




INTER-OFFICE MEMO

City Manager's Office

To: Mayor Hopewell, Vice Mayor McKinney, and City Commissioners

From: Kenneth P. Collard, City Manager, ICMA-CM, P.E. 

Date: October 26, 2009

Subject: 2009 Budget Third Quarter Report – Executive Summary

Attached please find the Fiscal Year (FY) 2009 Budget Third Quarter Report. This document was prepared as promised in various discussions that preceded your adoption of the 2009/2010 "status quo" Budget. The City Administration made a commitment when the budget was adopted that we would:

- Not overreact to changing economic data; and
- Fight through the short term budget challenges by making timely and informed decisions; and
- Responsibly address the long term structural, fiscal challenges facing the City.

This Third Quarter Report builds on the foundation laid by the initial quarterly reports and further assures that we are keeping our collective commitments.

The Management Services staff under the leadership of Tom Skrobola prepared this data rich, 40+ page document in a continuing effort to identify, quantify and effectively monitor a broad spectrum of dynamic factors affecting the current economic circumstance, establish a broad baseline of information and subsequently begin to track patterns that develop relative to key parameters affecting the City's evolving fiscal condition.

The report's data includes Consumer Indicators, Economic Indicators, Budget Highlights, Pension Funding, City Revenues and Expenditures, and Management Controls. As we track the data over time, we will be able to draw firmer conclusions about probable trends and offer projections for City revenues and expenditures to assure that we maintain balanced budgets and address long term, fiscal problems consistent with the goals of the Five-Year Fiscal Plan.

The following comments trace the evolution of the City's recent fiscal circumstances, our understanding of the same and recommendations towards moving forward.

PERSPECTIVE AT BUDGET DEVELOPMENT

During the 3rd quarter of 2008, as we anticipated the development of the 2009 Proposed Budget, the US and most particularly the Michigan economy continued to show signs of chronic deterioration. The stock markets continued their slide and the Big 3 automakers struggled to maintain profitability and market share. The seemingly solid, validated projections that undergirded the Five-Year Fiscal Plan and formed the basis for earlier budgets started to come into question on a limited basis particularly relative to State Shared Revenues and capital investments. At the same time, we remained committed to continued efforts to develop a retiree healthcare fund to address accrued liabilities, reduce healthcare obligations through collective bargaining and fully implement the Five-Year Fiscal Plan. We slowly realized that we had to abandon the five-year fiscal horizon as the foundation for the upcoming 2009-2010 budget preparation.

After seemingly exhaustive review, the administration asked the City Commission to consider adoption of a two-year status quo budget with a clear understanding that revenues would be reviewed quarterly and formal budget amendments; if required, would be adopted at mid-year. Our request for a two year, status quo budget emanated from the conclusion that due to “the uncertain and unprecedented nature of the current economic environment” we did not have adequate knowledge to forecast reasonably accurate annualized revenues. This was readily acknowledged as a dramatic departure from the fiscal planning model that had served us well in recent budgeting exercises.

PERSPECTIVE AT BUDGET ADOPTION

As the proposed budget was being tendered for City Commission consideration, the national financial markets systematically collapsed, the level of fiscal uncertainty escalated dramatically and consumer confidence plunged. Locally, parameters that control property tax revenues declined precipitously, substantial losses began to accrue in the Pension Fund, and unemployment accelerated. As the 2009-2010 budget was adopted, our perspective was that 2010 would be a period of severe budgetary stress with revenues possibly declining 10% or more.

The adopted budget’s goal, as noted in the Transmittal Letter was “maintaining priority services during a period of growing need and high economic uncertainty, while maintaining effective stewardship of our financial and human resources.” We called for an approach that “would maintain a 360 degree perspective, grounded in reality and inspired by the desire of our elected and appointed leadership to **fulfill the common good.**”

OUTCOMES FROM THE 1ST HALF OF 2009 “STATUS QUO” BUDGET MANAGEMENT PROCESS

In the 1st half of 2009, the administration has enhanced its understanding of the evolving economic recession and the prospects for recovery. In addition, we have pragmatically and prudently:

- Exercised additional Management Controls over the activities listed below and identified more than \$550,000 of 2009 Budget savings:
 - Travel and Conferences
 - Telephones
 - Vacancies
 - Overtime
 - Collective Bargaining
 - Contractual Services

- Closely monitored the 2009/2010 Budgets and identified:
 - Expenditure relief relative to Energy/Fuel of \$650,000 and relative to Debt Financing of \$175,000;
 - Projected Revenue shortfall for Interest Earnings of \$250,000;
 - Identified the potential for realizing “savings” but limiting traditional “carry forward” funding;

- Reviewed Reserve Funds:
 - Identified unencumbered reserves in the Internal Insurance Fund of approximately \$4 million,
 - Initiated an analysis to determine the appropriate fund balance for the Internal Insurance Fund.

- Developed contingency plans for each Department to address the possibility of a 5% Revenue loss.
 - These plans represent reductions of programs and services necessary to balance budgets and modify operations after a loss of \$8 million.

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Relative to an incremental budgeting perspective, the 2010 General Fund Budget is “manageable.” That means that we foresee no set of circumstances that would require budgetary reductions in excess of 5% to achieve the goals identified in the Five-Year Fiscal at the end of 2010.

CURRENT PERSPECTIVE

Approximately 11 months through the 2009 budget year, we continue on our learning curve noting our shortcomings as we pause to celebrate our enhanced understanding and accomplishments. As a result of these earlier efforts, we are more confident in making recommendations to address short term budget challenges as we continue to prosecute our long term strategy.

As to understanding, we now know that:

- The Federal government is pumping trillions of dollars into the economies of both Wall Street and Main Street;
- Barack Obama is our president and leads an administration trying to stabilize the economy and “fix” the health care system;
- GM and Chrysler have endured bankruptcy and emerged as new, hopefully more viable corporations with fractionalized ownership;
- The financial markets have failed and are being drastically restructured and re-regulated;
- Huge quantities of wealth created in the housing market and the stock markets have vanished;
- Jobs have hemorrhaged from the economy in numbers not seen since the great depression;
- Consumer’s confidence has plunged to historical depths.

Locally, we know that

- Kalamazoo is faring better than most other communities in this troubled economy;
- Unemployment, although significantly better than most markets in Michigan, remains at a historical high level of 12%;
- Precipitous declines in residential property taxes fortunately have not been experienced;
- Potentially precipitous declines in commercial property taxes loom;
- Legacy costs, including pensions, retiree healthcare obligations and infrastructure obligations need careful monitoring and prudent management;
- Legacy cost projected contribution have moderated markedly with the recover of the stock market;
- Major revenue reductions in State Shared Revenue, Act 51 and interest income are totaling more than \$3 million are expected in 2010;
- Identified budgetary savings and enhanced administrative control of expenditures have managed the 2009 budgets successfully;
- However, after implementing recurring budgetary savings, indentifying substantial additional savings and potential cost avoidance opportunities, prudent contributions toward accruing legacy cost liabilities and declining revenue projections make 2010 a problematic budgetary timeframe.

The emerging realities for 2010 and beyond especially in regard to revenues draws us quickly back to the need for fiscal planning. In essence, we're intellectually evolving away from the budgetary crisis model which we used in the initial stages of managing the recessionary issues while we continue to generate pragmatic, real time analyses to "fight" through the shorter term issues associated with the 2009 and now the 2010 budgets. We're evolving to a position where macro reviews of legacy assets and core service obligations juxtaposed with available resources demand our attention and best thinking to develop a strategy that will rebalance current investments and future demands.

PLAN OF ACTION – PENSION FUND LEGACY COST

We will need to identify and select viable options to limit the potential for large pension fund contributions in order to minimize the impact on operating budgets. A thorough, review and evaluation of cost reduction possibilities is continuing and will include but not be limited to:

- Closing of the defined benefit pension plan and conversion to a defined contribution plan,
- Increasing employee contributions to the pension fund,
- Decreasing the pension benefits for future employees,
- Decreasing the pension benefits for existing employees relative to future years of service,
- Reduce or eliminate other post-employment benefits to offset the increased pension costs and
- Increase the minimum retirement age.

Long term legacy costs for the pension system are particularly challenging. Even with an assumed rate of return on investments of 7.5% will be insufficient to preclude multi-million dollar contributions to the fund beginning in 2017. Currently, the resources that may need to be diverted to satisfy legacy costs support service delivery activities.

GENERAL CONCLUSIONS

The eventual scope, magnitude and timing of the fiscal challenges addressed in future budgets will be determined by the "shape" and timing of the recovery as well as decisions made in Lansing relative to state shared revenues and Washington, D.C. relative to universal healthcare and additional stimulus initiatives. The city administration will continue to monitor the developments in these areas and recommend appropriate actions to address the "real" budgetary and fiscal challenges as they emerge and/or morph.

In reviewing the totality of circumstances surrounding the recession, its impact on our fiscal circumstances and conditions within our community, I am seriously troubled by the steady accrual of “bad” fiscal news over the last 120 days. The rapid and continuing deterioration of the state’s fiscal condition, the erosion in local commercial property values, the almost unprecedented unemployment and the concurrent plunge in consumer confidence and the limited response of the national and especially state economy to the American Reinvestment and Recovery Act (ARRA) funding transfusion have left me with a conclusion, based on straight line projections, that we can only achieve the goals of our fiscal plan over its five year horizon by reducing expenditures by 5% in 2010 and an additional 5-10% over the balance of the plan’s life. In my estimation, the most likely scenario is that the city’s budgets will have “shrunk” by 15-20% from the onset of the recession to its inevitable conclusion.

On the upside, I believe that the state and federal governments “energized” by an appropriate public mandate to assure public safety and preserve our public infrastructural will address the structural realities that constrain our local budgets and in the process we may recover more than half of that shrinkage. If the state and federal governments fail to address the structural constraints in the near term, I believe that municipalities in Michigan must secure authorization to generate voter approved, local revenues to provide adequate funding for core services and reliable infrastructure.

IMMEDIATE ACTION STEPS

As identified in our budget commitments, “short term budget challenges” are best met by “making timely and informed decisions” and it is our collective responsibility to “address the long term structural, fiscal challenges facing the City.” In order to meet those commitments, I recommended in early August that:

1. The budget reductions identified to date be accepted and integrated into the 2009 and 2010 budgets by action of the City Commission.
2. The City Commission direct the administration to identify viable budget reduction alternatives during the 3rd quarter of 2009 that:
 - a. Reduce General Fund operating budgets by \$2M relative to the adopted 2009 budget, and
 - b. Reduce General Fund non-departmental expenditures, transfers and initiatives by \$1.5M relative to the adopted 2009 budget.
 - c. Reduce reserve funds where appropriate.
3. The City Commission consider approving the alternatives identified in 2a and 2b above during the 3rd quarter review process.
4. The City Commission direct the administration to begin identifying and analyzing options for offsetting investment losses in the pension fund.
5. The City Commission and the administration utilize appropriate means to seek public participation in establishing priorities for both the fiscal plan and the 2010 budget.

The administration has developed specific budget balancing proposals relative to items 2a, b and c, consistent with your direction. Those proposals and the description of the projected financial conditions which give context to them will be presented at the City Commission meeting on October 26, 2009 for your consideration, action and additional direction.

The actions anticipated above and the dialogues that develop around them will best position us to keep our collective commitments and assure that an appropriate balance is struck between the strategic focus areas (i.e. Economic Vitality, Neighborhood Development, Responsible and Responsive Government, Environmental Stewardship, Community Building, and Fiscal Stewardship) and the available resources.

In closing, I would like once again thank you as the City Commission, as individual, elected City Commissioners and as competent, trustworthy and very caring human beings “for providing the leadership, direction and support which steer the development of the budget, and for your support of philosophies and strategies that are central to how our City government functions” in these uncertain times and “are vital to the future of our City.” Thank you and may we be granted the wisdom and energy to continue to do good things on behalf of all of our community.