
Subject: 86% Increase in Net Governmental Expenditures - FY 2015 vs FY 2020
Attachments: Pages from AgendaPacket-Finance Commission-February 8, 2021 5.00 PM (6).pdf; Achieving a Structurally Balanced Budget.pdf; TC response.pdf

From: Phil Koen <pkoen@monteropartners.com>

Sent: Friday, February 12, 2021 8:35 AM

To: Rob Rennie <RRennie@losgatosca.gov>; Matthew Hudes <MHudes@losgatosca.gov>; Marico Sayoc <MSayoc@losgatosca.gov>; Maria Ristow <MRistow@losgatosca.gov>; Mary Badame <MBadame@losgatosca.gov>; Ron Dickel <[REDACTED]>; [REDACTED]; Rick Tinsley <[REDACTED]>; [REDACTED]

Cc: Laurel Prevetti <LPrevetti@losgatosca.gov>; Arn Andrews <aandrews@losgatosca.gov>; Stephen Conway <sconway@losgatosca.gov>; [REDACTED]; Lee Fagot <[REDACTED]>

Subject: 86% Increase in Net Governmental Expenditures - FY 2015 vs FY 2020

Dear Council and Finance Commission Members,

I offer the attached with the hope you might find it useful information.

Phil Koen



BEST PRACTICES

Achieving a Structurally Balanced Budget

Adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget

Most state and local governments are subject to a requirement to pass a balanced budget. However, a budget that may fit the statutory definition of a "balanced budget" may not, in fact, be financially sustainable. For example, a budget that is balanced by such standards could include the use of non-recurring resources, such as asset sales or reserves, to fund ongoing expenditures, and thus not be in structural balance. A true structurally balanced budget is one that supports financial sustainability for multiple years into the future. A government needs to make sure that it is aware of the distinction between satisfying the statutory definition and achieving a true structurally balanced budget.

GFOA recommends that governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget. The policy should include parameters for achieving and maintaining structural balance where recurring revenues are equal to recurring expenditures in the adopted budget.

As a first step, the government should identify key items related to structural balance. These include: *recurring and non-recurring revenues, recurring and non-recurring expenditures, and reserves.*

Recurring revenues are the portion of a government's revenues that can reasonably be expected to continue year to year, with some degree of predictability. Property taxes are an example of recurring revenue. A settlement from a lawsuit is a good example of non-recurring revenue.

Some revenue sources may have both non-recurring and recurring components. These sources require finance officials to exercise judgment in determining how much of the source is truly recurring. For instance, a government may regularly receive sales tax revenues, but a large part of its base may be made up of retailers with highly volatile sales. In this case, it may be prudent to regard

unusually high revenue yields as a non-recurring revenue under the assumption that such revenues are unlikely to continue, making it imprudent to use them for recurring expenditures. Another example might be building permit revenues in a period of high growth in the community. Governments should review their revenue portfolio to identify non-recurring revenues and revenues with potentially volatile components, such as the examples above.

Recurring expenditures appear in the budget each year. Salaries, benefits, materials and services, and asset maintenance costs are common examples of recurring expenditures. Capital asset acquisitions are typically not thought of as recurring because although some capital assets may be acquired every year, they are not the same assets year after year. In general, recurring expenditures should be those that you expect to fund every year in order to maintain current/status quo service levels. In general, a government has a greater degree of flexibility to defer non-recurring expenditures than recurring ones.

Reserves are the portion of fund balance that is set aside as hedge against risk. The government should define a minimum amount of

funds it will hold in reserve.² This serves as a "bottom line measure" to help determine the extent to which structural balance goals are being achieved. If reserves are maintained at their desired levels, it is an indication that the organization is maintaining a structurally balanced budget. If reserves are declining, it may indicate an imbalance in the budget (e.g., if reserves are being used to fund on-going expenditures). It should be noted that reserves levels are not a perfect measure of structural balance, but are a good and readily available measure.

With the forgoing terms defined, a government should adopt a formal policy calling for structural balance of the budget. The policy should call for the budget to be structurally balanced, where recurring revenues equal or exceed recurring expenditures. The policy should also call for the budget presentation to identify how recurring revenues are aligned with or not aligned with recurring expenditures.³

For a variety of reasons, true structural balance may not be possible for a government at a given time. In such a case, using reserves to balance the budget may be considered but only in the context of a plan to return to structural balance, replenish fund balance, and ultimately remediate the negative impacts of any other short-term balancing actions that may be taken. Further, the plan should be clear about the time period over which returning to structural balance, replenishing reserves, and remediating the negative impacts of balancing actions are to occur.⁴

Notes:

- Note that this Best Practice excludes non-operating funds like capital and debt funds. While governments should ensure that these funds are financially sustainable as well, the specific recommendations found in this Best Practice may not always be a match to the circumstances of non-operating funds.
- Please note that the best practice is not advocating that recurring revenues be formally allocated or "earmarked" to recurring expenditures, but rather is advocating that the budget presentation provide transparency as to whether recurring revenues and recurring expenditures are balanced.



TOWN OF LOS GATOS
FINANCE COMMISSION REPORT

MEETING DATE: 02/08/2021

ITEM NO: 3

DESK ITEM

Item 3.

DATE: February 8, 2021
TO: Finance Commission
FROM: Laurel Prevetti, Town Manager
SUBJECT: Provide Advice to the Town Council Regarding Mid-Year Budget Options and Five-Year Forecast Scenarios

REMARKS:

Attachment 5 contains public comment received between 11:00 a.m. on February 5, 2021 and 11:01 a.m. on February 8, 2021.

A member of the public provided a communication to the Finance Commission (distributed as an Addendum on February 5, 2021) regarding the growth in net governmental expenses between FY 2014/15 and FY 2019/20, noting an 86% total increase from FY 2014/15 to FY 2019/20. In addition, the resident noted a lack of dedicated revenue sources for future capital project funding and had questions on the restricted pension trust activities. A Commission member subsequently asked if staff could provide a high-level response.

Staff response:

- To arrive at an 86% increase in Net Governmental Expenses, the resident selected FY 2014/15 as the base year. The resident selected a year when the Town recorded \$16.5M in program revenues versus 2020 when the Town recorded \$15.0M in program revenues. Base year selection is important in that the Statement of Activities presents program expense less program revenues. The higher the program revenues in a given year, the lower the net program expenses which also means lower net governmental expenses. Program revenues are increased in years when the Town receives substantial grants and/or donations on the capital side of the ledger, so program revenues vary by this key factor from year to year. The beginning base year selected was a year where there were an additional \$1.5M in program revenues than shown in 2020 (FY 14/15 had substantial grant revenues and \$450K in new library project donations), the result is to indicate a "growth" in

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Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

REMARKS (continued):

net governmental expenses that includes the \$1.5M gap between program revenues received in 2015 versus 2020 and thus impacting the percent growth of net governmental expenses from FY 2014/15 to the end of FY 2019/20.

- It is difficult to compare the growth of net governmental expenses due to the variability of program revenues received each fiscal year; therefore, it might be more relevant to compare the General Fund 2014/15 Adopted Operating Budget to the FY 2019/20 Adopted Operating Budget for a true percentage increase as shown below:

General Fund Adopted Expenditure Budget Comparison FY 2014/15 to FY 2019/20

	FY 2014/15	FY 2019/20	Increase(Decrease)
Total Adopted Budget	\$ 43,493,413	\$ 52,914,515	\$ 9,421,102
Less GFAR capital transfers	(6,991,491)	(6,681,884)	309,607
Less "one-time" capital transfers to Workers Comp Internal Service Fund		(1,061,256)	(1,061,256)
Less "one-time" capital transfers to Non-Point Source Fund		(100,000)	(100,000)
Less "one-time" capital transfers to Successor Agency RDA Housing	(50,200)		50,200
Net Operating General Fund Budget	\$ 36,451,722	\$ 45,071,375	\$ 8,619,653
Net General Fund Operating Expenditure Budget Growth Over 5 FY's			\$ 8,619,653
% Total Growth over 5 Years			23.65%
% Average Annual Growth FY 2014/15 to FY 2019/20			4.73%

- The resident's observations on the lack of dedicated capital funding are correct and have been well documented in the Town's Capital Improvement Plan (CIP) budget each year. Each year, the CIP notes that the Town continues to be challenged to find an ongoing reliable revenue to fund Town infrastructure projects and that this challenge remains a top priority. In addition, during discussions of the Measure G Sales Tax in 2018, staff documented over \$70 Million in unmet infrastructure needs for projects, such as pothole, street, and road repair.
- The resident had questions on the restricted pension trust activities. Staff's mid-year analysis focused on operating revenues and expenditures and did not include the revenues that relate to the restricted pension trust. The funds available either in the restricted pension fund or in the General Fund Pension/OPEB reserve are likely either to be sent directly to CalPERS or remain in the restricted asset account at the end of the current fiscal year pursuant to future Council action.

Dear Members of the Town Council and the Finance Commission:

I am writing to you to respond to the Staff memo (attached) that was submitted to the Finance Committee in response to my letter which discussed the 86% increase in Net Governmental Expenses over the past five years.

The Staff's response creates unnecessary confusion regarding the trend in total actual government expenditures. The Staff has previously acknowledged during the Joint Town Council/Finance Commission that the Net Total Governmental Expenses have increased, and the Town's auditors have raised a specific concern that the Town's current tax base is unable to provide sufficient revenue to fund the total net governmental expenditures. So, it is perplexing that the Staff is now trying to suggest that the 86% increase was not that large or worse is not a concern.

As to my specific comments:

- The Staff's assertion that it is difficult to compare growth in net governmental expenses due to variability of program revenue received is baseless. Comparing actual annual financial results is a very common financial analysis tool which is used to determine underlying trends in revenues and expenses. Just because there are fluctuations in revenue or expense elements in any one year, does not diminish the value of the comparison, it helps explain what has happened. While there were 10% more program revenues in FY 2015 than FY 2020, that does not change the fact that total net governmental expenses increased 86% over the five-year period.
- To be very clear, over the past five years the net total cost of government for the Town has risen at an extraordinary rate in both absolute dollar terms and relative to the growth in total tax revenues recognized. Even if you change the base year for the comparison, which was a concern of the Staff's, the answer does not change. Let us select 2016 as the base year, a year in which the Town received \$1.4m less in program revenue than in FY 2020 (just the opposite of FY 2015). Comparing FY 2016 to the FY 2020 Net Governmental Expense gives us a 71% increase over the four-year period vs. the 86% increase over the five-year period. The 71% equates to a compounded annual growth rate of 12.2%. Over that same four-year period total tax revenues increased 19% or at a compounded annual growth rate of 4.4%. My original conclusion that the cost to run the Town's government is increasing at a rate this is 3x the rate of increase in tax revenues is still valid. As this Council begins to debate a revised five-year forecast, please understand it is fiscally unsustainable to have the growth rate in net government expenses increasing at 3x the growth rate of tax revenues over a five-year period. This is a structural issue, not a one- year budget issue, that needs to be addressed as you discuss the next five years. I have also attached a best practices article published by the GFOA which I would encourage the Council to read.

- The Staff memo goes on to suggest that “it might be more relevant to compare the General Fund FY 2015 adopted budget to the FY 2020 adopted operating budget for a **TRUE** percentage increase”. The statement is incorrect and even more importantly does this Town a great disservice by distracting the reader from what has happened. Let me make several points:
 - a. A general fund budget does not reflect the **government wide financial activity**, nor does it reflect the **actual spending** that has occurred. The GASB in Statement 34 mandated that one of the basic financial statements for State and Local Governments is the Statement of Activities. This Statement brings together on a **government-wide basis** all the financial activity in one place and reports that activity on an accrual basis.
 - b. Using budget to budget comparisons to determine actual revenue and expenditure trends has been discussed numerous times and has been repeatedly criticized by many, including members of the old Finance Committee. And yet the Staff continues to put forth this analysis which can lead to wrong conclusions. The Staff’s memo seemingly suggests that the “true percentage increase” in total governmental expenses from FY 2015 to FY 2020 was only 23.6%. The problem is a) the General Fund represents only a portion of the total government wide activities not the total government wide activities; b) the General Fund budget does not reflect “actual results”; c) the General Fund budget is not developed using accrual accounting as required by the GASB in preparing the Statement of Activities; d) the General Fund budget does not include depreciation expense associated with the Town’s investment in infrastructure; and e) the General Fund budget reflects only what the Town is budgeting to **fund** pension and post retirement plans not the actual pension and benefit **expense recognized** as required to be reported by GASB. It provides no information when trying to understand the actual expenditure trends over the past five years. **But the real damage is if the Council were told, not knowing any better, that the “true percentage increase” in total net government spending over the past five years was 23.6% and they believed it, when it was 86%.** Based on this incorrect statement, there is considerable risk the Council could make bad policy decisions regarding adding new programs or increasing the cost base of the Town because they did not fully understand the actual financial trends.

In closing, over the past five years total net governmental expenditures have grown at a rate that is 3x the growth in total taxes, which is the primary source of revenue for this Town. In FY 2020, for the first time in the history of Los Gatos, total tax revenues were insufficient to fund the total net governmental expenditures. This is a structural issue which must be addressed as the Council begins its work on a five-year forecast.