



Office of the City Auditor

## INFORMATION CALENDAR

July 8, 2014

To: Honorable Mayor and Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: Tough Budget Decisions Four Years Later: Building Analytical Capacity for Wiser Decision Making

### SUMMARY

In the three years since issuance of our audit [Employee Benefits: Tough Decisions Ahead](#)<sup>1</sup> changes at the State level have affected future liabilities for local governments. Berkeley, like most California cities, will soon be paying more pension costs up front. The good news is that increased annual payments to CalPERS, the statewide pension plan, will bring annual pension payouts closer to true annual pension costs, steadily decreasing unfunded liabilities. The bad news is that cities will be reducing services and public facilities, reducing compensation, and sometimes taking inappropriate risks in order to balance their budgets for many years to come. This “new normal” will challenge us to take a very long-term view of how to budget to wisely protect and effectively use our declining resources.

Berkeley has the opportunity to develop a more long-term perspective and strategies for the sustainability of our programs, services, and our physical and fiscal infrastructure. Some of the mistakes California cities made in the past were due to short-term thinking. Council can move in the right direction by enhancing the organization’s analytical capacity, people and systems, and by consistently asking tough questions about how today’s decisions will affect future generations.

### CURRENT SITUATION AND ITS EFFECTS

Unfunded pension liabilities and underfunded infrastructure needs are putting increasing pressure on California city budgets, including Berkeley’s. Forecasting and budgeting practices that managed temporary shortfalls in the past must be modified to deal with the projected steady increase in expenses and volatility of expenses and revenues.

**Pensions:** Between Fiscal Year 2016 and Fiscal Year 2017, the Budget Office estimates that the City’s pension costs will increase by \$4 million, and will to continue to increase annually after that. Only four years of projected costs are currently available. We know that the annual cash outflows for pension costs will continue to increase

<sup>1</sup> [http://www.cityofberkeley.info/uploadedFiles/Auditor/Level\\_3\\_-\\_General/2010-11-16\\_Item\\_13\\_Employee\\_Benefits\\_Tough\\_Decisions\\_Ahead-Auditor\(1\).pdf](http://www.cityofberkeley.info/uploadedFiles/Auditor/Level_3_-_General/2010-11-16_Item_13_Employee_Benefits_Tough_Decisions_Ahead-Auditor(1).pdf)

because of recent policy changes by California's Public Employee Retirement System (CalPERS).

**Infrastructure - Buildings, Parks, Facilities and Streets:** Over \$500 million in unfunded needs for repair and restoration of the City's physical assets were identified in [reports](#) Council requested in 2011<sup>2</sup>. Voters provided funding to address unfunded street repair needs and some stormwater infrastructure needs in 2012, following recommendations from our audit report [Failing Streets: Time to Change Direction to Achieve Sustainability](#).<sup>3</sup> Over the last few months, Council has been grappling with infrastructure needs, including consideration of a 2014 ballot measure for Parks, Recreation, and Waterfront.

**Infrastructure – Fiscal Technology:** Over \$7 million is needed to replace the City's 20-year-old core enterprise software, known as FUND\$. The City Manager identified only \$2 million in available funding in a [FUND\\$ Status Report](#) to Council on March 25.<sup>4</sup> An annual set-aside of \$500,000 has been prudently proposed. However, replacing the payroll system alone was estimated at well over a million dollars. Identifying and allocating the necessary staff with the required expertise to thoroughly analyze the City's needs may be an even more serious a challenge. Why? A shortage of the right people with the right skills to do the job.

**Analytical Capacity:** Budgetary pressures will likely reduce the City's analytical capacity, meaning both computer systems and human capital. Delays in replacing FUND\$ and improving City systems deprive the City of valuable tools needed to make the best decisions. If budget cuts continue, and as long as the City continues to use modified "across the board" cuts, fewer staff will be available for redesigning our systems and for doing the analytical work needed for decision making.

**Tough and Tougher Choices:** The available options for addressing unfunded needs are limited:

- 1) Reduce direct services (by cutting the number of employees and programs and by closing public facilities)
- 2) Reduce employee total compensation (salaries and benefits)

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<sup>2</sup> [http://www.cityofberkeley.info/uploadedFiles/Clerk/Level\\_3\\_-\\_City\\_Council/2012/02Feb/2012-02-28\\_Item\\_31\\_Discussion\\_and\\_Direction\\_Regarding.pdf](http://www.cityofberkeley.info/uploadedFiles/Clerk/Level_3_-_City_Council/2012/02Feb/2012-02-28_Item_31_Discussion_and_Direction_Regarding.pdf)

<sup>3</sup> [http://www.cityofberkeley.info/uploadedFiles/Auditor/Level\\_3\\_-\\_General/Streets%20Audit%20Report\\_Final\(2\).pdf](http://www.cityofberkeley.info/uploadedFiles/Auditor/Level_3_-_General/Streets%20Audit%20Report_Final(2).pdf)

<sup>4</sup> [http://www.cityofberkeley.info/Clerk/City\\_Council/2014/03\\_Mar/Documents/2014-03-25\\_Item\\_34\\_FUND\\$\\_Status\\_Report.aspx](http://www.cityofberkeley.info/Clerk/City_Council/2014/03_Mar/Documents/2014-03-25_Item_34_FUND$_Status_Report.aspx)

3) Reduce support, oversight, and compliance services which, in the long run, will drive up costs and reduce direct services.

No matter where you live, the public generally does not advocate reducing any services. Public pressure to sustain and expand direct services is the primary culprit for inappropriate reductions to indirect services. Some members of the community advocate balancing the budget by reducing employee compensation, which can only be done at the bargaining table. In addition to the human cost, and other unintended consequences, this solution could also reduce analytical capacity, making it difficult to hire and retain employees such as computer analysts and other knowledge workers such as management analysts, accountants and, yes, the auditors.

Studies comparing wages in private sector and in public sector have often found that total compensation is fairly similar between the sectors. The difference is that wages are lower and benefits higher in public sector, but cost and compensation have recently become volatile. Statewide changes have reduced pension benefits for new employees and local changes have affected the salaries of current employees, which may impact the competitiveness of Berkeley's compensation packages in the near future. To address risks to our support and oversight functions and our analytical capacity, the City will need to find a way to respond timely to changing labor markets, particularly given the lack of affordable housing in Berkeley and nearby.

#### BACKGROUND

**Pension Liabilities:** In California, a retroactive expansion of benefits in the late 1990s and the more recent stock market downturn combined to make pension costs unsustainable. Demographic changes, chiefly the rise in life expectancy, also contributed to the high costs.

Since the issuance of our 2010 audit, State law has reversed that expansion of benefits, so that pension costs for new employees will be more manageable. It will take many years for the benefits of that change to be fully realized. CalPERS has adopted more fiscally prudent policies, to help governments reduce their future liabilities. The short term result is that annual cash payouts for pensions will be significantly increased over the foreseeable future, though the long term benefit is that liabilities will continue to decline. Actuarial changes have less significant impact, but the impact is negative for both the short and long term. Recognizing that people are now living longer contributes to the increased current cost, and also increases the future liabilities.

**Insolvent local governments:** Given the pressures of the benefits and other liabilities and the economic downturn, the public and the press have continued to express concern about whether more cities will be heading towards insolvency. A recent report by the Center for State & Local Government "Are City Fiscal Woes Widespread? Are pensions the cause?" concludes that generally, pensions played a role but were not the most significant pressure facing the insolvent localities studied. Berkeley does not have

some of the problems identified for these cities (such as population decline and very high foreclosure and unemployment rates), but does need to address pension and infrastructure funding. This will take analytical strength and long-term thinking.

As a university town, Berkeley is fortunate in having a less volatile economy, but we also have significant constraints preventing us from “growing our way” out of trouble by attracting more tax-generating businesses and residents. Like all California cities, we also have constraints on raising taxes and fees because of Proposition 13. The report mentions Proposition 13, along with the retroactive pension changes and the recession, as key pressures for California cities.

### **What suggestions have been made for improving budget reduction systems?**

Most cities have used modified “across the board” budget cuts to deal with budget problems that they believe are short term.

The question of how across the board budgets cuts impact analytical capacity was addressed in a 2012 Council concurrence with our [recommendations](#) to disclose and scrutinize impacts of proposed reductions:

- Are we increasing the risk of fraud by making this budget cut?
- Does this budget cut impact our ability to provide oversight of grants, community agencies, vendors, and staff performance?<sup>5</sup>
- Will this budget cut hamper our ability to provide the best and most timely information needed for decision-making?

Implementing this recommendation would help manage the risks and increase the transparency of long term budget reductions that are expected to begin in Fiscal Year 2016.

**Performance Based Budgeting:** The risks and pitfalls of long term budget reductions were further developed in a [report](#)<sup>6</sup> from Cal Goldman Masters of Public Policy candidates, completed at the City Auditor’s request and shared with Council on April 1, 2014. The students suggested that current budget systems can work well for small or occasional cuts, but are ill equipped to address major structural changes. They suggested moving forward using a model called priority based budgeting.

Council asked the Department of Health, Housing and Community Services (DHHCS) to incorporate elements of priority based budgeting in their plan to effectively address

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<sup>5</sup> [http://www.ci.berkeley.ca.us/uploadedFiles/Auditor/Level\\_3\\_-\\_General/A.3.a\\_Info%20Item\\_and\\_Annual%20Report%20for%20Discussion\\_2012%20Final.pdf](http://www.ci.berkeley.ca.us/uploadedFiles/Auditor/Level_3_-_General/A.3.a_Info%20Item_and_Annual%20Report%20for%20Discussion_2012%20Final.pdf)

<sup>6</sup> [http://www.cityofberkeley.info/Clerk/City\\_Council/2014/04\\_Apr/Documents/2014-04-01\\_Item\\_28\\_Berkeley\\_Based\\_Budgeting.aspx](http://www.cityofberkeley.info/Clerk/City_Council/2014/04_Apr/Documents/2014-04-01_Item_28_Berkeley_Based_Budgeting.aspx)

health inequities identified in Berkeley's Health Status Report 2013. A June 10 report to Council, [Public Health Priorities and Budgeting](#),<sup>7</sup> describes work to date. .

#### ENVIRONMENTAL SUSTAINABILITY

To move forward with Berkeley's Climate Action goals and Zero Waste by 2020 goals, improved analytical capacity is needed.

#### POSSIBLE FUTURE ACTION

Berkeley has taken some steps to develop a more long-term perspective and strategies for sustainability of our programs, services, and our physical and fiscal infrastructure. The City needs to increase these efforts. Some of the mistakes California cities made in the past were due to short-term thinking. Council can move in the right direction by enhancing the organization's analytical capacity, people and systems, and by consistently asking tough questions about how today's decisions will affect future generations

There may be ways to strengthen elements of priority based budgeting in the community agency allocation process, and in other areas of the 2016-2017 budget. Council could give direction to the City Manager about balancing the need for analytical capacity and support and oversight services with the community's competing priorities for direct services. The City Manager could include disclosure of the answers to these questions for each proposed reduction in the 2016-2017 budget:

- Are we increasing the risk of fraud by making this budget cut?
- Does this budget cut impact our ability to provide oversight of grants, community agencies, vendors, and staff performance?<sup>8</sup>
- Will this budget cut hamper our ability to provide the best and most timely information needed for decision-making?

#### FISCAL IMPACTS OF POSSIBLE FUTURE ACTION

Providing more disclosure of budget impacts would be less resource-intensive than embarking on citywide priority based budgeting, but would still require significant staff time. Moving to priority based budgeting would require very significant staff resources, and commitment from a unified community and a collaborative City Council to undertake a public priority-setting process.

#### CONTACT PERSON

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<sup>7</sup> [http://www.cityofberkeley.info/Clerk/City\\_Council/2014/06\\_Jun/Documents/2014-06-10\\_Item\\_54\\_Public\\_Health\\_Priorities.aspx](http://www.cityofberkeley.info/Clerk/City_Council/2014/06_Jun/Documents/2014-06-10_Item_54_Public_Health_Priorities.aspx)

<sup>8</sup> [http://www.ci.berkeley.ca.us/uploadedFiles/Auditor/Level\\_3\\_-\\_General/A.3.a\\_Info%20Item\\_and\\_Annual%20Report%20for%20Discussion\\_2012%20Final.pdf](http://www.ci.berkeley.ca.us/uploadedFiles/Auditor/Level_3_-_General/A.3.a_Info%20Item_and_Annual%20Report%20for%20Discussion_2012%20Final.pdf)

