TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER

DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: MAY 6, 2008

CMR: 229:08

SUBJECT: DIFFERENCES BETWEEN THE CITY OF PALO ALTO AND CITY OF VALLEJO BUDGETS

RECOMMENDATION

This is an information report and no Finance Committee action is requested.

BACKGROUND

During a Finance Committee meeting in February 2008, the Committee asked staff for information comparing the budgets and financial conditions of the cities of Palo Alto and Vallejo, in light of Vallejo’s recently publicized fiscal problems. On February 21, 2008, the San Francisco Chronicle stated that, “Vallejo is on the brink of a dubious distinction – becoming the first City in California to declare bankruptcy. The fiscal crisis, which comes more than three years after the state took over the city’s debt-ridden public schools, is a result of snowballing police and firefighter salaries and overtime expenses coupled with plummeting tax revenue from the weak housing market, officials say.” (Source: www.sfgate.com, February 21, 2008 article by Carolyn Jones).

Although Vallejo’s dire fiscal circumstances abruptly flashed across various news media this year, underlying structural and financial issues had been emerging for some time. The recent housing and credit crisis, which has severely affected Vallejo’s revenue stream, has exacerbated those issues. As the Vallejo City Manager stated in his 2007-08 budget transmittal letter: “…for over a decade the City has wrestled with severe financial difficulties. Year after year we have asked the employees for give-backs, used one-time monies, or reduced services. This year the situation was even worse.”

From these unfortunate circumstances, cities may glean information to prevent or mitigate similar occurrences.
DISCUSSION
Staff has reviewed Vallejo’s budget documents, Comprehensive Annual Financial Reports, and other publicly available sources such as newspaper articles, to analyze events and trends causing Vallejo’s General Fund (GF) financial dilemma. Unfortunately, and undoubtedly due to the gravity of its financial situation, calls to Vallejo staff for additional and more helpful, detailed information were not returned. This has resulted in a generally high level comparison with a number of inferences from available information.

Economic Base and Revenue Issues
A number of factors have caused Vallejo’s economic base to erode. These include:
- The closure of the Mare Island Naval base in 1996 which provided well-paying jobs and a vital economic foundation.
- The inability of Vallejo to replace the economic benefits of the shipyard with other commercial or industrial tax generators such as malls or technology companies.
- The City’s predominant focus on residential development which has performed poorly due to current economic events in the real estate market.
- The failure to keep big-box stores like Wal-Mart or high end supermarkets with the consequent result of sales tax leakage to surrounding jurisdictions.
- Recent plans to integrate the downtown and waterfront with a mixture of restaurants, offices, and condominiums forestalled because of the credit crisis.

In addition, other economic conditions have contributed to a decrease in GF revenue sources, including:

- The property transfer tax declined from a peak of $5.5 million in 2004-05 to an estimated $3.7 million in 2007-08, a $1.8 million or 33 percent decline. This is a consequence of the slumping housing and commercial real estate market.
- A significant decrease in building, planning and other permit fees from $5.2 million in 2004-05 to an estimated $2.7 million in 2007-08, a $2.5 million or 48 percent decline.
- Sales tax revenues have declined slightly since 2005-06.
- Property taxes have remained relatively flat since 2005-06
- Other revenue source declines from 2005-06 through 2007-08 such as Marine World receipts and transfers which total $3.7 million.

These revenue drops represent $8 million or nearly 10 percent of Vallejo’s sources of funds.
Expense Issues
On the expense side, particularly in the area of salaries and benefits, Vallejo has experienced considerable pressure:

- Salaries and benefits have comprised approximately 78 percent of Vallejo’s total GF expenses since 2003-04 until its recent efforts to reduce staffing.
- Total GF salary and benefit increases from 2004-05 through the adopted 2006-07 budget grew at a compound annual growth rate of 10.2 percent.
- Police and Fire expenses totaled 73 percent of total budgeted expenses (before reductions) in 2006-07, leaving little flexibility in reducing other expenditures. Public safety minimum staffing requirements, overtime, and relatively high salaries have severely strained Vallejo’s resources (see discussion below).

Comparing Palo Alto and Vallejo
In general, contrasting the budgets of two cities is fraught with many difficulties. An “apples to apples” comparison for GF services is made complex by the type and level of services provided as well as how those services are funded. Unlike Palo Alto, Vallejo does not have locally provided library or recreational services. Instead, Vallejo makes direct and comparatively modest contributions to the Solano County library system and to a Greater Vallejo Recreation District. Vallejo’s payments to the county for library services in 2005-06, for example, were $0.4 million whereas Palo Alto’s library services in the same year cost $5.7 million. Other operations, such as animal control and shelter services, are provided by separate agencies to which the City also makes contributions. Another important difference between the cities is that Vallejo has a number of redevelopment districts that can fund, through incremental property taxes, capital and other improvements. Palo Alto does not have any redevelopment district areas and implements capital work using General Fund resources.

Recognizing the dissimilarities in the way services are delivered to the public by each city, some background information is helpful in comparing Palo Alto and Vallejo. In 2006-07, Palo Alto had a population of 62,615 while Vallejo had a population of 121,425. Palo Alto has a land area of 29.9 square miles and Vallejo has 25.6 square miles. Excluding Palo Alto’s Community Services and Library departments, it had 508.9 Full Time Equivalents (FTE) while Vallejo had 463.4 FTE. Once again, programs and levels of service differ from jurisdiction to jurisdiction so comparisons must be made carefully.

Although there are significant economic, geographic, demographic, and budget differences between the cities (see attachment 1 for comparative data), informative comparisons and conclusions can be drawn. In particular, Vallejo’s current fiscal situation highlights issues raised in a recent City of Palo Alto report on maintaining a sustainable budget (CMR: 387:07).
Economic Base
A fundamental cause of Vallejo’s budget dilemma is the erosion of its economic base. The loss of Mare Island’s economic benefits; the strong emphasis on residential development; and the weak retail sector have undermined Vallejo’s ability to maintain and generate revenues. The City was aware of these issues, but has been unable to surmount them. Its latest effort at mixed development in its waterfront area to stimulate retail sales and commercial development has suffered as a consequence of the credit and housing crunch. Vallejo could not have anticipated the credit bubble and the consequent housing crisis, but it did need to resuscitate and diversify its economic base starting in 1996.

The reality of a California local jurisdiction’s financing structure and the legal requirements surrounding it make it imperative to pay ongoing attention to funding sources. Without hotels, a diversified property tax base (residential and commercial), and strong retail activity generated by shopping centers, automobile dealerships, business to business activity, local governments cannot maintain or enhance services in the long-term. Palo Alto’s efforts in this area such as: working to maintain the Honda and Toyota dealerships, changing zoning to allow ground floor retail, increasing business through efforts like Destination Palo Alto, and working with Stanford to expand the shopping center and build a new hotel will help the City to avoid circumstances occurring in Vallejo. Although the economic cycle makes these revenue sources volatile, they are essential to a local jurisdiction’s financial health whether it is Vallejo or Palo Alto.

Revenue Structure
As the pie charts below reveal, Vallejo’s revenue sources are more highly concentrated than Palo Alto’s. Their top 4 categories (property tax, sales tax, utility users tax, and program revenues) constitute 70 percent of total sources, while Palo Alto’s top 4 (property tax, sales tax, charges for services, and operating transfers) total 57 percent. Palo Alto’s remaining revenue categories are more diverse and more robust than Vallejo’s. Transient occupancy and rental income, for example, are important revenue sources that provide additional depth and breadth to Palo Alto’s revenue base. Whereas no one source for the City exceeds 15 percent of total revenues, Vallejo’s property, sales and utility user taxes constitute 23, 16, and 16 percent, respectively.
2007-08 Vallejo Adopted Budget Revenues

- Program Revenues: 15%
- Sales Tax: 16%
- Utility Users Tax: 16%
- Motor Vehicle License Fees: 12%
- Property Transfer Tax: 4%
- Franchise Fees: 5%
- Other: 9%
- Property Tax: 23%

2007-08 Palo Alto Adopted Budget Revenues

- Sales Tax: 15%
- Operating Transfers In: 12%
- Property Tax: 15%
- Transient Occupancy Tax: 5%
- Utility Users Tax: 5%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Charges to Other Funds: 8%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%

- Other Revenue: 1%
- Charges to Other Funds: 8%
- From other Agencies: 1%
- Rental Income: 9%
- Return on Investment: 2%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
- Other Revenue: 1%
- Other Taxes and Fines: 6%
- Return on Investment: 2%
- Rental Income: 9%
- From other Agencies: 1%
- Permits & Licenses: 4%
- Charges for Services: 18%
With 23 percent of total revenues derived from property taxes, Vallejo is much more vulnerable to real estate downturns, particularly in the residential sector it has sought to build out. Related to this, Vallejo has experienced a sharp decrease in its property transfer tax and in building, planning and permit fees. This has been a consequence of plummeting home sales. In contrast, Palo Alto’s property tax revenues equal 15 percent of General Fund resources. Palo Alto is fortunate to have less volatility in real estate prices and more diversity in its residential and commercial property mix. Both of Palo Alto’s property and transfer tax revenues are roughly split between the residential and commercial sectors at 63 percent and 37 percent, respectively.

Expense Structure
On the expense side, recent articles have stressed two causes for Vallejo’s budget dilemma: salaries/benefits and the costs of public safety. The former constituted 78 percent of Vallejo’s 2007-08 budget while the latter absorbed 73 percent of resources. Palo Alto’s respective shares of these same expense categories in the 2007-08 budget were 65 percent and 52 percent. Although the proportion of Vallejo’s budget for salaries and benefits is much higher than the average jurisdiction, there are several explanations. To address its long-term issues, Vallejo did cut capital, supplies and materials, and transfer (e.g., transportation subsidy) expenses – the usual reductions most jurisdictions make to maintain services until the budget rebounds. To place the above percentages in perspective, this cost cutting approach has the effect of raising salaries and benefits as a percentage of the budget over time. Nevertheless, Vallejo does have higher salaries (public safety) and a more generous employee benefit package (retiree medical) compared to other jurisdictions.

Vallejo’s employee benefits package has been ample. It pays all current employee and dependent health care premiums for its PERS health care plans. It continues to provide PERS Care, the most expensive plan available and which Palo Alto has discontinued. With the exception of a 5 percent monthly share of premium costs for spouse coverage, all retiree medical premium costs are paid by Vallejo. Retirement plans are similar to Palo Alto’s with 2.7 percent at 55 for miscellaneous employees and 3.0 percent at 50 for public safety personnel. In contrast to Palo Alto, Vallejo requires that the employee share of their retirement plans is paid entirely by employees. Beginning in 2007-08, miscellaneous employees in Palo Alto began to pick up 2 percent of the employee share. The remaining benefits package consisting of dental, vision, employee assistance program, and life insurance is fairly similar to Palo Alto’s.

Given the last decade’s double-digit increases in health care costs and the provision of all PERS health plans (including PERS, this line item must be exerting considerable pressure on Vallejo’s budget. Although Vallejo makes reference to its retiree medical liability and intended to devote an additional $1.0 million to this cost in 2008-09, their financial condition likely will not allow this. In March 2008 Palo Alto transferred $30 million to a PERS retiree medical trust toward its liability. There has been little indication in the newspapers or in public documents that Vallejo is contemplating changing its benefit structure. It has focused mainly on salary reductions which do have the effect of reducing retirement payments. As it has with contributions toward retiree health premiums, one option for Vallejo is to negotiate current employee payments toward their premiums.
According to the newspapers, Vallejo’s salary structure is in excess of average municipal compensation, specifically in the public safety area. As one newspaper reported, “Vallejo’s base pay for firefighters is more than $80,000 a year. Last year, 21 of them topped $200,000 in salary and overtime, according to city payroll records.” Indeed, starting in 2007-08, the base pay for a firefighter was $80,300 and for a police agent $83,700. It appears that an agreement was reached recently with public safety unions to cut salaries by 6 percent, reducing salaries to $75,800 for a firefighter and $78,900 for a police officer. Vallejo’s public safety salary levels, particularly for firefighters, are at a premium.
As of July 1, 2007 the base pay for a Palo Alto firefighter was $63,900 and for a police officer $76,100. Prior to the 6 percent reduction in pay, Vallejo’s firefighters were earning $16,400 or 26 percent more than Palo Alto’s. Police officers were earning nearly $7,500 or 9 percent more than our officers. It appears that from 2003-04 through the 2006-07, public safety salary and benefit costs were rising at a compound annual growth rate of between 8 and 9 percent. This unsustainable growth rate combined with a sharp decline in revenues are clear reasons why public safety costs represent 73 percent of Vallejo’s budget and why the city is on the brink of bankruptcy. As one of Vallejo’s council members concluded, “The root of the problem is the contracts the city simply cannot afford.” (S.F. Chronicle, April 21, 2008). As of April 22, the date by which a declaration of bankruptcy was anticipated, the City was still in negotiations with its unions.

Palo Alto’s labor philosophy and strategy has been to track average Bay Area compensation while recognizing competitive market conditions for specific personnel. Vallejo exceeded this benchmark at a time when it could ill afford to do so. According to one source, Vallejo had not conducted a fire department salary survey in 20 years. Palo Alto conducts a salary survey with each new contract negotiation.

Reserves
During economic downturns and when revenues are falling, the City of Palo Alto has resorted to expenditure reductions to balance its budget. The question often arises, particularly from the City’s labor unions, as to why reserves are not used to cushion negative impacts on the budget. Vallejo’s experience is instructive. At the beginning of the 2006-07 fiscal year Vallejo’s GF balance was $10.9 million. Within less than two years this balance was depleted. The use of one-time monies is not a solution for an ongoing and deep structural deficit. Expenses must be brought into alignment with revenues to stabilize the budget and prevent imbalances moving forward. By the end of 2007-08, the City of Palo Alto is expected to have a Budget Stabilization Reserve of $25.8 million.

Conclusions
Vallejo has used all of its General Fund reserves, will not have adequate cash flow after June 30, and is facing a $13 million deficit for fiscal year 2008-09. The City’s financial situation is dire. It is important to note, however, that many jurisdictions, though not to the same degree, face challenges similar to Vallejo’s: increasing health care costs; retiree medical liabilities; revenue sources extremely sensitive to economic cycles; union pressures and agreements limiting flexibility to reduce costs (e.g., minimum staffing requirements that require overtime); and legal and regulatory constraints. Although Vallejo has experienced a “perfect storm” of negative events, their intractable dilemma does provide instruction that may help jurisdictions weather similar storms. Some of these insights were raised in the sustainable budget discussions held in the past year with the Finance Committee. They include:

- Maintain a vibrant economic base that can generate solid revenue streams over time.
- Diversify the revenue base to reduce exposure to the economic cycle and over dependence on any one source.
- Maintain a balance between residential and commercial development so as to retain the resources that meet expected service levels.
• Have a program priority plan determining core versus discretionary services so as to
reduce costs in the event of a major revenue downturn.
• Examine services that can be provided in an alternative, cost-efficient manner that is
equally or near to equally effective e.g., regional service agreements.
• Determine the degree of risk the City is willing to incur as it seeks to control expenses.
• Open a dialogue with employees and unions on how to share steeply rising medical
costs.
• Maintain strong reserves (Vallejo depleted a high level of reserves rapidly) and the
policy of reducing expenditures as structural deficits emerge.
• Continue annual updates to the City’s Long Range Financial Forecast.

Fortunately, the City of Palo Alto is fairly far removed from the extreme fiscal conditions
Vallejo faces. Nevertheless, it is important to monitor revenue and expenses carefully. Public
safety, community, and library services are high priorities in Palo Alto. As CMR: 387:07
showed, these services have grown from 58.3 percent of the budget in 1997 to 61.5 percent in
2007. Since 2003 and in real dollar terms, public safety expenses have risen by $2.4 million
while community and library services have remained constant. Collectively, all other City
departments and services have declined. Given current capital plans for police, library and
recreational facilities, it can be expected that operating, equipment, and maintenance costs will
increase for these facilities and consume a larger slice of the City’s resources.

In light of these initiatives, a $455 million infrastructure backlog, ongoing benefit cost pressures,
a souring national and state economy, and other new and yet-to-be-determined programs, the
City may want to establish a prioritization plan for its resources. As the Finance Committee
stated during its review of a sustainable budget on October 16, 2007, engaging the community in
a discussion of resources and program priorities is a necessary first step in a complex endeavor.
It also is a step that helps to avoid some of the pitfalls that have beleaguered Vallejo.

RESOURCE IMPACT
This report is for informational purposes and does not have a resource impact.

POLICY IMPLICATIONS
This report is consistent with Council policy direction and requests.

ENVIRONMENTAL REVIEW
Discussion of this general topic does not represent a project under California Environmental
Quality Act (CEQA).