EDITOR'S NOTE: The following report was prepared by the City Manager Richard C. Wilson of Santa Cruz to accompany his proposed budget for 2005-6. His report includes a historical perspective. The Sentinel is reprinting main segments of the report, picking up with his report on what happened to California finances with collapse of the tax-rich, high-tech economy.

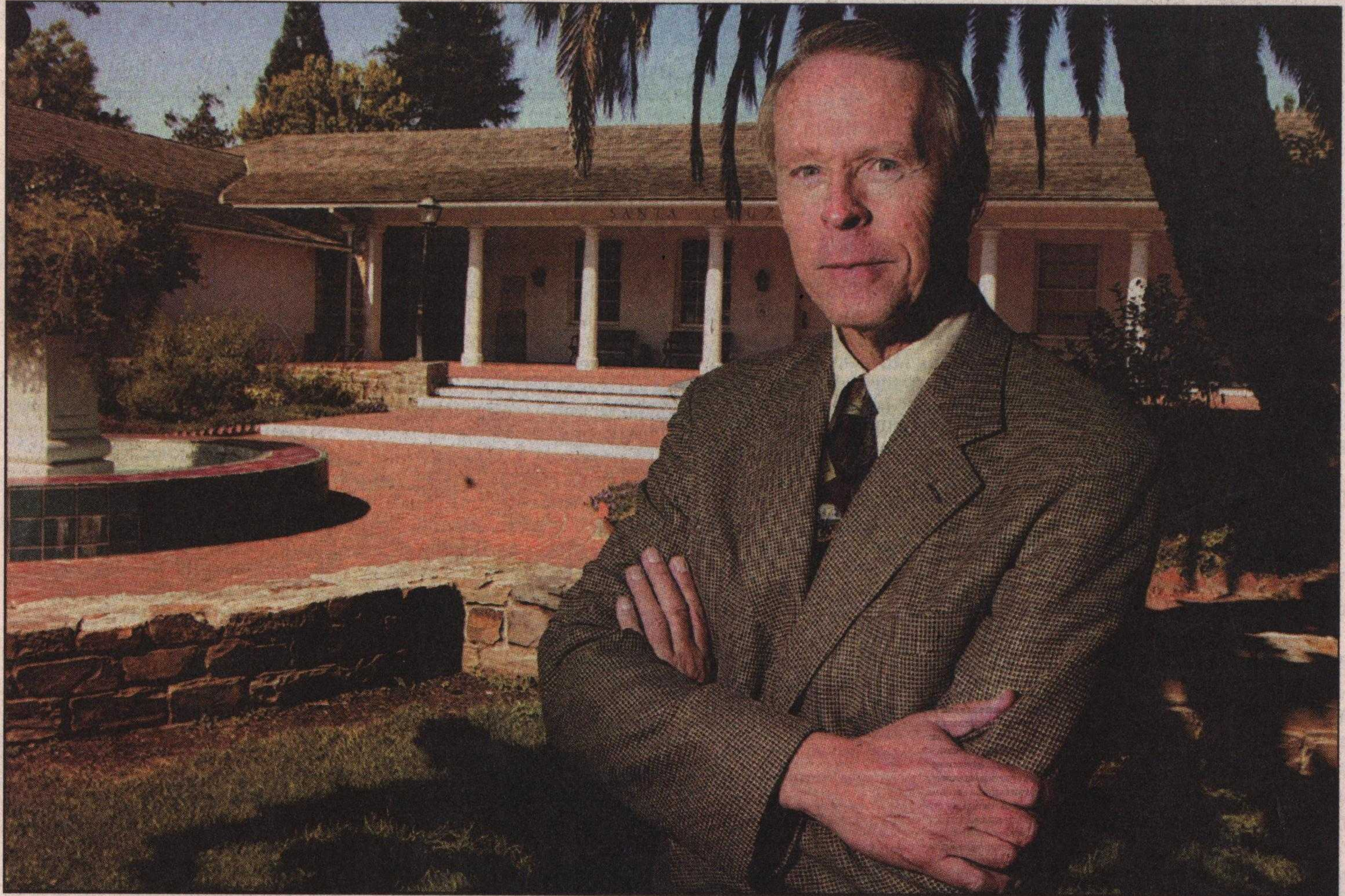
By **RICHARD C. WILSON**

In 2001, the boom collapsed. Tax receipts dwindled, and the expenditure obligations incurred during the boom years continued to grow. The state, once again, transferred billions from local government to itself, repeating what it had done in 1992 and 1993. Local governments, faced with soaring costs and declining revenues, cut their budgets, often severely.

Many local governments asked their voters to approve tax increases to avoid even worse cuts. In 2004, Santa Cruz city voters approved Measure F, a five-year, quarter-cent sales tax. California's cities, counties, special districts and redevelopment agencies launched a full-scale assault on the state with a ballot measure (1A) that would constitutionally protect local government revenues and end the state's ability to make up for its own shortfalls by taking local government's money.

Fortunately for local government, the measure won.

Looking ahead



Bill Lovejoy/Sentinel file

City Manager Richard Wilson, shown in front of City Hall in Santa Cruz, says the gap between city revenue and spending is ever-widening.

A deep look at the

sales taxes, property taxes and utility taxes.

The long-term outlook for sales taxes is anything but positive, as the service sector of the economy continues to grow at a faster rate than sales of taxable merchandise. Moreover, it is hard to imagine that the city would accept the kind of economic activity that would be required to produce a substantial increase in sales-tax revenues, given that it takes $100 million in sales to produce $1 million in tax receipts for the city. Nor can the city take its existing sales-tax base for granted, because the city is disproportionately dependent on a small number of large sales-tax producers. Assuming that none of the city's large producers leave or falter, the most plausible future of the sales tax for the city of Santa Cruz is that it will grow at something like the rate of inflation, give or take a little.

Ever-increasing property values have rendered property-tax revenues one of the few bright spots for the city. Property taxes have risen by more than the rate of inflation during the past few years of booming real estate, but only modestly more. Even if property taxes continue to be the strongest sector of the tax base, there is no prospect that they could fill the huge gap between the current tax base and future expenditures.

The last of the big three taxes is the utility tax. This tax has proven to be, by far, the most volatile of the three main taxes that fund the city. We hope that, if California's economic recovery continues and Northern California's economy strengthens, we will see additional utility ment, the measure won.

A deep look at the city's budget crisis

Looking ahead

The boom of the 1990s and the recession that followed are now over, and a slow-growth economy, which is reminiscent of the 1980s, has re-emerged. The gap between what taxes produce and what the city must spend to maintain its historic level of services is bigger than it has ever been. Worse, that gap will grow in the years ahead. There is no plausible scenario under which the city's tax revenues would increase at a pace sufficient to meet its expenditure obligations.

As if the financial situation described above isn't challenging enough, the city will also suffer the loss of a major source of revenue as a result of adverse court decisions regarding Proposition 218.

That source is what has long been called "franchise fee in-lieu" payments from the water, sewer and refuse enterprises to the General Fund. The total amount of those payments in the fiscal year that will begin July 1, 2005, would have been $2.9 million. These payments have been made, as far as we can tell, since the 1960s.

Despite the longstanding nature of this practice, in Santa Cruz and in other cities that operate their own utilities, the courts have ruled, first in a Roseville case and now in a Fresno case, which for all practical purposes settles the matter, that Proposition 218 renders the practice impermissible. For that reason, no revenues from this source are included in the proposed Fiscal Year 2006 Budget.

A radical reduction in services will be required unless the City Council asks the voters to approve, and the voters do approve, a "franchise tax" that would continue the historic practice.

Budget

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Also, we dare not forget that the city is relying on $2.2 million in annual sales-tax revenues from Measure F, which will expire in June 2009. Unless the quarter-cent sales tax established by Measure F is extended or made permanent, an additional set of radical cuts will be required in 2009.

What options does the city have? Peter Drucker, probably the most famous and revered of management consultants, has long advised that the most fundamental management decisions involve providing or not providing given functions.

For example, a hospital must decide whether or not it will provide obstetrics services. If so, it will incur all the costs of providing those services, and will pay what it must to doctors, nurses and staff, as well as for facilities, equipment and associated costs; if not, it will incur none of these costs. There is not nearly as much maneuvering room to adjust the costs of a function, Drucker advises, as management is often prone to think. In other words, modest budget problems can be addressed by cost-cutting across an organization, but large budget problems require a more fundamental assessment of the number and cost of functions the institution performs.

In the case of Santa Cruz, we have spent the last four years cutting 70 positions from the workforce and trimming nearly every function. While we must always work at becoming more cost effective on an across-the-board basis, the benefits of continuing to do so will be modest at best. It is no longer possible to cut millions of dollars from the city's budget by cutting a little bit here and a little bit there.

Cost increases in two areas will be particularly difficult.

The first is workers' compensation.

The cost of workers' compensation benefits reflects the schedule of benefits established by the state, and the increasing cost of health care. A recently completed actuarial study estimated that the city is in arrears by $6.4 million in its workers' compensation fund. The General Fund share of this obligation is $4.5 million. Nor does it appear that the future cost of workers' compensation will moderate. It is no wonder that the subject of workers' compensation has been a statewide political issue, and will remain one.

The cost of excess workers' compensation insurance illustrates the magnitude of this problem.

The city insures against individual losses above a given threshold. In 1999, that threshold was $250,000. The threshold is now $500,000 for an individual loss. The cost of this coverage has risen tenfold since 1999.

The second area is the increasing cost of health care benefits. This is a national problem.

Employers now create jobs with health care benefits only as a last resort, due to the high and rapidly rising cost of these benefits. Employers that pay the full cost of health care benefits for their employees and their employees' families are becoming an endangered species. The city of Santa Cruz is currently paying the cost of health care benefits with funds that became available on a one-time basis. The long-term historic cost of health insurance over the decades has been about 5 percent of payroll; it is now 10 percent of payroll and growing. These cost increases are not the result of improved or expanded health coverage or benefits, as these benefits have not changed.

There is a third critical problem, and that is the cost of retirement benefits. Because the lion's share of the increase in pension costs is already reflected in the proposed budget and because future increases are largely known, more detailed discussion is not offered here. That does not change the fact that pension costs will be a major burden for the public sector in California for at least a generation.

Why won't the city's tax base grow to cover these costs? Consider the revenue side of the equation. Eighty percent of the city's General Fund tax revenues come from three sources:

if California's economic recovery continues and Northern California's economy strengthens, we will see additional utility taxes from the industrial and commercial sectors. Even if that happens, however, utility taxes are not about to close the city's budget gap.

Even if the city's tax receipts surprise us and do better in the years ahead than they have done in the past, they will come nowhere close to offsetting increased costs such as those discussed above, because local government remains a labor-intensive sector. In some areas, such as refuse collection and sewer treatment plant operation, improved technologies have enabled cities to cut costs and function with fewer employees. Most city functions, however, remain labor intensive.

Seventy percent of the city's budget goes to salaries and benefits, and this is unlikely to change very much. This means that no other expenditures are remotely as consequential as salaries and benefits.

It is easy to say that the city should cut its non-personnel costs and redirect the money to salary and benefit increases. The 30 percent of the budget that is not salaries and benefits consists of a multitude of relatively small but still essential expenditures, from utility bills to vehicles and equipment to the few capital expenses that remain in the budget. We have a responsibility to manage these costs as well as we can. We have achieved many successes on this side of the budget, and there is more to be done. It is not pos-

See BUDGET on PAGE F4

Budget

Continued from Page F1

sible to create any meaningful room to increase salary and benefit costs by cutting the 30 percent of the budget that is not salaries and benefits.

The city ought to be increasing, not decreasing, the share of the budget that is not salaries and benefits, because current spending is wholly inadequate to preserve the plant, equipment and property the city owns.

Unless city employee salaries decrease every year to offset the amount by which increases in the costs of workers' compensation, health care and pensions exceed the rate of inflation, the city's expenditures will rise by more than the city can afford. The city will then do what every employer does, and must do, under these circumstances: it will reduce the number of employees.

The adopted Fiscal Year 2005 Budget provided 70 fewer full-time positions than the 2001 budget. If the voters agree to replace the city's "franchise fees" with a "franchise tax," the Fiscal Year 2006 Budget will in the end eliminate 10 to 20 more positions. If the "franchise tax" is not approved, we will need to cut the equivalent of about 50 positions. This is merely this year's version of what will be a continuing struggle to adapt the city's expenditures, which are guaranteed to increase by more than the rate of inflation, to the city's tax receipts, which are unlikely to do so.

There are three possible long-term solutions.

First, if we want to maintain the existing level of city services and also maintain the existing level of taxable economic activity in the city, we could develop a long-term strategy of tax increases to make up the difference between what the existing tax base will generate and what desired public-sector services will cost.

Second, we could dramatically reduce our expectations for city and other public-sector services, and spend only what the existing tax base yields.

Third, we could increase the size and vitality of the tax-producing economy. These are not mutually exclusive approaches; combinations could be chosen.

We must acknowledge that we are not amenable to the types of projects that would produce significant benefit in terms of tax revenues to the city. It seems unlikely that future economic development will provide much help in terms of the city government's financial situation.

Indeed, future development is far more likely to increase demands for services, from higher-density residential development, than to pay for services.

The city is about to begin its next General Plan. We are accustomed to thinking of general plans in terms of the land uses they provide for and the environment those uses create. Every city's land-use policies also determine its economic future. The next General Plan will serve the city poorly if it sets forth lofty goals about public services and the quality of life in Santa Cruz but says nothing about how to pay for these things.

We do not have a short-term budget problem that is going to go away. We have a fundamental mismatch between the city's tax base and the cost of public goods and services. It is not a new mismatch; it has been in place for a long time. It is now bigger than ever.

The financial challenges of the future are daunting. They have never loomed so large.

Nevertheless, the city of Santa Cruz is not an airline or a car company that could go out of business. Whatever financial problems the city may face, the city is here to stay. The city institution will continue to do the best it can with the resources available to it.

The City Council has worked diligently and conscientiously in recent years to adapt to ever-increasing financial duress. The council has taken many actions it did not wish to take, and done so with good will and with an underlying sense of optimism for the future. On behalf of the city's employees, I express my thanks to the mayor and to the members of the City Council.