Council Agenda Report

February 22, 2012

TO: City Council

FROM: Arne Croce, Interim City Administrative Officer
Bill Statler, Pro Bono Budget Advisor

SUBJECT: BUDGET AND FISCAL POLICIES

RECOMMENDATION

Conceptually approve the proposed *Budget and Fiscal Policies* in guiding preparation of the Preliminary Budget, with final adoption in June 2012 in conjunction with approval of the 2012-13 Budget.

DISCUSSION

Background

As discussed on November 9, 2011 when the Council approved the budget process for 2012-13, clearly articulated budget and fiscal policies provide an essential foundation for effective financial decision-making and in protecting the City's fiscal health.

The City's fiscal health is a lot like personal health: it isn't what you live for; but it is hard to enjoy your life without it. Cities don't exist to be fiscally healthy: they exist to make communities better places to live, work and play. However, this requires the fiscal capacity to link community goals with the resources needed to achieve them. In short, fiscal health is not an end in itself; but it is an important part of the tool kit in achieving "ends."

And like personal health, fiscal health is rarely luck. The strength of the local economy is obviously an important fiscal health factor – just as genes are in personal health. However, regardless of the strength of its local economy, no agency is immune from economic downturns or unexpected expenditure needs.

Formal statements of key budget and fiscal policies provide the foundation for assuring long-term fiscal health by establishing a clear framework for effective and prudent financial decision-making.

For this reason, clearly articulated policies are a city's "north star" in guiding the preparation and implementation of budgets and financial plans. They help make tough decisions easier by stating an organization's values before they are placed under stress by adverse circumstances. The organization might still choose to do something different – effective policies are guides, not straightjackets – but they are a powerful starting point: *but for "this," the organization should do what?*

Stated simply, articulating and then following prudent fiscal policies is the most effective and proven way for government agencies to ensure their long-term fiscal health. They are both preventative and curative: clearly articulated policies help prevent problems from arising in the good times; and help respond to bad times when they do occur. They also help provide continuity as elected officials and staff change. Lastly, they are most powerful when it put in place before the need for them arrives.

In summary, adopting key fiscal policies is an essential factor for effective stewardship of the City's resources, both in the short and long-term. Based on "best practices" recommended by professional organizations like the Governments Finance Officers Association of the United States and Canada (GFOA) and the California Society of Municipal Finance Officers (CSMFO) as well as the major credit rating agencies, fiscal policy areas that the City will want to address include:

- Budget purpose and organization (including a balanced budget policy and what this means)
- Revenue management
- User fee cost recovery: when should user fees fund services versus general purpose revenues?
- Minimum fund balance and reserves
- Financial reporting and budget administration
- Investments
- Appropriations limit
- Capital improvement plan (CIP) management
- Capital financing and debt management
- Human resources management
- Productivity
- Contracting for services

Proposed Budget Policies

"One size does not fit all" in setting fiscal policies Careful consideration needs to be given in developing policies that are appropriate given the unique circumstances of each city. Fully addressing all of the areas noted above is planned in the coming year. However, in preparing for the next fiscal year, attached are six *Budget and Fiscal Policies* that we recommend focusing on at this time:

- Budget purpose and organization
- Revenue management
- User fee cost recovery
- Minimum fund balance and reserves
- Financial reporting and budget administration
- Contracting for services

Each of these will provide an important foundation and guidance for staff preparation of the Preliminary Budget for 2012-13, as well for the Council's review of it at the workshops and hearings that follow will its issuance by May 25, 2012.

In considering the proposed *Budget and Fiscal Policies*, it is important to note that in several cases, the City may not have yet achieved the policy goal – and it may take more than one year to do so. Even so, it is important to articulate the goal: clearly stating where the City wants to be (versus where it may be today) will significantly enhance the City's ability to achieve it. For this reason, each policy area is followed by a brief summary of "compliance status." Where the City has not yet achieved the goal, a status summary on the City's progress in doing so is provided.

Minimum Fund Balance and Reserves

While each of the policy areas speak for themselves, minimum fund balance is an especially important policy in determining the City's ability to respond to unexpected fiscal hardships such as local disasters, downturns in the economy, external revenue hits like (State budget takeaways) and unforeseen operating or capital needs.

The proposed policy sets the City's policy goal for minimum General Fund balance at 25% of operating expenditures. This target was developed based on the City's fiscal circumstances using a draft methodology under preparation by the Government Finance Officers Association of the United State and Canada (GFOA). It uses a structured assessment of a city's exposure to the following eight fiscal risks:

1. **Vulnerability to extreme events and public safety concerns.** Major extreme events the community could reasonably be subject to and the likelihood and potential magnitude of loss for each event.

2. **Revenue source stability.** Volatility of each major revenue source based on factors such as past experience and trends with that revenue, characteristics of the tax or rate payers, state or federal revenue takeaways and economic factors.

3. **Expenditure volatility.** Spikes in expenditures, usually arising from special, non-recurring circumstances such as lawsuits; critical special projects without a funding source; or new state or federal spending requirements and unfunded mandates.

4. **Leverage.** Common examples include pensions, unfunded asset maintenance and debt: is the source of leverage very large? Does it have an off-setting funding source or asset?

5. **Liquidity (cash flow).** Intra-period cash imbalances, such as property taxes that are only received at one or two points during the year.

6. **Other funds.** Are there other funds that have a significant dependence on the General Fund?

7. **Growth.** This factor is only relevant if significant growth is a realistic possibility in the next three to five years. Includes assessing likely potential marginal costs associated with serving new growth compared with marginal revenues, and resulting gaps.

8. **Capital projects.** Are there high priority projects without a funding source, where reserves may be looked to as a funding source?

Depending on the results of this assessment, the draft GFOA methodology provides recommended targets ranging from a minimum of 17% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted. Based on this structured assessment methodology relative to the City's fiscal situation, a target of 25% of operating expenditures is recommended, which represents 90 days of cash flow.

This compares with the City's existing circumstances, where reserves at the end of the current fiscal year are projected to be 12% of operating expenditures. Given the fiscal challenges facing the City, it is not reasonable to achieve this goal in the coming year: doing so will need to be a multi-year process.

In addressing this circumstance now and in the future, the proposed policy recommends that whenever the City's General Fund reserves fall below this target, the City will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the City will allocate about half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Circumstances where taking reserves below policy levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

- One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, economic development and revenue base improvements, productivity improvements and other strategies that will strengthen City revenues or reduce future costs.

- And where a fiscal forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

Next Steps

If conceptually approved by the Council at this time, staff will use these principles – in concert with the Major City Goals set by the Council for the coming year – as the foundation in guiding preparation of the Preliminary Budget for 2012-13. Final adoption of the policies will occur in June 2012 in conjunction with approval of the 2012-13 Budget. For future reference, the City's *Budget and Fiscal Policies* will be included the budget document (as will any future additions or revisions).

ATTACHMENT

Budget and Fiscal Policies

Budget and Fiscal Policies

BUDGET PURPOSE AND ORGANIZATION

A. **Balanced Budget.** The City will maintain a balanced budget. This means that:

1. Operating revenues must fully cover operating expenditures, including debt service.
2. Ending fund balance must meet minimum policy levels or other target levels established by the Council for the fiscal year.

Under this policy, it is allowable for total expenditures to exceed revenues in a given year; however, in this situation, beginning fund balance should only be used to fund capital improvement plan projects or other "one-time," non-recurring expenditures. (See *Fund Balance and Reserves* policy for other circumstances when it would be appropriate to use beginning fund balance.)

B. **Council Goal-Setting, Transparency and Meaningful Community Engagement in the Budget Process.** The Council will set goals for the coming year early in the budget process that provides transparent and clear policy direction in linking goals with resources. The community will be provided with meaningful opportunities to be engaged in the goal-setting and budget process.

C. **Budget Objectives.** Through its Budget, the City will link resources with goals and results by:

1. Identifying community needs for essential services.
2. Organizing the programs required to provide these essential services.
3. Establishing program policies and goals, which define the nature and level of program services required.
4. Identifying activities performed in delivering program services.
5. Proposing objectives for improving the delivery of program services.
6. Identifying and appropriating the resources required to perform program activities and accomplish program objectives.
7. Setting standards to measure and evaluate the:
   a. Output of program activities.
   b. Accomplishment of program objectives.
   c. Expenditure of program appropriations.

D. **Measurable Objectives.** The Budget will establish measurable program objectives and allow reasonable time to accomplish those objectives.

E. **Goal Status Reports.** The status of major program objectives will be formally reported to the Council on an ongoing, periodic basis.

F. **Mid-Year Budget Reviews.** The Council will formally review the City's fiscal condition, and amend appropriations if necessary, six months after the beginning of each fiscal year.

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives. However, as noted in the November 2011 report to the*

Council on the proposed budget process for 2012-13, linking resources to outcomes and measuring performance will always be a work in progress, with ongoing improvements.

GENERAL REVENUE MANAGEMENT

A. Current Revenues for Current Uses; One-Time Revenues for One-Time Purposes. The City will make all current expenditures with current revenues, avoiding procedures that balance current budgets by postponing needed expenditures, accruing future revenues or rolling over short-term debt. The City will avoid using one-time revenues to fund ongoing program costs.

B. Revenue Distribution. The Council recognizes that generally accepted accounting principles for state and local governments discourage the "earmarking" of General Fund revenues, and accordingly, the practice of designating General Fund revenues for specific programs should be minimized in the City's management of its fiscal affairs. In those cases where it does occur, the basis and methodology for earmarking should be clearly articulated in the City's Budget and Fiscal Policies.

C. Special Tax and Assessment Levies. The City will seek to lower special tax rates and assessments whenever possible through expenditure reductions and other cost containment strategies. However, the City will not use General Fund resources to subsidize reductions in allowable levies in the General Obligation Bond Fund, Retirement Fund, Assessment Districts or other similar funds.

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives.*

USER FEE COST RECOVERY

A. **Ongoing Review**

Fees should be reviewed and updated on an ongoing basis to ensure that they keep pace with changes in the cost-of-living as well as changes in methods or levels of service delivery. In implementing this goal, a comprehensive analysis of City costs and fees should be made at least every five years. In the interim, fees will be adjusted by annual changes in the Consumer Price Index as well whenever there have been significant changes in the method, level or cost of service delivery.

B. **User Fee Cost Recovery Levels**

The following factors will be considered in setting user fees and cost recovery levels,

1. ***Community-Wide Versus Special Benefit.*** The level of user fee cost recovery should consider the *community-wide* versus *special service* nature of the program or activity. The use of general-purpose revenues is appropriate for community-wide services, while user fees are appropriate for services that are of special benefit to easily identified individuals or groups.

2. ***Service Recipient Versus Service Driver.*** Cost recovery goals should also consider the concept of *service recipient* versus *service driver*. For example, it could be argued that the applicant is not the beneficiary of the City's development review efforts – the community is the primary beneficiary. However, the applicant is the *driver* of development review costs, and as such, cost recovery from the applicant is appropriate.

3. ***Effect of Pricing on the Demand for Services.*** The level of cost recovery and related pricing of services can significantly affect the demand and subsequent level of services provided. At full cost recovery, this has the specific advantage of ensuring that the City is providing services for which there is genuinely a market that is not overly-stimulated by artificially low prices.

Conversely, high levels of cost recovery will negatively impact the delivery of services to lower income groups. This negative feature is especially pronounced, and works against public policy, if the services are specifically targeted to low income groups.

4. ***Feasibility of Collection and Recovery.*** Although it may be determined that a high level of cost recovery may be appropriate for specific services, it may be impractical or too costly to establish a system to identify and charge the user.

C. **Factors Favoring Low Cost Recovery Levels**

1. There is *no* intended relationship between the amount paid and the benefit received. Almost all "social service" programs fall into this category as it is *expected* that one group will subsidize another.
2. Collecting fees is not cost-effective or will significantly impact the efficient delivery of the service.
3. There is *no* intent to limit the use of the service. Again, most "social service" programs fit into this category as well as parks and many public safety (police and fire) emergency response services.
4. Collecting fees would discourage compliance with regulatory requirements and adherence is primarily self-identified, and as such, failure to comply would not be readily detected by the City. Many small-scale licenses and permits might fall into this category.

D. **Factors Favoring High Cost Recovery Levels**

1. The service is similar to services provided through the private sector.
2. Other private or public sector alternatives could or do exist for the delivery of the service.
3. For equity or demand management purposes, it is intended that there be a direct relationship between the amount paid and the level and cost of the service received.
4. The use of the service is specifically discouraged. Police responses to disturbances or false alarms might fall into this category.
5. The service is regulatory in nature and voluntary compliance is not expected to be the primary method of detecting failure to meet regulatory requirements. Building permit, plan check and subdivision review fees for large projects would fall into this category.

E. **General Concepts Regarding the Use of Service Charges**

1. Revenues should not exceed the reasonable cost of providing the service.
2. Cost recovery goals should be based on the total cost of delivering the service, including direct costs, departmental administration costs and organization-wide support costs.
3. The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.
4. A unified approach should be used in determining cost recovery levels for various programs based on the factors discussed above.

F. **Low Cost-Recovery Services**

Based on the criteria discussed above, the following types of services should have very low cost recovery goals, although in selected circumstances, there may be specific activities within the broad scope of services provided that should have user charges associated with them.

1. Delivering public safety emergency response services such as police patrol services.
2. Maintaining and developing public facilities that are provided on a uniform, community-wide basis such as streets, parks and general-purpose buildings.
3. Providing social service programs and economic development activities.

G. **Recreation Programs**

1. Cost recovery for activities directed to adults should be relatively high.
2. Cost recovery for activities directed to youth and seniors should be relatively low. In those circumstances where services are similar to those provided in the private sector, cost recovery levels should be higher.
3. For cost recovery activities of less than 100%, there should generally be a differential in rates between residents and non-residents. However, the Community Services Director is authorized to reduce or eliminate non-resident fee differentials when this is reducing attendance and thus cost recovery and there are no appreciable expenditure savings from the reduced attendance.
4. The Community Services Director is authorized to offer reduced fees such as introductory rates, family discounts and coupon discounts on a pilot basis (not to exceed 18 months) to promote new recreation programs or reenergize existing ones .

H. **Development Review Programs**

Cost recovery for planning, building and safety (building permits, structural plan checks, inspections) and engineering (public improvement plan checks, inspections, subdivision requirements, encroachments) services should be very high: in most instances, it should be 100%.

I. **Comparability With Other Communities**

Surveys of fees charged by other comparable agencies should not be the sole or primary criteria in setting City fees. As outlined below, there are many factors that affect how and why other communities have set their fees at their levels. Accordingly, comparability of Bell's fees to other communities should be one factor among many that is considered in setting City fees.

1. What level of cost recovery is their fee intended to achieve compared with Bell's cost recovery objectives?
2. What costs have been considered in computing the fees?
3. When was the last time that their fees were comprehensively evaluated?
4. What level of service do they provide compared with our service or performance standards?
5. Is their rate structure significantly different than ours and what is it intended to achieve?

Status: In Progress. *The City has not prepared a comprehensive analysis of its user fees. Doing so will require significant resources and may not be possible in the coming year. However, focused reviews in areas where a compelling need is identified will be presented to the Council.*

FUND BALANCE AND RESERVES

A. **General Fund Minimum Balance.** The City will strive to maintain a minimum unassigned fund balance of at least 25% of operating expenditures in the General Fund. This represents 90 days of cash flow and is based on the GFOA's draft methodology for setting reserve levels in adequately providing for:

1. Economic uncertainties, local disasters and other financial hardships or downturns in the local or national economy.
2. Contingencies for unseen operating or capital needs.
3. Unfunded liabilities such as self-insurance, pensions and retiree health obligations.
4. Institutional changes, such as State budget takeaways and unfunded mandates.
5. Cash flow requirements.

Whenever the City's General Fund reserves fall below this target, the City will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the City will allocate about half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Circumstances where taking reserves below policy levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

- One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, economic development and revenue base improvements, productivity improvements and other strategies that will strengthen City revenues or reduce future costs.
- Where a forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

B. **Facilities, Equipment, Fleet and Infrastructure Replacement**. The City will establish an Asset Replacement Fund and strive to set annually aside funds to provide for the timely replacement of long-lived capital assets such as facilities, equipment, vehicles and infrastructure. The annual contribution to this fund will generally be based on the annual use allowance or depreciation, which is determined based on the estimated life of the asset vehicle or equipment and its original purchase cost. Interest earnings and sales of surplus equipment as well as any related damage and insurance recoveries will be credited to this fund.

C. **Future Capital Project Fund Balance Assignments.** The Council may assign specific fund balance levels for future development of capital projects or other long-term goals that it has determined to be in the best interests of the City.

D. **Other Commitments and Assignments.** In addition to the assignments noted above, fund balance levels will be sufficient to meet funding requirements for projects approved in prior years which are carried forward into the new year; debt service reserve requirements; commitments for encumbrances; and other reserves, commitments or assignments required by contractual obligations, state law or generally accepted accounting principles.

Status: In Progress. *The City currently has reserves of about 12% of General Fund expenditures; and no funds have been set aside for asset replacement. Achieving this goal is likely to be a multi-year endeavor.*

FINANCIAL REPORTING AND BUDGET ADMINISTRATION

A. **Annual Reporting.** The City will prepare annual financial statements as follows:

1. In accordance with Charter requirements, the City will contract for an annual audit by a qualified independent certified public accountant. The City will strive for an unqualified auditors' opinion.
2. The City will use generally accepted accounting principles in preparing its annual financial statements and will strive to meet the requirements of the Award for Excellence in Financial Reporting program of the Government Finance Officers Association of the United States and Canada (GFOA).
3. The City will issue audited financial statements within 180 days after year-end.

B. **Interim Reporting.** The City will prepare and issue timely interim reports on the City's fiscal status to the Council and staff. This includes on-line access to the City's financial management system; monthly reports to program managers; more formal quarterly reports to the Council and Department Heads; mid-year budget reviews; and interim annual reports.

C. **Budget Administration.** As set forth in the City Charter, the Council may amend or supplement the budget at any time after its adoption by majority vote of the Council members. Council approval is required for all new appropriations from fund balance. The City Manager has the authority to make administrative adjustments to the budget as long as those changes will not have a significant policy impact nor affect budgeted year-end fund balances.

Status: In Progress. *The City has not issued audited financial statements since 2009. The City has contracted with Macias Gini & O'Connell for the preparation of an independent audit for the fiscal years ending 2010, 2011 and 2012. Since more than 180 days have lapsed since the end of the last two completed fiscal years, it will not be possible to present these reports to the GFOA's Award for Excellence in Financial Reporting program. However, the City will strive to submit its comprehensive annual financial report for 2011-12 to the GFOA. The City is also making progress in improving interim financial reporting. For example, the Council will receive its first mid-year budget review in February 2012. However, the City's current financial management information system is limited in its ability to provide timely information and on-line access to City staff. An evaluation of ways to improve the City's financial reporting is currently underway.*

CONTRACTING FOR SERVICES

A. **General Policy Guidelines**

1. Contracting with the private sector or other public agencies for the delivery of services provides the City with a significant opportunity for cost containment and productivity enhancements. As such, the City is committed to using private sector resources or partnering with other public agencies in delivering municipal services as a key element in its continuing efforts to provide cost-effective programs.

2. Contracting approaches under this policy include construction projects, professional services, outside employment agencies and ongoing operating and maintenance services.
3. In evaluating the costs of private sector or other public agency contracts compared with in-house performance of the service, indirect, direct, and contract administration costs of the City will be identified and considered.

4. Whenever private sector or other public agency providers are available and can meet established service levels, they will be seriously considered as viable service delivery alternatives using the evaluation criteria outlined below.
5. For programs and activities currently provided by City employees, conversions to contract services will generally be made through attrition, reassignment or absorption by the contractor.

B. **Evaluation Criteria**

Within the general policy guidelines stated above, the cost-effectiveness of contract services in meeting established service levels will be determined on a case-by-case basis using the following criteria:

1. Is a sufficient private or public sector market available to competitively deliver this service and assure a reasonable range of alternative service providers?
2. Can the contract be effectively and efficiently administered?
3. What are the consequences if the contractor fails to perform, and can the contract reasonably be written to compensate the City for any such damages?
4. Can a private sector contractor or other public agency better respond to expansions, contractions or special requirements of the service?
5. Can the work scope be sufficiently defined to ensure that competing proposals can be fairly and fully evaluated, as well as the contractor's performance after bid award?
6. Does the use of contract services provide the City with an opportunity to redefine service levels?
7. Will the contract limit the City’s ability to deliver emergency or other high priority services?
8. Overall, can the City successfully delegate the performance of the service but still retain accountability and responsibility for its delivery?

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives.*