizing the importance of these issues, the City continues to work toward a comprehensive plan to address both. Both of these issues involve multiple governmental and non-profit agencies and will require some level of budget support by the City in order to be successful.

Overall Approach to Balancing the Budget

The approach to getting to a balanced budget and creating room for non-funded or under-funded programs is illustrated bellow. Reading from left to right, the goal is to focus on City service priorities first, reducing subsidies, programs, and services that do not help the City meet their core service requirements and identifying new or expanded revenues that can underwrite existing or expanded services. If this is not sufficient, then moving on to organizational options that might lead to reduced staffing needs or program expenses. Lastly, reduce compensation in areas of least impact to overall compensation and benefits. Ultimately, the City has difficult decisions to make, and it is unlikely that subsidies or program reductions will be sufficient to provide the City the budget room they need to thrive.

Budget-Balancing Approach