

# FY 2009 BUDGET THIRD QUARTER REPORT



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# Summary

## ECONOMIC CONDITIONS

**Unemployment (page 10):** Statewide unemployment in Michigan is projected to approach 16 percent by 2010. Nationally, unemployment is nearing 10 percent. While the growth of the unemployment rolls has slowed, employment shows no sign of upward movement at this time.

**Auto Sales (page 16):** Projections of 7.0-7.5 million domestic sales for GM, Ford and Chrysler for 2009 are ahead of the May 2009 projections by the Revenue Estimating Conference (6.5 – 7.0 million) and even further ahead of the January 2009 projections by the automakers and Wall Street analysts which were between 4.5 and 5.5 million units.

**Consumer Price Index (page 18):** The same three scenarios with regards to inflation present themselves again, just as they did at the end of the 2<sup>nd</sup> Quarter of 2009:

1. Deflation: this continues to be a receding threat;
2. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;
3. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.

**Stock Market (page 21):** The current assumption is that domestic and global equities are near the beginning point of a sustained growth cycle. It would be pure speculation to try and predict whether the long-term trend will approach that of the last 25-75 years or not.

**Mortgage Rates (page 24):** The upward swing in mortgage rates that occurred in the second quarter of 2009 has been reversed. It seems clear that mortgages are going to continue to be forced downward by the Federal Reserve, unless inflation becomes an issue.

**Pension (page 27):** At the assumed 7.5% Rate of Return, the City would be required to contribute more than \$650 thousand to the Pension Trust Fund in 2017, and \$1.4 million in 2018. Changes in smoothing do not appear to be advisable at this time, although we will revisit this issue periodically.

## REVENUE

**General Fund Total Revenue (Jan – May 09): est. \$44.5 million (2008: \$45.6 million)**

**Projected General Fund Total Revenues for 2009: \$52.9 million (Adopted Budget: \$54.3 million):**  
projected net loss of revenue of \$1.4 million.

**Property Taxes (page 31):** For FY 2009, we anticipate roughly \$300 thousand less in property tax revenue versus the Adopted Budget, due mostly to increases in captured tax dollars for Brownfield Redevelopment Authority properties.

Instead of the \$600 thousand increase in property tax revenue for the General Fund that was projected for 2010, we are anticipating a decrease of approximately \$1.2 million, netting a total loss of property tax revenue of \$1.8 million to the General Fund for FY 2010 when compared to our original projection.

**Stated Shared Revenue (page 34):** we are projecting losses of \$500 thousand for Revenue Sharing in FY 2009 beyond the losses already projected, and another \$1.7 million for the FY 2010 beyond what was projected in the 2009 Adopted Budget.

**Act 51 Revenue (page 36):** There is likely to be a loss of roughly \$200 thousand of Act 51 revenue in FY 2009 compared to the 2009 Adopted Budget. Roughly the same amount of revenue should be realized in 2010 as in 2009. This would represent a drop of roughly \$230 thousand for the road system in FY 2010 compared to 2008 Actual amounts. Shortfalls in the road funds will have to be made up by reductions in road service levels and/or additional appropriations from the General Fund.

**Interest Income (page 35):** The General Fund stands to lose approximately \$350 thousand in investment returns in 2009 versus the Adopted 2009 Budget.

**Stimulus Package (page 36):** Administrative staff in Community Planning and Development needed to manage ARRA programs may be paid for with ARRA money. This is estimated to total roughly \$77 thousand a year for 2010 and 2011. The Stimulus funding resulted in savings of more than \$1.2 million in bonded indebtedness, primarily due to cash-financing major street projects and the early warning system. When combined with favorable interest rates realized at the sale (due largely to the renewal of the City's bond rating with a "stable" economic outlook by the rating agencies), this will result in savings of \$90 thousand in FY 2009 and \$160 thousand every subsequent year.

## EXPENDITURES

**General Fund Total Expenditures (Jan – May 09):** est. \$32.8 million (2008: \$33.4 million) – net revenue of \$11.7 million (2008: \$12.2 million).

**Projected General Fund Total Expenditures for 2009:** \$52.7 million (Adopted Budget: \$54.7 million). Projected savings of \$2.0 million.

**Health Care (page 38):** **Savings realized since FY 2007 have created an unencumbered balance of \$4.5 million in the City's internal Insurance Fund.** The General Fund is entitled to \$2.8 million of this, \$500 thousand of which was budgeted to be returned to the General Fund in FY 2009. This provides a potential source of funding for losses in Revenue Sharing and/or Property Tax dollars in the short-term or an investment opportunity to offset accrued retiree healthcare liabilities.

**Energy (page 39):** Since the 2009 Budget amounts for Energy are based on 2008 prices, we can expect some budgetary relief in this area. Taken in total, the overall savings in FY 2009 should be approximately \$150 thousand for the General Fund and \$150 thousand in FY 2010.

**Overtime (page 39):** The projected overtime expense exceeds the Public Safety budget by approximately \$150 thousand. A portion of this overtime has been necessitated by virtue of six of our Public Safety Officers who have been called to active military duty in our nation's armed forces.

**Travel/conferences (page 39):** Education and Training expenses in the General Fund (not including amounts to be reimbursed by the State of Michigan) totaled \$49 thousand through August 2009, compared to \$72 thousand during the same period in 2008, and \$55 thousand for the same period in 2007.

The projected amount for 2009 is roughly \$65 thousand, compared to the budgeted amount of \$170 thousand. This projects to a budgetary savings of \$100 thousand.

**Telephones (page 39):** Through May 2009, telephone costs for the General Fund are recorded at \$320 thousand, compared to \$400 thousand for the same period in 2008. The savings of approximately \$80 thousand has been realized by adopting the latest contract pricing from Nextel for cell phones as well as recent improvements in telephonic contract pricing.

## MANAGEMENT CONTROLS

**Cost Containment (page 43):** Reduction plans approximating 5% per department have been submitted by departments to the City Manager. These would represent nearly \$8 million out of the total city-wide budget, and more than \$2.5 million out of the General Fund budget. During June mid-year adjustments, nearly \$250 thousand of cost reductions have been identified for FY 2009 without reducing staff or service levels.

## SUMMARY

The General Fund is currently projected in FY 2009 to lose approximately \$1.5 million of budgeted revenue for FY 2009.

The General Fund is currently projected to lose approximately \$4.3 million of revenue in FY 2010 when compared to the amounts originally projected for FY 2010 in the FY 2009 Adopted Budget.

**Overall, General Fund expenditures are projected to total \$2.0 million less than the FY 2009 Adopted Budget. Projected revenue is approximately \$1.5 million less than the Amended Budget, netting \$500 of positive variance for the General Fund, inclusive of mid-year Budget adjustments adopted by the City Commission in August 2009.**

For budget stabilization purposes, the General Fund is estimated to have the following unencumbered reserves available by the end of FY 2009:

### GENERAL CIP RESERVES

We are anticipating approximately \$1.95 million of capital reserves, which is comprised of the following:

- \$1.325 million in capital bond funds;
- \$625 thousand in capital cash funds.

### GENERAL FUND RESERVES

We are anticipating \$2.3 million of health care savings accumulated in the Insurance Fund due to the General Fund.

We are anticipating \$1.95 million of Budget Stabilization and Capital Contingency reserves.

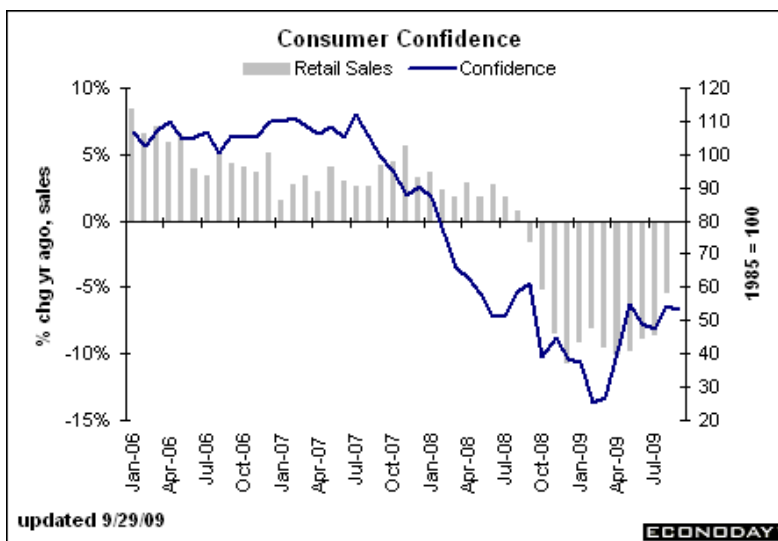
We are anticipating approximately \$800 thousand of fund balance beyond the 13% minimum Commission policy requirement.

### **TOTAL UNENCUMBERED RESERVES AVAILABLE TO THE GENERAL FUND: \$7.0 million**

These amounts can be utilized to stabilize the Budget against unforeseen circumstances, as well as to "smooth" the budget as it approaches the new fiscal "normal", in order to maintain service levels to the greatest degree practicable.

# Consumer Indicators

## Consumer Confidence



Source: Econoday.com

### Table 1 Description

The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. Questions focus on respondents' outlook on their economic condition, the general economic condition, the business environment and employment. This is a lagging indicator.

### Expert Testimony

Consumer confidence did not improve in September according to the Conference Board's index that fell back to 53.1 from 54.5.

The worse news in the report is the current assessment of the labor market with substantially more respondents saying that jobs are hard to get (47.0 percent vs. 44.3 percent), and fewer saying that jobs are plentiful (a miniscule 3.4 percent vs. August at 4.3 percent).

There's more trouble as the rare inversion in income expectations widened with more seeing a decrease, now at 19.8 percent, to more than offset a slight gain in those seeing an increase, now at 11.2 percent. This reading indicates bottom line pessimism and points to weak retail sales in the months ahead.

Buying plans for cars tumbled to 4.4 percent from 5.3 percent and offer an early indication that the end of the clunkers program may be the start of new trouble for the auto sector.

Those planning to buy a house fell sharply, down 7 tenths to 2.3 percent and likely reflecting at least to a degree the approaching end of the \$8,000 first-time buyer credit. Inflation expectations dropped to 5.2 percent vs. August's 5.4 percent as a reflection of lower gasoline prices.

- Econoday.com, September 29, 2009

Says Lynn Franco, Director of The Conference Board Consumer Research Center: "Consumer Confidence, which had improved in August, retreated slightly in September. The Present Situation Index decreased, as consumers viewed both current business conditions and the labor market less favorably than last month. While not as pessimistic as earlier this year, consumers remain quite apprehensive about the short-term outlook and their incomes. With the holiday season quickly approaching, this is not very encouraging news."

Consumers' assessment of current conditions was less favorable in September. Those claiming business conditions are "bad" increased to 46.3 percent from 44.6 percent, while those claiming conditions are "good" increased to 8.7 percent from 8.5 percent. Consumers' appraisal of the job market was also less favorable. Those claiming jobs are "hard to get" increased to 47.0 percent from 44.3 percent, while those claiming jobs are "plentiful" decreased to 3.4 percent from 4.3 percent.

Consumers' short-term outlook was also slightly more pessimistic. Those anticipating an improvement in business conditions over the next six months decreased to 21.3 percent from 22.2 percent, while those expecting conditions to worsen decreased to 15.0 percent from 15.2 percent.

The labor market outlook was virtually unchanged. Those expecting more jobs in the months ahead edged down to 17.9 percent from 18.0 percent, while those expecting fewer jobs remained the same at 23.1 percent. The proportion of consumers expecting an increase in their incomes increased slightly to 11.2 percent from 10.8 percent.

- *Conference-Board.org, September 30, 2009*

Americans' worries about job security flared up in September, causing a widely watched barometer of consumer confidence to fall unexpectedly and raising more concern about the upcoming holiday shopping season.

The index - fueled by signs that the economy might be stabilizing - had enjoyed a three-month climb since hitting a historic low in February of 25.3 but has been bumpy since June as rising unemployment has caught up with shoppers.

A reading above 90 means the economy is on solid footing. Above 100 signals strong growth.

The big concern is the job market. Economists surveyed by Thomson Reuters project job losses slowed in September. On average, they predict 180,000 were lost this month, down from 216,000 in August. But Labor Department figures to be released this Friday are projected to show unemployment ticking up to 9.8 percent in September from 9.7 percent in August.

Economists expect holiday sales to be at best flat from a year ago, the weakest holiday season since at least 1967 when the Commerce Department started collecting the data.

- *Consumer Confidence falls in September, Anne D'Innocenzio, AP, September 29, 2009*

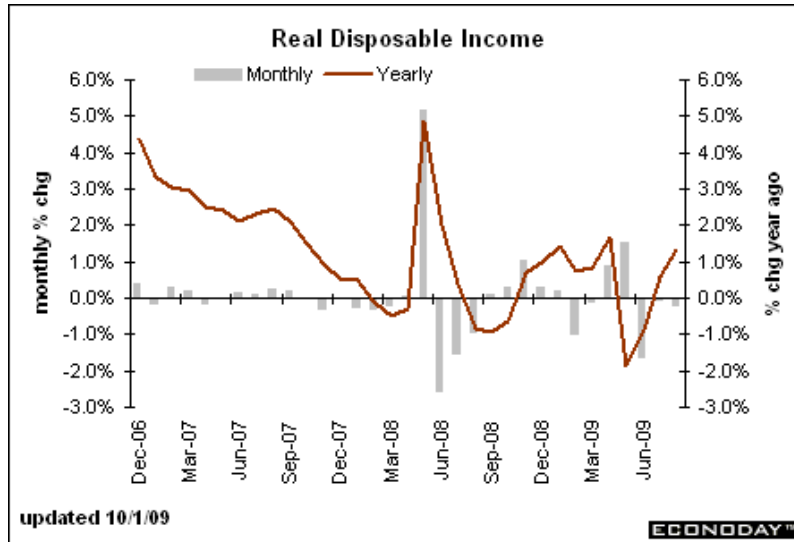
## Looking Ahead

As a lagging indicator, consumer confidence will not likely show gains into positive territory (over 80) until the public feels that the recovery is underway, which will likely be after business investment and jobs begin recovering.

Taken as a whole for the 3<sup>rd</sup> quarter consumer confidence went up 4 points, but given September's retreat it should continue to be monitored for potential future slippage. The sudden deterioration of consumer

confidence indicates that the public remains pessimistic about a near-term recovery, and this index will likely remain relatively negative into 2010.

# Disposable Income



Source: Econoday.com

## Table 2 Description

Changes in taxes or social security cost of living adjustments can cause some sharp variations in monthly disposable income growth. However, on the whole, monthly changes in disposable income fluctuate less than monthly changes in personal consumption expenditures.

## Expert Testimony

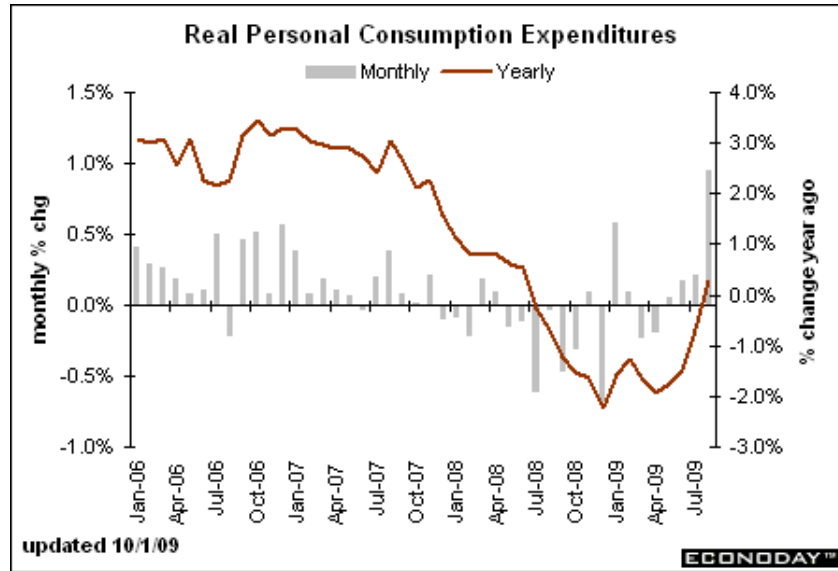
News on the consumer sector this morning was mixed as personal income came in a little above expectations, however jobless claims were somewhat worse than anticipated.

Personal income in August edged up 0.2 percent after a 0.2 percent increase the month before. The August gain in income was above the consensus forecast for a 0.1 percent rise. The wages and salaries component also rose 0.2 percent in the latest two months.

Year on year, personal income growth slipped to minus 2.6 percent from minus 2.5 percent in July. Year-ago headline PCE inflation firmed to negative 0.5 percent from minus 0.8 percent the previous month. Year-ago core PCE inflation eased to 1.3 percent from 1.4 percent in July.

– Econoday.com

# Consumer Spending



updated 10/1/09

Source: Econoday.com

**Table 3**  
**Description**

Monthly changes in personal consumption expenditures are usually skewed by large changes in spending on durable goods. Spending on nondurable goods and services tend to be less volatile from one month to the next.

## Expert Testimony

Consensus expectations were that spending would be higher due to a surge in motor vehicle sales notwithstanding, consumers spread cash elsewhere, too. Consumer spending spiked on cash-for-clunkers auto purchases as personal consumption expenditures surged 1.3 percent in August, following a 0.3 percent rise in July, and beating the consensus forecast for a 1.1 percent increase.

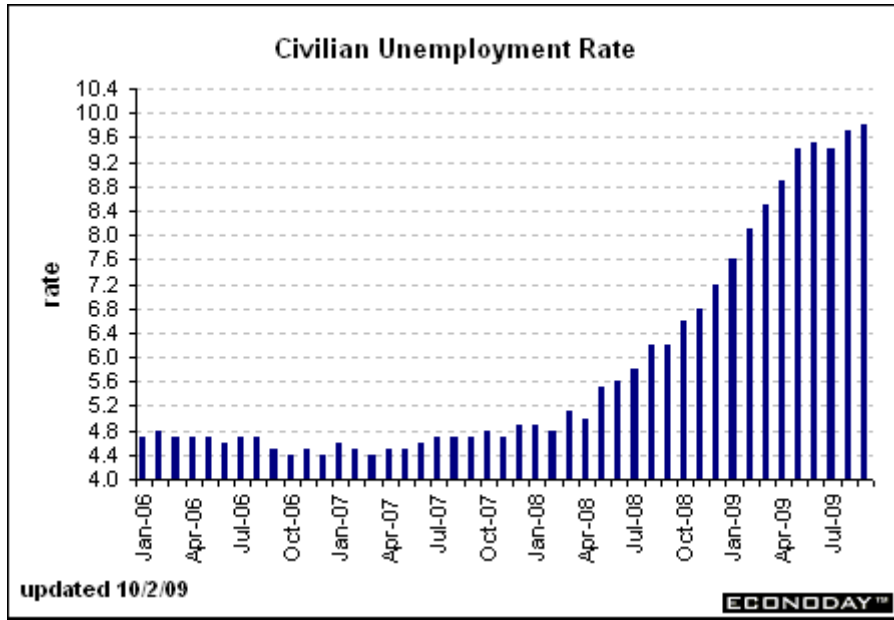
Strength was continued in durable good orders, which jumped 5.3 percent on sharply higher motor vehicle sales. Nondurables were robust also with a 2.3 percent boost while services advanced 0.4 percent.

Inflation was mixed as the headline number was moved notably higher while the core rate was subdued. The headline PCE price index jumped to 0.3 percent after a flat reading in July. Core PCE inflation was unchanged at 0.1 percent, equaling market expectations.

The consumer is making a comeback-even beyond the jump in auto sales. Nondurables and services were healthy-even after discounting inflation. And soft core inflation numbers should let the FOMC keep interest rates low as planned.

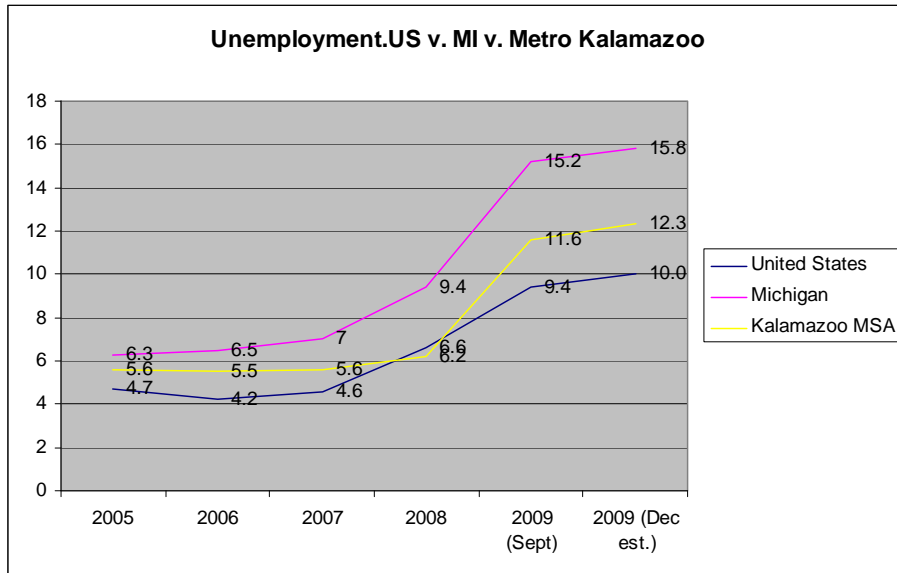
– *Econoday.com*

# Unemployment



Source: Econoday.com

**Table 4**



Sources: 2005-2008: Bureau of Labor Statistics; 2009 (Sept); <http://forecasts.org/unemploy.htm> (Dec 09 est.)

**Table 5**

## Description

The civilian unemployment rate is a lagging indicator. The Bureau of Labor Statistics counts as unemployed “those who were not employed during the reference week (based on the definition above), had actively looked for a job sometime in the 4-week period ending with the reference week, and were currently available for work...as a percentage of the labor force.” <http://www.bls.gov/news.release/metro.tn.htm>

## Expert Testimony

The September jobs report was disappointing - but the consensus may have grown too optimistic. Job losses are not nearly as severe as earlier in the recession and the unemployment rate is drifting up slowly as expected.

Nonfarm payroll employment in September fell 263,000, following a revised decline of 201,000 in August and a revised decrease of 304,000 in July. The September drop in payroll employment was worse than the consensus forecast for a 170,000 contraction. August and July revisions were down a net 13,000 (the net declines were worse).

Job losses were widespread in both goods-producing and service-providing sectors. By major categories, goods-producing jobs decreased 116,000 in September, following a 132,000 drop the month before. In the latest month, construction jobs fell 64,000 while manufacturing declined 51,000 and mining slipped 1,000.

Service-providing losses, however, surged back to a 147,000 fall, after contracting only 69,000 in August. The drop in service-providing jobs was led by trade & transportation, down 60,000, and by government, down 53,000. Trade was tugged down mainly by retail jobs which fell 39,000. Government weakness was led by the non-education component of local government, down 24,000, as revenue shortfalls have forced job cuts despite fiscal stimulus monies.

Since the start of the recession in December 2007, payroll employment has fallen by 7.2 million.

Turning to the household survey, the civilian unemployment rate continued its uptrend, rising to 9.8 percent from 9.7 percent in August and compared to the market forecast for 9.8 percent. The latest rate is the highest since 1983.

– *Econoday.com*

## Looking Ahead

**The W.E. Upjohn Institute's 2009 Business Outlook forecasts a 2 percent drop in employment in 2009 and a 0.1 percent drop in 2010 in the metro Kalamazoo area. This is echoed by IHS Global Insight in a study published for the U.S. Council of Mayors.**

**The greater Kalamazoo area (represented by the Metro Survey Area as defined by the U.S. Census) tracks the national employment data, and makes this region one of the leading regions in Michigan. Kalamazoo County currently has the 4<sup>th</sup> best unemployment rate among Michigan counties.**

**Leading indicators would suggest that the nationwide recession is over or nearing its end.**

**Statewide unemployment in Michigan is projected to approach 16 percent by 2010. Nationally, unemployment is nearing 10 percent. While the growth of the unemployment rolls has slowed, employment shows no sign of upward movement at this time.**

# Housing Starts and Existing Home Sales

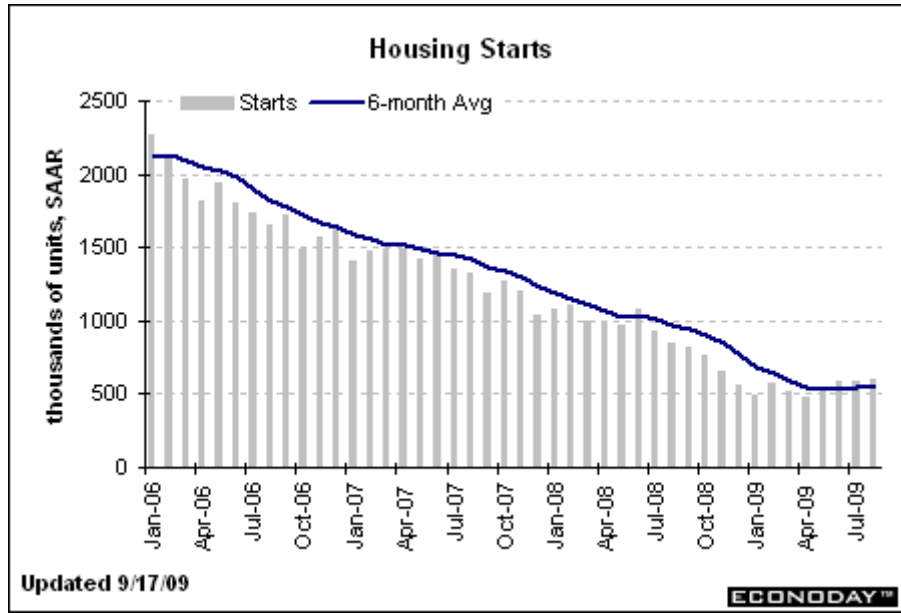
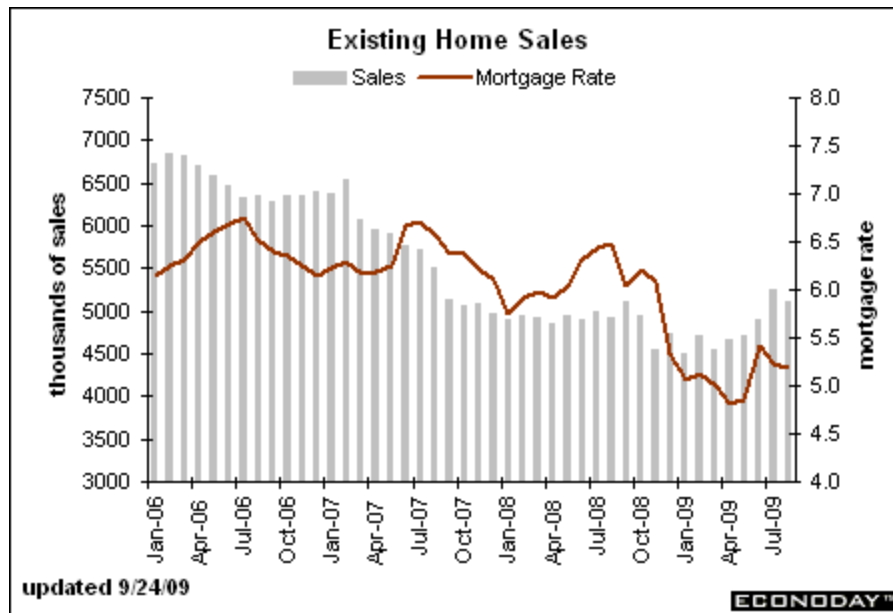


Table 6



Source: Econoday.com

Table 7  
Description

This table shows a change in the historical pattern involving mortgage rates and home sales. Typically, a distinct reverse relationship exists between home sales and mortgage rates. Mortgage Rates traditionally move in the same direction as the Federal Reserve Bank's discount rate policy.

The Federal Reserve eased lending rates throughout 2008 to counteract the onset of a recession. However, the rate easing did not overcome a huge drop in demand for housing, which despite the easing of interest rates was based partially on the recession, but also on the tightening of mortgage practices at financial institutions around the country.

Many banks now will not offer mortgages with principal amounts above 80% of the property's value, whereas less than a year ago it was possible to obtain jumbo loans for 95% of the property's value.

## Expert Testimony

New home starts rebounded as multifamily starts rose from recession lows and single-family starts took a step back.

Housing starts in August rose 1.5 percent, following a revised 0.2 percent drop the previous month. The August pace of 0.598 million annualized units was down 29.6 percent year-on-year and essentially met the market forecast for 0.600 million units (up from the end-of-May annualized projection of .500 million units from the Second Quarterly Report).

The rebound in August was led by the multifamily component which jumped 25.3 percent after plunging 15.2 percent the month before. The single-family component slipped 3.0 percent after rising 3.3 percent in July. Overall starts have risen significantly since recession bottom.

Earlier this week, Fed Chairman Ben Bernanke said that the recession very likely is over. The August boost in housing starts adds to those odds.

Existing home sales ended four months of gains, down 2.7 percent in August to a 5.10 million annual rate that falls well short of expectations for 5.35 million (up from 4.77 as of end-of-May from the Second Quarter Report).

Better affordability has been underpinning sales as it likely did in August as well. The median price fell \$4,500 to \$177,700. Distressed sales made up 31 percent of total sales, unchanged from July, and down slightly from the 33 percent end-of-May figure reported in the Second Quarterly Report).

Supply is down 10.8 percent in the month of August to 3.622 million homes on the market. The average time from listings to sales is 8.5 months, which is a 2-1/2 year low. A year ago this stood at 10.6 months.

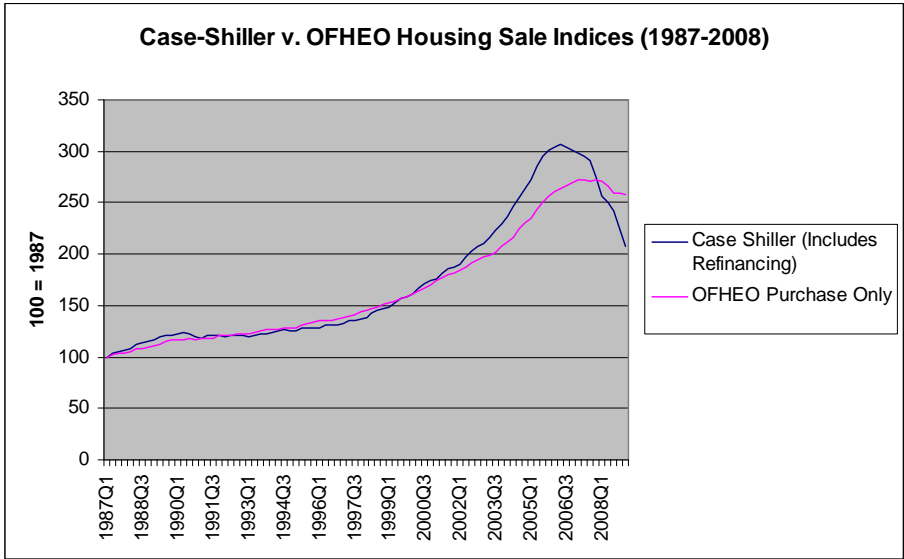
– *Econoday.com*

## Looking Ahead

The analysis above suggests that a curious change has taken place in the mortgage industry. Before the housing and economic crisis there had been years of upward pressure imposed by lenders on appraisers to enable larger loans to be processed. Now, it appears that lenders are imposing downward pressure on appraisers to enable people to qualify under the now re-imposed traditional lending restrictions of 20% down payment, credit-worthiness, income-to-loan ratio maximums, and so on.

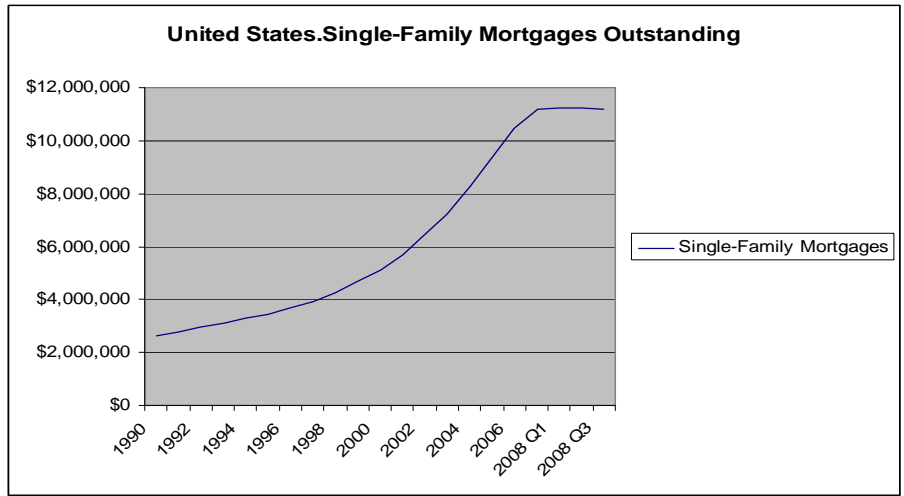
**Sales of existing homes were at a low between November 2008 and May 2009. Since June, however, sale levels have rebounded 20% to levels seen from October 2007 – October 2008. This is still 10% lower than levels seen in the previous 18 months. It appears that the housing market has stabilized, but it is difficult to see a sustained growth pattern until employment and wages begin to pick up again.**

**It appears that housing starts will not begin to pick up nationwide for at least a year, if not two years, due to massive amounts of excess inventory, both due to excess construction in recent years, as well as unprocessed/unsold foreclosure inventory.**



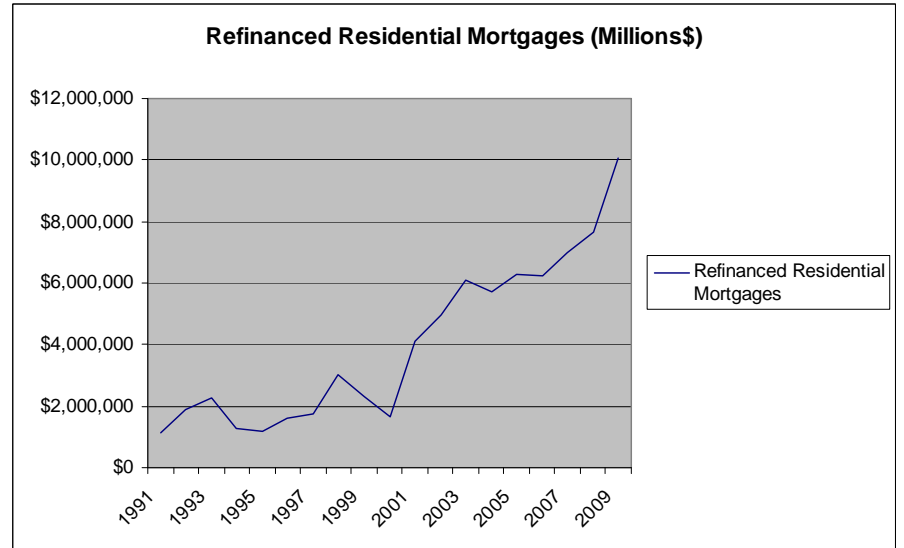
Source: fhfa.gov

**Table 8**



Source: fhfa.gov

**Table 9**



Source: fhfa.gov

**Table 10**  
**Analysis (Tables 8 – 10)**

The Case-Shiller index measures the value attached to residential property. It includes sales and financing. By contrast, the OFHEO Purchase-Only index only includes sales. The presence of appraised values used for refinancing mortgages most likely caused the recent bubble in the Case-Shiller curve.

Staff recently completed a sampling of 50 randomly selected foreclosed residential properties from 2006-2008, in order to assess their current status and estimate how much excess foreclosed inventory may still be awaiting a post-foreclosure sale (which would directly impact future residential sales studies).

As of October 1, 2010, 6 of the selected 50 properties remain with the foreclosing organization. Given that there have been roughly 500 foreclosures above the norm in the last four years, it suggests that there may be 50 properties in the City at this time that are “holdovers” from previous foreclosure processes and awaiting disposition. As these are recycled into the normal marketplace, they will likely cause some drag on the sales study – however, this is not a large enough number to cause major concern at this point.

The resetting of adjustable-rate (ARM) subprime mortgages under the current “traditional” tight mortgage standards (the vast majority of which were initiated under relaxed credit standards prior to the 2008 financial crisis) represents another potential supply of future residential foreclosures.

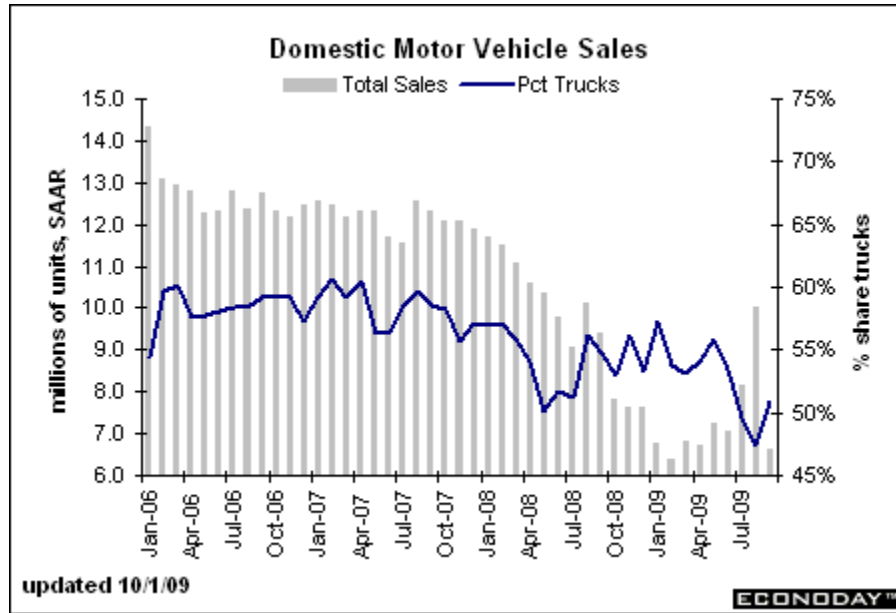
As of the January 2009, subprime ARMs represent about 1% of all housing units in the United States, and about one-half of those were behind in their payments or in foreclosure. A similar percentage of residential properties are due to have their loans reset by the end of 2010. Translated to Kalamazoo, given that there is a higher level of subprime mortgages, this would suggest that there are several hundred properties that face a realistic danger of being in foreclosure due to resetting subprime ARMs by the end of 2010.

The above samplings seem to indicate that there will continue to be higher-than-normal foreclosure levels for at least another year or two in Kalamazoo, although the potential for a major spike in foreclosures seems unlikely.

**Fortunately, the uptick that was experienced in the Second Quarter did not last, and foreclosures for the 1-year residential “Sales Study” period for the 2010 Assessment Roll (October 1, 2008 – September 30, 2009) totaled roughly 370, almost identical to our experience for all of 2008.**

**It would appear at this point that the residential price pressures caused by foreclosures have largely abated in Kalamazoo and the surrounding areas.**

# Auto Sales



Source: Econoday.com

**Table 11**  
**Description**

This chart represents unit sales of domestically produced cars and light duty trucks (including sport utility vehicles and mini-vans). Individual manufacturers report sales on the first business day of the month. Motor vehicle sales are good indicators of trends in consumer spending.

## Expert Testimony

Vehicle sales evaporated in September were down 34 percent for domestic-made cars and trucks in a decline that points to a giant mid-single digit percentage decline for total September retail sales.

September domestic-made sales came in at a 6.7 million annual rate vs. August's stimulus-boosted 10.1 million. Swings like this raise separate questions, on the long-term effectiveness of one-time stimulus programs and whether more such programs will be needed.

September annualized sales figures compare very unfavorably to annualized vehicle sales figures from April through June, which were 9.3, 9.7 and 9.9 million, respectively.

- Econoday.com

## Looking Ahead

Motor Intelligence ([http://www.motorintelligence.com/m\\_frameset.html](http://www.motorintelligence.com/m_frameset.html)) projected annualized sales for GM, Ford and Chrysler for 2009 at 7.0 – 7.5 million units. This compares favorably to the estimates that the Michigan Department of Treasury's Revenue Estimating Conference prepared in May 2009 (6.5 – 7.0 million units).

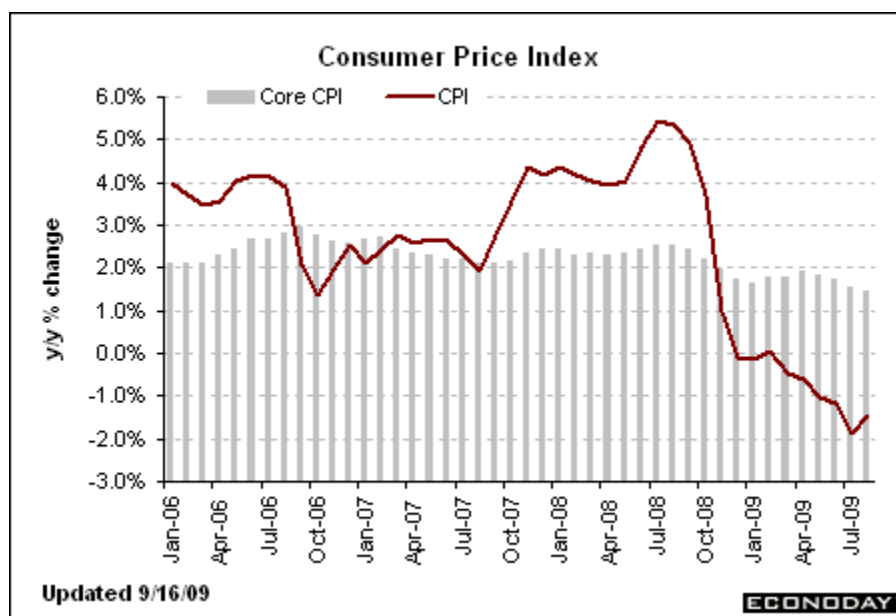
**Projections of 7.0-7.5 million domestic sales for GM, Ford and Chrysler for 2009 are ahead of the May 2009 projections by the Revenue Estimating Conference (6.5 – 7.0 million) and even further**

**ahead of the January 2009 projections by the automakers and Wall Street analysts which were between 4.5 and 5.5 million units.**

**The unprecedented bankruptcy process for Chrysler and General Motors proceeded very rapidly through the courts with the sponsorship of the Obama Administration. The new Chrysler and GM companies are largely owned by a consortium led by the federal government and the United Auto Workers union. While the long-term effects of these developments are impossible to determine at this point, they appear to signal an improved condition for the Michigan-based automakers, which should help to stabilize the state government's fiscal situation.**

# Economic Indicators

## Consumer Price Index



Source: Econoday.com

### Table 12 Description

The Consumer Price Index is a measure of the average price level of a fixed basket of goods and services purchased by consumers. Monthly changes in the CPI represent the rate of inflation.

### Expert Testimony

In August, consumer price inflation surged on higher energy costs while the core rate held steady and soft. The headline CPI jumped 0.4 percent in August after no change in July and matched market expectations. However, core CPI inflation remained steady with a 0.1 percent gain, meeting the consensus forecast.

Within the energy component, gasoline jumped a monthly 9.1 percent for August; fuel oil spiked 6.2 percent; electricity dipped 0.1 percent; and piped natural gas rose 0.4 percent.

Several factors kept the core rate soft. The cash-for-clunkers tax credits helped push prices for new vehicles down by 1.3 percent. Apparel slipped 0.1 percent. Shelter costs were sluggish, including owners' equivalent rent rising only 0.1 percent. The recession has kept rents soft which also impact owners' equivalent rent which is based on actual rent for owner-type houses. On the upside, prescription drugs increased 0.6 percent and airline fares jumped 1.7 percent.

- Econoday.com

There has been considerable concern about the recent increase in the money supply affecting inflation. However, the money supply has constantly lagged inflation for almost 50 years, rather than leading it. (<http://wfhumel.cnchost.com/inflationgraph.html>)

Both inflation forecasts that staff identified (forecast.com and cxoadvisory.com) indicated that inflation would remain well in check for the next 18 months, below 3%. Traditionally, cyclical activity in economic production, as expressed by movements in the Producer Price Index and seasonal cycles has been seen as the keys to forecasting inflation.

## Looking Ahead

Concern about inflation has hovered for years due in large part to the consistently large account balance between the United States and large exporting nations like China, Japan and India, and also because of the enormous Treasury holdings that China and Japan hold.

**The same three scenarios with regards to inflation present themselves again, just as they did at the end of the 2<sup>nd</sup> Quarter of 2009:**

- 1. Deflation: this continues to be a receding threat;**
- 2. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;**
- 3. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.**

## Stock market



Table 13

### Expert Testimony

"[There will be a] bear market trend into mid July 2009. However it is increasingly unlikely that DJIA 6,600 will hold and therefore the bear market is targeting a trend towards a break of the lower target of 6,000."  
- *Dow Jones Stock Market Index Forecast 2009 – Update 1*, Nadeem Walayat, fxstreet.com, Feb. 25, 2009

"During bear market rallies, the market can persist in positive behavior, so that many people think a new bull market has begun. But eventually, the bear reasserts and the down trend resumes. We can see that there is a short-term line of resistance just above current price levels. Even if the rally is destined to continue, it is likely that we will experience a short-term pull-back as the market prepares to break through the resistance."  
- *Bear Market Rally*, Carl Swenlin, decisionpoint.com, Mar. 27, 2009

"We are in a stocks stealth bull market that has already delivered a powerful 35% gain to date, so whilst a stock market correction is expected into the end of June, it is still just a correction against the trend."  
- *Stocks Stealth Bull Market Quick Update*, Nadeem Walayat, <http://www.marketoracle.co.uk/Article11074.html>, June 3, 2009

"Cracks are beginning to appear in the medium-term picture, and any correction should not be fully embraced as positive until it is clear that it is over."  
- *Another Ascending Wedge*, Carl Swenlin, decisionpoint.com, June 15, 2009

"I hear that a number of people are expecting a crash, but I see no evidence that would make me anticipate anything more than a normal correction."  
- *Support Still Holds Correcting Prices*, Carl Swenlin, decisionpoint.com, October 2, 2009

"Today's Market Lesson - Do not THINK too MUCH! Don't get lost in reasons of why the market must move, rather focus on what the market is doing on the price charts! AS you are trading the PRICE CHART and NOT the fundamental DATA! They can and DO move in OPPOSITE DIRECTIONS! Funnymentials are a RED HERRING that continue to sucker both the professionals and the inexperienced, whereas they should amount to no more than 10% to 20% of the your decision making process when trading rather than the over inflated 80% or more that many weight towards in depth Funnymentials studies into for instance corporate earnings forecasts. Your swing trading analyst is not too interested in what the funnymentials suggest."

- *Stocks Bull Market Correction Continues*, Nadeem Walayat,  
<http://www.marketoracle.co.uk/Article13947.html>, October 4, 2009

## Looking Ahead

The so-called “expert” testimony above is indicative of the general incoherency involved in market-timing strategies.

Abraham Lincoln once recalled how as a boy he would observe farmers bracing the goods they had purchased equally on either side of their horses to keep from tipping over, a bit of wisdom he used to balance competing interests, a technique our experts seem to be steeped in as well.

The posturing of the experts notwithstanding, the stock market has made a comeback which has not been seen since 1933 in terms of speed and size.

As was discussed in the 1<sup>st</sup> and 2<sup>nd</sup> Quarterly Report for 2009, traditional chart analytics and similar wisdom have suggested since late March that the market would have one more significant correction before its last upward push to the starting point of the new long-term trend/cycle. This seems to have taken place.

Indeed, the latest charts for the past year show a classic inverted head-and-shoulders curve from 9,200 in October 2008 down to 6,500 in March 2009 and back to 9,200 in August 2009, resulting in a 5 month span to reach bottom and another 5 months to climb back up again to the starting point.

Despite many market-watchers’ predictions of a gloomy September, based on historically bad September returns in the stock market, the Dow Jones and S&P indices continued their rallies through September and added between 3-5 percentage points of value.

While it is obvious that March 2009 represented the bottom point of the market cycle, it is still unclear where the new “Alpha” or beginning of the new stock market cycle begins, in terms of a sustained long-term trend.

Ironically, the record-breaking run of the stock market since March 2009 has sparked fears of overvaluation in comparison to consensus estimates about corporate earnings for 2010. Historically, the ratio of the price of a share as compared to the estimated future net earnings of a corporation for the next 12 months (also known as “Future Price/Earnings Ratios” or FPE) are about 15:1.

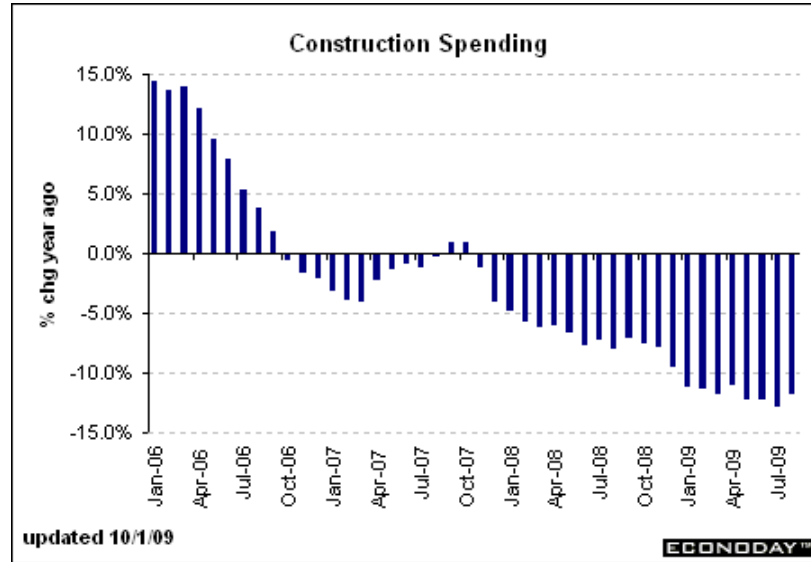
Currently, the FPE is about 27:1, which might suggest that perhaps earnings are underestimated or stocks are overpriced or a combination – or that corporations have not yet “found bottom” in terms of cost-cutting measures. However, the Standard and Poor’s forecast for 2010 would suggest that the estimated corporate profits and prices will be somewhere between 15-20 for 2010, a very reasonable and historically supportable range. See: <http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS>

Major bumps in either the positive or negative direction may be forthcoming yet based largely on whether the federal government enacts major policy changes regarding banking, the economy, health care, global trade and the environment, and other issues that could significantly impact the economy, the stock market and expected corporate earnings.

**The current assumption is that domestic and global equities are near the beginning point of a sustained growth cycle. It would be pure speculation to try and predict whether the long-term trend will approach that of the last 25-75 years or not.**

**Please see the Pension section of this report for more discussion on this topic.**

# Construction Activity



Source: Econoday.com

## Table 14 Description

“Construction spending” represents the dollar value of new construction activity on residential, non-residential, and public projects. This is a coincident indicator of economic activity, meaning that it moves with the economy as a whole.

## Expert Testimony

The construction sector is seeing notably divergent trends. Housing is on an uptrend while nonresidential and government construction outlays are headed downward.

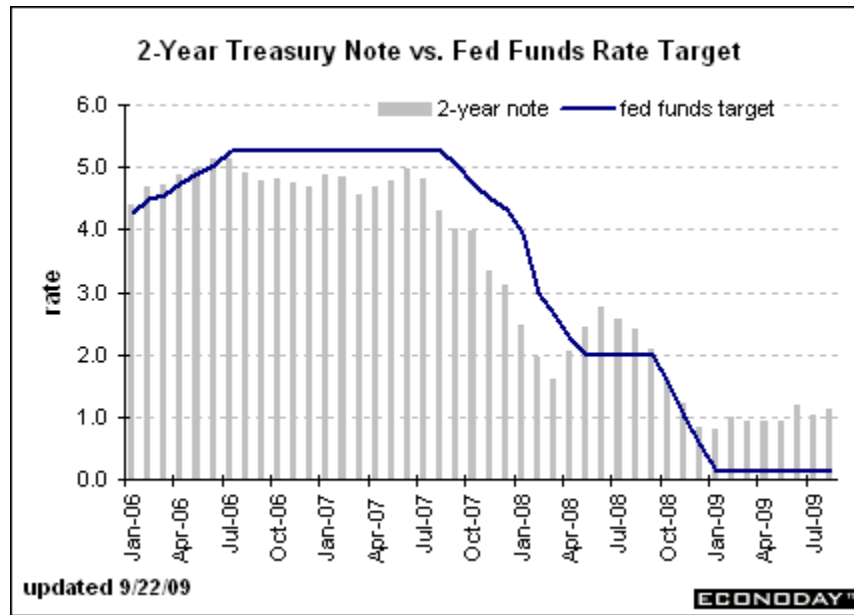
Overall construction spending rebounded 0.8 percent in August after declining 1.1 percent in July. The August gain was well above the market projection for no change. The boost in spending in August was led by a 4.7 percent jump in private residential outlays. In contrast, private nonresidential slipped 0.1 percent and public outlays dropped 1.1 percent in August.

- *Econoday.com*

## Looking Ahead

The recovery and job growth cycle is still anticipated nationwide sometime in 2010, and a positive 4<sup>th</sup> Quarter for 2009 appears to be taking shape. Since construction is a “coincident” indicator of economic activity, when we do see this index recover, it should spell positive news generally speaking.

## Treasury Indices



Source: Econoday.com

**Table 15**  
**Description**

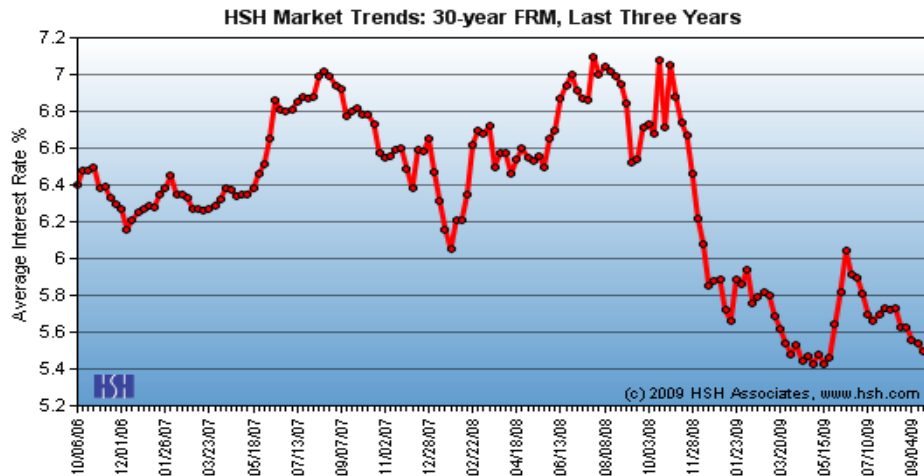
Treasury notes are sold at regularly scheduled public auctions. Competitive bids at these auctions determine the interest rate paid on each Treasury note issue.

### Analysis

Federal Funds Futures were heavily tilted since March 2009 towards the assumption that the Federal Reserve would enact a 25 basis point increase in its August or September 2009 meetings, which did not occur. The Federal Reserve does not yet believe that inflation is enough of a concern to tilt rates upward, as they attempt to reverse job losses through monetary policy and achieve "full employment" goals.

Traditional monetary policy has been exhausted by the near zero federal funds rate. As stated in the First and Second Quarterly Review, there is a danger of extending cheap interest rates too far and encouraging too much risk in the bond market in response, much like what occurred in the last economic cycle that caused many exotic credit instruments to appear on the market. The recent upturn in the demand for corporate bonds in relatively risky sectors like casinos and entertainment underscores this tension.

# Mortgages and Mortgage Rates



**Table 16**  
**Description**

HSH's Fixed-Rate Mortgage Indicator (FRMI) averages 30-year mortgages of all sizes nationwide, including conforming, the new expanded conforming, and jumbo.

## Expert Testimony

Mortgage rates sank this week, to their lowest levels since spring. The benchmark 30-year fixed-rate mortgage fell 11 basis points to 5.25 percent, according to the Bankrate.com national survey of large lenders. One year ago, the mortgage index was 6.41 percent; four weeks ago, it was 5.41 percent.

According to the Mortgage Bankers Association, almost two-thirds of applications last week were from homeowners who wanted to refinance.

<http://www.bankrate.com/finance/mortgages/rates-fall-for-5th-week.aspx>

## Looking Ahead

In December, Fannie Mae will raise fees and tighten lending standards on some mortgages bought by the government-controlled financial titan. And at the beginning of 2010, the Federal Housing Administration will make it harder to get a "streamline refinance."

Beginning Dec. 11, Fannie won't buy a loan with a credit score under 620, which means lenders won't underwrite them. For most loans, the minimum credit score will be even higher than that. For example, to refinance a loan on a single-family house with less than 25 percent equity, the minimum credit score would be 660. That's also the minimum score for buying a house with less than 25 percent down.

FHA's streamline refinancing program is for homeowners who already have FHA-insured mortgages traditionally haven't required credit checks or employment verification. They haven't required appraisals if the new loan amount doesn't exceed the original loan amount. Those rules change Nov. 17. Borrowers will have to verify that they have paying jobs, and the FHA will gather credit scores. And more borrowers will have to get appraisals.

<http://www.bankrate.com/finance/mortgages/rates-fall-for-5th-week.aspx>

**The upward swing in mortgage rates that occurred in the second quarter of 2009 has been reversed. It seems clear that mortgages are going to continue to be forced downward by the Federal Reserve, unless inflation becomes an issue.**

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# FY 2009-10 Budget Highlights

- **FY 2009-10 Budget Cost Containment:** At this time, nearly \$560 thousand of cost reductions have been identified without layoffs or significantly affecting service levels.
- **5-Year Fiscal plan:** this is the third Budget that contains a detailed projection of General Fund balances for five years beyond the target fiscal period.
- **2-Year Budget framework:** we have lengthened the budgeting perspective and shortened the fiscal perspective to align with uncertainty. This affords the potential for “smoothed” cuts in FY2009 that can minimize cuts that are needed for balancing the FY2010 budget.
- **Health Care cost containment:** the City negotiated agreements with our labor units that have saved the City approximately \$7 million in health care costs during FY2006 – FY2008. Savings realized since FY 2007 has created an unencumbered balance of \$4.5 million in the City’s internal Insurance Fund.
  - The City Commission recently agreed to a new contract with AFSCME that indexed health care contributions for FY 2009 – 2011. The recently ratified KMEA contract mirrors this as well. The new AFSCME and KMEA contracts and the non-bargained for benefits also include a Pharmacy Initiative, which will increase our employees’ use of generic drugs, providing the same health care plan for much lower costs to the City.
  - The new KMEA contract and the non-bargained for benefits package now provide a stipend and tax-free savings account for retiree health care for new employees, in place of the defined benefit retiree health care. This is a critical step towards containing health care costs and establishing predictability in the long term.
- **Budget Stabilization Fund:** by adding \$1.3 million in FY2009, this fund is estimated to have a balance of \$1.6 million by the end of FY2009;
- **Capital Contingency Fund:** this is estimated to have a balance of \$300 thousand by the end of FY 2009, to assist in the repair/replacement of unexpected City property damage and loss.
- **Tax Installments:** enactment of Public Act 512 by the Governor shortens the City Tax Installments from 12 payments to 6 payments (due December 31<sup>st</sup>) for a one time increase of \$600 thousand. The conversion process was completed with the Summer 2009 tax billing cycle.
- **Tax Anticipation Notes:** due to the renewed bond ratings, the City realized savings of \$100 thousand of interest costs for 2009 TANs based on 1.28% interest rates from the competitive bid process. The shortened tax installment program will reduce TAN borrowing from \$6 million in FY2009 to possibly as low as \$3 million in FY2010.
- **Bond Ratings:** due to the quality of the City’s fiscal management, our bond rating has been renewed at AA with a stable economic outlook by both Fitch and Standard and Poor’s. Through funding from the American Recovery and Reinvestment Act, the City realized savings of over \$160 thousand of debt service payments for each of the next 15 years on the 2009 Capital Improvement Project Bond, based both on the federal American Recovery and Reinvestment Act (ARRA) or “stimulus package”, which provided over \$1.27 million in capital grants to the City to reduce planned bonded indebtedness, but also low coupon rates of 4.06%, which were at least 25 basis points below expectations.

# Pension Funding

**December 31, 2008:** Historic losses of \$150 million in 2008 (representing approximately 29% of the Pension Trust Fund market value) will have to be recognized over a five-year “smoothing” period. As of December 31, 2008, the Pension Fund had approximately \$368 million in market assets, and an actuarial value estimated at \$506 million.

**Experience in 2009:** After a steep slide of an additional \$90 million of market value losses through the end of February 2009, which left the Pension Trust Fund at around \$280 million of market asset value as of March 1<sup>st</sup>. However, the market has recovered somewhat, and as of October 1, 2009, the Pension Trust Fund is at \$430 million of market value of assets, or about 17% higher than it was on January 1, 2009.

**Projections: 2009 – 2029:** A number of informal projections have been run for the pension system for the next 20 years, using various assumptions regarding rates of return on investment to begin to identify contribution requirements.

The Michigan Constitution requires that the normal cost of the benefits be paid to the Pension Trust Fund of the municipality each year. In application, the normal cost is adjusted up or down by an amortized portion of the current funded level to determine the actual contribution.

The normal cost of benefits is the value accrued in benefits by employees from a year of service. For the year ending 2008, the net normal cost for all active employees totaled a little more than \$6 million (when roughly \$1.5 million of employee contributions are netted out).

**For the purposes of comparison, it has been assumed that the Pension Trust Fund’s market value will achieve a rate of return of 24.3% in 2009, resulting in the Pension Trust Fund balance being 20 percent higher on December 31, 2009 (net of more than \$15 million in expenses) than it was on December 31, 2008, giving it an actuarial value of roughly \$500 million. The actuarial (smoothed) funding level would fall from 146% to 140%.**

The following rate of return scenarios are based on a range of reasonably foreseeable outcomes in the market over the next 20 years. It must be noted that level-percent rate of return assumptions are simplified scenarios for the purposes of problem identification:

- **5% Rate of Return:** the City would be required to contribute nearly \$1 million to the Pension Trust Fund in 2014, and \$3 million in 2015. This amount would continue to increase indefinitely.
- **7.5% Rate of Return:** the City would be required to contribute more than \$650 thousand to the Pension Trust Fund in 2017, and \$1.4 million in 2018. This amount would continue to increase indefinitely.
- **10% Rate of Return:** At 10%, the City would not be required to make any contribution for the foreseeable future.
- **12.5% Rate of Return:** At 12.5%, the City would not be required to make any contribution for the foreseeable future.

- **Average History:** this is a completely different approach of estimating returns. It involves using the “slope” of past recoveries during the 25 year history of the Retirement Investment Committee. There have been four stock market drops followed by recoveries over that period of time. Each year of recovery, from the first to the fifth, has been averaged to come up with a normal scenario. Using the approach, the City would avoid making contributions.

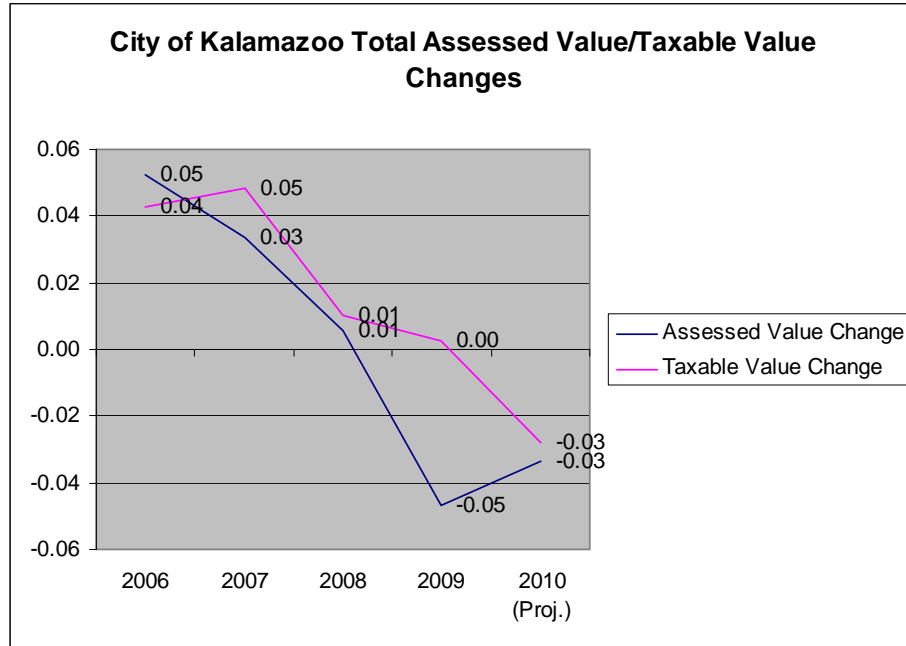
**Smoothing recognition of gains/losses to assets (5 years vs. 10 years):** The City has the option of changing the smoothing period for recognition of gains and losses in the portfolio. They currently utilize a 5-year smoothing period, which means that gains and losses are cut into 5 equal units and spread over a 5-year period. The vast majority of public pension systems utilize smoothing periods between 5 and 10 years.

The City’s actuarial firm of Gabriel, Roeder and Smith has been asked to produce alternative forecasts of City contributions based on the City changing to a 7 year or 10 year smoothing period. This will be presented to the Retirement Investment Committee for consideration in conjunction with their periodic review of methodology and assumptions.

**The Retirement Investment Committee will be reviewing the information provided by our actuarial firm of Gabriel, Roeder and Smith at their regular November 2009 meeting, and determining whether to recommend to the City Commission any changes in actuarial methods and assumptions, including smoothing of asset recognition, amortization of liabilities, and so on.**

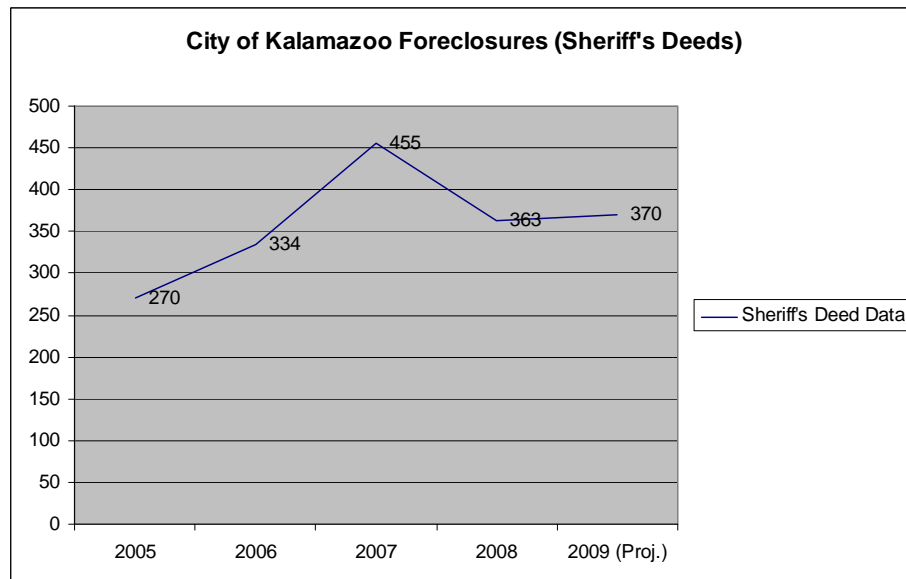
# Revenues

## Property Taxes



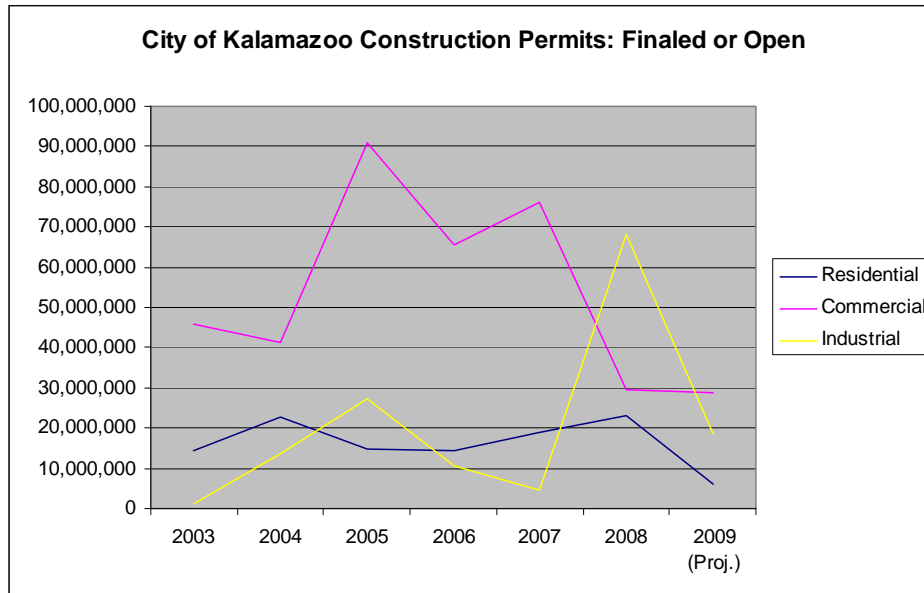
Source: City of Kalamazoo Assessor's Office

**Table 17**



Source: City of Kalamazoo Assessor's Office

**Table 18**



Source: City of Kalamazoo Assessor's Office

### Table 19 Description (Tables 17 – 19)

**2008 and prior:** Table 17 shows that City of Kalamazoo total assessed value (which is based on property sales and industrial appraisal studies, and moves with the market value of property) had been rising steadily at 5% (which is the City's historical average for the last 15 years), but increased only 3% for the 2007 roll and only 1% for the 2008 Assessment Roll.

**2009:** The 2009 Assessment Roll utilized a study period of October 1, 2007 – September 30, 2008, which showed a substantial loss of 5% compared to the previous Assessed Value. Because there was a substantial gap between the Assessed Value and the Taxable Value for most properties, this change did not cause a downturn in Taxable Value for 2009. In combination with inflation, the Taxable Value for the City's properties stayed relatively flat for 2009.

**2010:** The 2010 Assessment Roll will be determined for Residential and Commercial property by utilizing sales data for the period of October 1, 2008 – September 30, 2009. The overall result will be a drop in Assessed Value of roughly 3%, and a drop in Taxable Value of 3%.

**Residential sales study:** Using the available data for sales from October 1, 2008 through September 30, 2009, the final number of qualified residential sales was a little over 350, down from the previous projection of 400.

In the First Quarterly Report for 2009, it was reported that sales prices for October 2008 through February 2009 were slightly ahead of 2009 Assessed Values.

In the Second Quarterly Report for 2009, it was reported that residential sale prices dropped significantly to an average of 8% lower than 2009 Assessed Values for the Second Quarter.

At this point, if we project the volume of sales along with sales prices for residential property through the end of September 2009, the 1-year sales study would produce a roughly 3.5% drop in Assessed Value for residential property in 2010. This would translate to a 1% drop in Taxable Value for residential properties, equivalent to roughly \$200 thousand of lost revenue for the General Fund.

**Commercial sales study:** Commercial real property (land and buildings) taxable value had increased from the 2008 to the 2009 Assessment Roll by 1.5%. Despite the nominal start for 2009 in terms of commercial construction activity, the aggregate value of commercial real property sales (despite their relatively small number) has dropped dramatically since October 2008 by an average of 13% compared to the 2009 Assessed Value.

Additionally, increased value in newer Brownfield properties has caused a “shift” of roughly \$250 thousand of revenue from the General Fund to the Brownfield Authority, which will be used to reimburse the costs of de-contamination Brownfield properties.

If we project the volume of sales along with sales prices for commercial property through the end of October 2009, the 1-year sales study would produce a roughly 13% drop in Assessed Value for commercial property in 2010. This would translate to an 8% drop in Taxable Value for commercial properties, equivalent to \$1 million of lost revenue for the General Fund, when the increased Brownfield capture amounts for 2010 vs. 2008 are factored out.

**Table 18** shows that in 2007 a seemingly temporary spike in residential mortgage foreclosures occurred (as represented by Sheriff’s Deeds). Historically we have seen 250-300 foreclosures a year. In 2007 we experienced nearly 450, after rising to 330 in 2006.

In 2008, the number of residential mortgage foreclosures fell to 365.

At the end of March 2009, Federal agencies Fannie Mae and Freddie Mac ended their moratorium on foreclosures, which has resulted in an industry-wide increase in foreclosures in April, May and June.

The pace of foreclosures fell in the Third Quarter back to the pace seen in 2008, resulting in a projected 370 foreclosures for 2009. While excess residential inventory will likely remain on the market for some time, the pace seems to have stabilized.

**Table 19** shows that the City experienced five strong years of combined construction totaling over \$470 million of value. Annual totals varied between \$70 million and \$115 million, driven primarily by commercial construction.

Last year, industrial construction was the largest driver, with Pfizer’s \$50 million project on Building 300 as the largest single piece. While residential construction remained steady in 2008 with historical levels at about \$20 million, commercial construction slowed to \$25 million, whereas it had averaged about \$55 million from 2003 – 2007. The large commercial projects completed in 2008 (such as the Miller Canfield building) were based on permits issued prior to 2008.

For 2009, Commercial construction began at a much higher pace than 2008, primarily because of the \$4.7 million Catheterization Lab project at Bronson Hospital. In the last few months, permit activity has slowed somewhat. Commercial permits are on pace with 2008 activity, which is slower than the previous 5 years.

Residential construction has slowed dramatically through August 2009, with less than one-half of the total activity seen in the last two years at the same time.

There are historically only a handful of industrial permits issued so historical comparisons are difficult. There have been two issued in 2009, including a \$1.275 million project at Pfizer’s Building #300. This is in addition to the \$50 million permit for Building #300 that was issued for Pfizer in 2008.

## Looking Ahead

The continued deterioration in the local economy has caused housing prices in the City to continue to slide, and foreclosed residential properties continue to represent excess low-price inventory that will dampen values for some time. The foreclosure situation seems to have stabilized, and should eventually return to normal, with home prices presumably following the same trend.

For the purposes of revenue generation, 2010 will be the first year in at least 25 years where there is almost certain to be negative inflation, causing 2009's taxable value to decrease slightly (3/10ths of a percent).

- **2009:** The Assessment Roll has been confirmed by the City Commission for 2009. We are almost exactly at the level of Taxable Value anticipated in the 2009 Adopted Budget.

The "shift" in taxable value from the General Fund to the Brownfield Redevelopment Authority mentioned above has caused a **drop in General Fund revenue of \$250 thousand** versus what was budgeted for 2009.

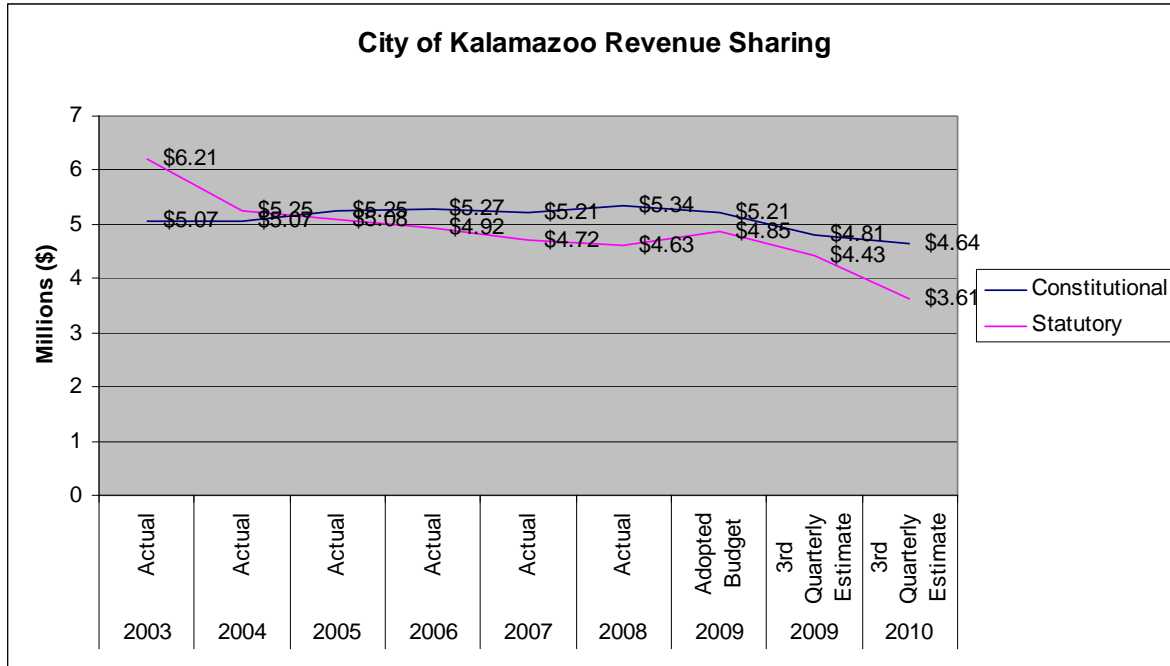
An elevated number of commercial property appeals have been filed with the Michigan Tax Tribunal. There are over 25 appeals filed for the 2009 Assessment Roll, compared to 13 in 2008 and 7 in 2007.

The aggregate value of commercial appeals filed exceeds \$35 million of taxable value. Normally, we could expect commercial property appeals to result in about 1/4 success for the appellant. **This may result in roughly \$50 thousand of potential lost tax revenue due to appeals.**

- **2010 Residential:** The City's FY 2009-10 Budget had projected an increase of \$300 thousand in tax revenue from residential property value inflation for 2010. The situation in residential sales has improved markedly in the Third Quarter versus the Second Quarter of 2009. **We are now projecting \$200 thousand of lost General Fund revenue based on the Residential sales study (this would be \$500 thousand when netted together with the originally projected gains mentioned above).**
- **2010 Commercial:** The City's FY 2009-10 Budget had projected \$300 thousand of tax revenue increases from commercial property value inflation for 2010. **We are now anticipating a \$1 million loss in General Fund revenue in Commercial property (this would equate to a net loss of \$1.3 million when combined with the originally projected gains mentioned above).**
- **2010 Industrial:** There is an estimated \$2 million of additional effective taxable value going "on line" for the 2010 Assessment Roll, **translating to \$50 thousand of increased revenue for 2010.**

**Summary: instead of the \$600 thousand increase in property tax revenue for the General Fund that was projected for 2010, we are anticipating a decrease of approximately \$1.2 million, netting a total loss of property tax revenue of \$1.8 million to the General Fund for FY 2010 when compared to our original projection.**

# State Revenue Sharing



Source: Treasury.gov and Michigan Department of Treasury

**Table 20**

<b>REVENUE SHARING ESTIMATES</b>				
(Millions \$)	0809 Budget – CITY FY 2009	May 09 Exec. Order – CITY FY 2009	Senate Bill 245 – CITY FY 2009	Senate Bill 245 – CITY FY 2010
STATE SALES TAX REVENUE	\$6,645	N/A	\$6,000	\$6,000
STATE-TO-LOCALS	\$1,086	\$1,045	\$1,037	\$937
	Pct. Chg ->	-6.5%	4.5%	13.7%
CITY	\$10.063	\$9,705	\$9,200	\$8,300
CITY	\$ Change From 0809 Budget ->	-\$358	-\$863	-\$1,763
CITY	% Change	-3.0%	-8.5%	-17.5%

**Table 21**

## Analysis

According to the Michigan Department of Treasury, the latest numbers from the end of May 2009 show that sales tax collections for the state from October through May (the State's fiscal period is October – September) remain down roughly 8.3% vs. the State's FY 08-09 budgeted amount, and roughly 10% vs. FY 07-08 collections. These are the same percentages that have been noted in the First Quarterly Report and the Second Quarterly Report.

Governor Granholm utilized Recovery Act dollars to help mitigate the size of State budget cuts in May 2009, resulting in an estimated reduction of FY 2009 State Shared Revenue to the City of approximately \$360 thousand versus our FY 2009 Adopted Budget amount.

### **STATE FY 2009-10 BUDGET ACTION TAKEN BY THE MICHIGAN LEGISLATURE, PENDING GOV. GRANHOLM'S ACTION (WHEN IT IS SENT BY THE SENATE)**

The Michigan House and Senate have passed an "All Cuts" proposal for the General Government Budget, which funds Revenue Sharing. This is based on a 11.1% reduction against the distributions made during the State's current fiscal period.

The "All Cuts" reduction is projected to be applied immediately against the October 2009 and December 2009 Revenue Sharing payments from the State, which would significantly impact our FY 2009 receipts negatively.

Michigan Senate leadership is currently holding the General Government Budget, and there is no indication that they will send it to the Governor for her review and action. The expiration of the current Continuation Budget at the end of October forces a deadline for action by the Governor no matter when she receives the bills from the Senate.

### **IMPACT ON THE CITY'S REVENUE SHARING DISBURSEMENTS FOR FY 2009 AND FY 2010**

For the City, according to the House Fiscal Agency analysis (<http://www.house.mi.gov/hfa/PDFs/rev%20share%2009-09.pdf>, see Page 32) the City will see an **effective cut of 11.1%** versus the FY 2008-09 receipts for Revenue Sharing.

The "All Cuts" reduction of 11.1% would create two significant shortfalls in Revenue Sharing beyond what we have budgeted and projected to-date:

- **FY2009:** the City stands to see additional reductions in FY 2009 of **roughly \$500k** for the last two payments combined, above and beyond the \$300k that we reduced in the mid-year Budget Adjustment based on the May 2009 Executive Order.
- **FY 2010:** the City would fall short of the projection we used for the FY 2010 budget plan of nearly **\$700k** when compared to the number we projected for the purposes of FY 2010 Budget planning.

**NOTE:** the FY 2010 scenario above assumes that the State will enact reductions of an **additional 10% of Revenue Sharing for their FY 2010-11 Budget**. This is based on the assumption that the State would have a roughly \$783 million (or 10%) shortfall in their General Fund Budget for their FY 2009-10 Budget.

### **COMPARING THIS LEGISLATION AGAINST THE SECOND QUARTERLY REPORT PROJECTION**

The Second Quarterly Report estimate was that the State would receive \$6 billion in Sales Tax

receipts in FY 2008-09 (the State was estimating \$6.2 billion at that time). The Quarterly Report's \$6 billion estimate represented almost exactly a 10% reduction versus the State's original FY 2008-09 Budgeted amount.

In the Second Quarterly Report, we assumed as a matter of principle that the state would not cut more from local governments than it actually lost in Sales Tax receipts. Accordingly, we estimated a **10%** cut for our FY 2010 Revenue Sharing when compared to the State's original FY 2008-09 Budget amount of \$1.086 billion, so that our FY 2010 amount would equal roughly \$9 million.

However, the "All Cuts" budget represents a **13.7%** cut relative to the State's original FY 2008-09 Budget, resulting in disbursements of only \$936 million in local Revenue Sharing in their FY 2009-10 Budget, which contrasts with the \$978 million that was estimated in the FY 2009 Second Quarterly Report in July.

## Looking Ahead

While many state revenue sources have been declining by more than 20 percent, the latest economic forecasts project losses of wage and salary income of 10 percent by the end of 2010. This would tend to support the projection that sales tax revenues will also suffer a 10 percent loss over that same period.

Governor Granholm has made it a priority to hold Revenue Sharing to local governments steady, so as to preserve Public Safety funding and to avoid forcing more governments into Public Act 72 financial management under the direction of the State.

The Governor and the legislature are proposing competing revenue enhancement packages that each would partially restore funding to Revenue Sharing to cities.

At this point, we have updated our FY 2010 Budget projections to account for SB 245 as passed, seeing it as a "worst-case" scenario, in addition to additional cuts of 10% to Revenue Sharing payments in October and December of 2010. based on a currently projected \$783 million (or 10%) shortfalls to the State's General Fund for FY 2010-11.

**Summary: we are projecting losses of \$500 thousand for Revenue Sharing in FY 2009 beyond the losses already projected, and another \$1.7 million for the FY 2010 beyond what was projected in the 2009 Adopted Budget.**

## Act 51 Revenue

According to the latest analysis conducted by the Michigan House Fiscal Agency on June 18, 2009 (see: <http://house.michigan.gov/hfa/transportation.asp>), the State is still receiving gas tax revenues for FY 08-09 at a rate about 5% lower than last year, which is the same rate of decline experienced in the first quarter of 2009.

The State disbursed about \$344 million to cities in Act 51 money in 2008.

The State is estimated to disburse about \$328 million in 2009.

Senate Bill 254 was signed recently by the Governor which would reduce the cities' amount to \$317 million for 2010, however the actual disbursement is ultimately controlled by the amount of Gas Tax the state collects. The House Fiscal Agency projected that disbursements of Act 51 money to cities should remain steady vs. 2009 receipts at about \$324 million in 2010.

**There is likely to be a loss of roughly \$200 thousand of Act 51 revenue in 2009 compared to the 2009 Adopted Budget. Roughly the same amount of revenue should be realized in 2010 as in 2009. This would represent a drop of roughly \$230 thousand for the road system compared to 2008 Actual amounts. Shortfalls in the road funds will have to be made up by reductions in road service levels and/or additional appropriations from the General Fund.**

## Interest earnings

The City's General Fund is projected to receive \$468 thousand in interest earnings in 2009, substantially less than the \$818 thousand originally budgeted for 2009 and the \$905 budgeted in 2008 (actual 2008 revenue returned was \$663 thousand). The historically low Federal Funds rate, which has suppressed short-term interest rates, is expected to continue through the remainder of the year.

While the City generally keeps about 40% of its cash in liquid investments (which are basically tied to the Federal Funds rate), the City has been successful in maintaining a little more than \$20 million dollars in intermediate investments. As these investments come due over the next year, the City will keep more dollars short in an attempt to avoid locking in low rates any longer than necessary to maintain reasonable maturity diversification.

**The General Fund stands to lose approximately \$350 thousand in investment returns in 2009 versus the Adopted 2009 Budget.**

# American Recovery and Reinvestment Act

Staff is continuing to review the "American Recovery and Reinvestment Act" to determine the funding that the City of Kalamazoo is eligible to receive by formula and what programs we may apply for. To date we have identified over \$9 million in formula funding and \$1.7 million from last year's Neighborhood Stabilization Program, for a total of over \$10 million. In addition, another \$18 million in Neighborhood Stabilization Program funds through the ARRA has been applied for and is under consideration by the Department of Housing and Urban Development.

Stimulus funds include one-time new program funding in the form of \$495 thousand from the Community Development Block Grant program, \$758 thousand for Homeless Prevention, and \$1.7 million in Neighborhood Stabilization Program funding to assist in post-foreclosure programs.

Stimulus funds are available in the amount of \$762 thousand from the Energy Efficiency and Conservation Block Grant program. This funding will be used to finance City Hall facilities improvements that were budgeted to be financed by municipal bonds. This will preserve roughly \$10 thousand of bond financing costs in FY 2009 and \$20 thousand in every subsequent year beginning with FY 2010.

Stimulus funding for existing capital projects include \$754 thousand for major street construction. This will supplant the same need for bond financing, preserving over \$500 thousand in estimated General Fund financed debt service over the next 5 years, beginning with \$40 thousand in FY 2009 and \$80 thousand in every subsequent year beginning with FY 2010.

Out of \$364 thousand directed towards Public Safety, \$125 thousand is for a new emergency warning system and \$239 thousand is for a new digital video recording system for police and fire vehicles.

The emergency warning system was budgeted as a bonded capital project, so the savings in bond payments will be about \$5 thousand per year beginning in FY 2009.

There is \$3.1 million designated for Transportation capital projects, equipment and vehicles. These will not supplant any existing resource allocations, so no net savings to the Transportation system will be realized.

**Administrative staff in Community Planning and Development needed to manage ARRA programs may be paid for with ARRA money. This is estimated to total roughly \$106,840 thousand a year for 2010 and 2011.**

**The Stimulus funding resulted in savings of more than \$1.2 million in bonded indebtedness, primarily due to cash-financing major street projects and the early warning system. When combined with favorable interest rates realized at the sale (due largely to the renewal of the City's bond rating with a "stable" economic outlook by the rating agencies), this will result in savings of \$90 thousand in FY 2009 and \$160 thousand every subsequent year.**

## General Fund Savings Due to ARRA

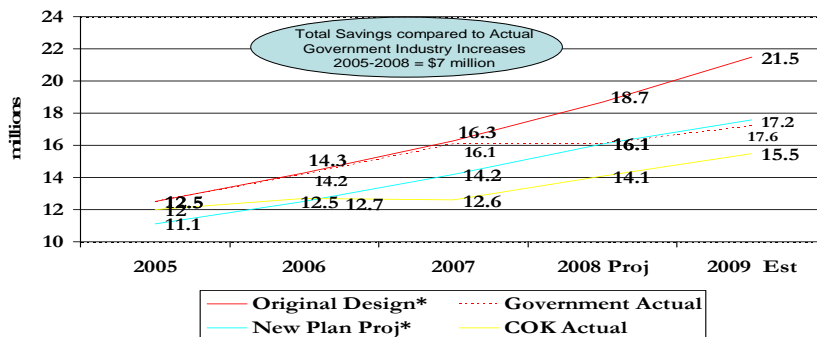
2009		2010	
Emergency Warning System	\$126,244		
		Patrol Car DVR's	\$239,000
		Energy Conservation Grant (City Hall)	\$762,000
		COPS Program	\$663,000
CD&P	\$72,586	CD&P	\$106,840
Major Streets	\$1,075,000	Major Streets	\$491,000
Youth Employment	\$150,000	Youth Employment	\$150,000
Bond Service Savings	\$90,000	Bond Service Savings	\$160,000

TOTAL	\$1,513,830	TOTAL	\$2,571,000
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# Expenditures

## Health Care

### Health Care Cost Comparison



\*Source: Mercer Health Benefits Report 1/26/07

**Table 22**

Since 2005, the City has saved over \$7 million dollars by virtue of consolidating the employee health care plans from three a la carte offerings to one, as well as increasing cost-sharing measures such as monthly employee health care contributions, co-pays and deductibles for care visits. The new contract with the Amalgamated Transit Union (ATU), effective January 1, 2010, means that every employee and retiree of the City will be on one plan, saving significant administrative and plan-design related costs.

In the latest round of bargaining, the following changes in employee benefits were made:

- **Retiree Health Care:** new hires in KMEA (and the non-bargained for group) will receive a monthly stipend of \$75 to place into a health savings retirement account through MERS. This will result in approximately \$5 – 10 thousand of new annual expenditures over the next five years. This money is pre-tax for the employee and its use for health care costs is also tax-free.
- **Pharmacy Initiative:** A pharmacy initiative has been agreed to. This pledges the employees to taking steps to replace their use of name-brand drugs with generic drugs that come at much lower prices. The City spends over \$1 million in prescriptions every year, and a full 85% of drugs purchased by our employees are name-brand products.
- **Cost-Sharing:** existing cost-sharing amounts have been inflated nominally.

**Savings realized since FY 2007 have created an unencumbered balance of \$4.5 million in the City's internal Insurance Fund.** The General Fund is entitled to \$2.8 million of this, \$500 thousand of which was budgeted to be returned to the General Fund in FY 2009. This provides a potential source of funding for losses in Revenue Sharing and/or Property Tax dollars in the short-term or an investment opportunity to offset accrued retiree healthcare liabilities. Other opportunities exist for the City to realize significant health care savings. Chief among them is mandating participation among KPSA and KPSOA retirees in the

federal Medicare Part B program (which is currently optional in the respective collective bargaining agreements for these groups). **Savings of \$250 thousand a year could be realized by this one change alone.**

# Energy

Energy costs through August 2009 are down over 7% versus the same period last year, and are down 3% versus 2007 during the same period. The large spike in 2008 versus both 2007 and 2009 is primarily due to the spike in prices for gasoline and diesel fuel in 2008. According to the estimates of the Energy Information Administration (EIA) of the U.S. Department of Energy:

**Gasoline:** averaged \$3.26 per gallon in 2008, averaged \$2.36 in 2009Q2, 2009Q3 is now averaging **\$2.31** per gallon and the 2009Q2 estimate for 2010 was \$2.69, 2009Q3 is now estimating 2010 at **\$2.65**.

<http://www.eia.doe.gov/steo>

**Diesel:** averaged \$3.80 per gallon in 2008, averaged \$2.46 in 2009Q2, 2009Q3 is now averaging **\$2.43** per gallon and the 2009Q2 estimate for 2010 was \$2.79, 2009Q3 is now estimating 2010 at **\$2.78**.

<http://www.eia.doe.gov/steo>

**Natural Gas:** averaged \$13.67/mcf in 2008, averaged \$11.38 in 2009Q2, 2009Q3 is now averaging **\$12.11/mcf** and the 2009Q2 estimate for 2010 was \$11.63, 2009Q3 is now estimating 2010 at **\$12.22**

<http://www.eia.doe.gov/steo>

**Electricity:** averaged 11.4 cents/kwh in 2008, averaged 11.9 cents/kwh in 2009Q2, 2009Q3 is now averaging **11.6cents/kwh** and the 2009Q2 estimate for 2010 was 12.3 cents/kwh, 2009Q3 is now estimating 2010 at **11.42 cents/kwh** in 2010. <http://www.eia.doe.gov/steo>

**Since the 2009 Budget amounts for Energy are based on 2008 prices, we can expect some budgetary relief in this area. Taken in total, the overall savings in FY 2009 should be approximately \$150 thousand for the General Fund and \$150 thousand in FY 2010.**

# Overtime

**Public Safety OT:** Public Safety is estimated for 2009 to utilize \$1.5 million of overtime versus \$1.35 million budgeted. **The projected overtime expense exceeds the Public Safety budget by approximately \$150 thousand.** A portion of this overtime has been necessitated by virtue of six of our Public Safety Officers who have been called to active military duty in our nation's armed forces.

**Non-Public Safety OT/non-Metro Transit (primarily Public Services OT):** Non-Public Safety/non-Metro Transit overtime is projected to total approximately \$1.2 million versus \$986 thousand budgeted. **This would exceed the budgeted amounts for this overtime by approximately \$200 thousand.**

# Travel/conferences

Education and Training expenses in the General Fund (not including amounts to be reimbursed by the State of Michigan) totaled \$49 thousand through August 2009, compared to \$72 thousand during the same period in 2008, and \$55 thousand for the same period in 2007.

**The projected amount for 2009 is roughly \$65 thousand, compared to the budgeted amount of \$170 thousand. This projects to a budgetary savings of \$100 thousand.**

## **Telephone/Cell phones**

Through May 2009, telephone costs for the General Fund are recorded at \$320 thousand, compared to \$400 thousand for the same period in 2008. The savings of approximately \$80 thousand has been realized by adopting the latest contract pricing from Nextel for cell phones as well as recent improvements in telephonic contract pricing.

# **Management Controls**

## **Phase I (immediate)**

### **Travel and Conferences: Limitations and Creative Solutions**

Out-of-state travel has been limited to those events that are required to retain professional certification and other demonstrated needs. Employees are being encouraged to adopt creative ways to achieve professional development, including webinars and other on-line learning opportunities.

### **Telephone Cell Phone Usage Review**

The Information Technology Department is working with staff from Budget and Accounting to develop a comprehensive review of telephony. Telephone units will be matched up to physical phone lines, and cell phones will be reviewed for business necessity.

### **Take-Home Vehicles and Car Allowance Review**

The need for take-home vehicles is being reviewed at this time.

### **Selective Hiring Freeze**

The Deputy City Manager, Human Resources Director and CFO have collaborated already on reviewing a number of requests to post job openings. Already several studies have been launched to see about re-designing tasks to achieve greater efficiency without simply replacing existing staff. In several cases, this review resulted in hiring a lower level staff person.

### **Overtime: Monitor and Control**

The Public Safety Chief and Public Services Director have instituted a review of overtime, and are monitoring data and practices in order to limit the overtime spent. Other departments are being asked to do the same.

## Phase II (if needed)

### **Furloughs: Voluntary and Involuntary**

A Preliminary analysis indicates that if all employees who are paid directly by the General Fund were given an unpaid day off, the savings to the City would save roughly \$100,000. General Fund staff other than sworn Public Safety officers total about \$30,000 - \$35,000 a day. Minimum staffing levels in Public Safety would have to be examined carefully in order to determine furlough parameters within the sworn officer ranks and to avoid creating overtime replacements.

### **Early retirement**

Due to the deteriorated state of the Pension Trust Fund, this is not currently a preferred option for staff reduction. Early Retirement Initiatives are currently planned elements of the City's 2011 Collective Bargaining Agreement process.

### **Outsourcing and Operational Reductions, Program elimination**

These opportunities are being looked at in many areas, particularly as it relates to the reduction plans that are being reviewed by City administration.

### **Future Wage/Benefit Constraints**

In light of the current state of the pension system, as well as issues with revenue sharing and property taxes, a heightened sense of the City's ability to pay to maintain staffing and service levels has been shared between the City administration and collective bargaining leadership. In 2009, the City successfully negotiated economically rational agreements with ATU, AFSCME and KMEA, as well as the KPSOA.

**Short term:** If the outlook for revenue sharing and/or property taxes worsens significantly in the near term, the City would likely approach the bargaining units in an effort to restructure existing agreements as a way to preserve jobs and service levels.

**Long-term:** the condition of the Pension Trust Fund has dramatically improved over the last six months, lessening the immediacy of potential contributions by the City. Nevertheless, through the process of future collective bargaining negotiations, the City will examine the prospect for a change of the current defined benefit pension system for new hires to a defined contribution pension (similar to the change that was negotiated with KMEA to convert new hires to defined contribution health care). This would involve a guaranteed annual expense to fund their retirement investment account, nevertheless such a change would gradually lessen the risk of very high and unpredictable payments into the Pension Trust Fund as described in the Pension write-up earlier in this report.

Furthermore, there is a wage opener in the KMEA and AFSCME contracts for 2011, which provides flexibility should the economic situation significantly change.

# Capital deferment

The City has bonded for over \$4.6 million in capital projects this year (not including the \$1.27 million of road projects being funded by the U.S Recovery Act). While deferring capital improvements is by no means a preferred option, cutting out about \$1 million of projects from that list would save about \$500 thousand in interest payments every 5-7 years.

Due to previously budgeted capital projects that have been released, staff has identified roughly \$2 million of available capital reserves that will be reallocated to priority capital projects.

## Reduction/Restructuring Plans

Reduction plans approximating 5% per department have been submitted by departments to the City Manager. These would represent nearly \$8 million out of the total city-wide budget, and more than \$2.5 million out of the General Fund budget.

The 2009 Budget amendments adopted by City Commission in August 2009 total more than \$250 thousand of savings to the General Fund.

Confidential reviews between the City Manager and Department heads will ensure that the Manager is able to employ the most comprehensive judgment when and if the decision to employ budget cuts becomes necessary.

The City Manager has asked department heads to design cost containment efforts by first identifying alternative methods to reduce cost while preserving services such as collaboration with other departments or organizations, as well as any new concepts that would alter how we do business and substantially reduce cost within an individual department or the entire organization.

It must be stressed that any cuts that are enacted will be sensitized to maintain service levels to the community, so that across-the-board cuts are out of the question. Management will strive to achieve greater efficiencies and change the way we do business in order to keep the focus on delivering high-quality services to the public.

**I wish to thank the dedicated staff in Management Services for their assistance and support in this process, particularly Patsy Moore, Jennifer Clark, Phil Miller, Wade Carlson, Connie Darling and Wayne Nelson.**

**Thomas C. Skrobola**  
**Director of Management Services/CFO**