The 2017 Proposed City Budget: Improved Sustainability Continues but Structural Challenges Persist

> *"… we find that the City of Milwaukee's financial condition and outlook have improved significantly since our last examination in 2009. Credit is due to city leaders for their responsible approach to financing their pension obligations, restructuring their health care offerings, and downsizing the city's workforce in the face of some enormous fiscal challenges. Also, the fact that those challenges were accommodated without depleting reserves or substantially deferring capital repair needs is further evidence of effective financial management."*

Public Policy Forum, *City of Milwaukee's Fiscal Condition*; September, 2016.

Overview: The City's Budget Sustainability Strategy

Structural balance refers to a government's capacity to fund existing expenditures over time with its projected ongoing revenues. A shortfall between existing expenditures and ongoing revenues is typically referred to as a "structural imbalance".

Changes in State Shared Revenue policy and the growing costs of employee health care benefits have challenged the city's structural budget balance dating to the mid-1990's. Recent events, most notably the need to reinitiate employer pension contributions in 2010 after a 15 year hiatus, have resulted in a persistent challenge to structural balance. In addition, a $13.7 million reduction to state intergovernmental aid in 2012, on top of an $11 million decrease in 2004, have contributed to what the Public Policy Forum has termed a "broken revenue system" which makes a sustainable budget structure exceedingly difficult to achieve.

The city's strategy to achieve structural balance has been multi-faceted. The strategy can be summarized as follows:

- **Resizing**: City government will need to operate on a smaller overall scale. Between 2008 and 2016, the city budget experienced a net reduction of approximately 430 Full Time Equivalents (FTEs) positions for a decrease of approximately $35 million to the annual "budget base". The city has used enhanced technology and equipment, improved deployment, and staff development to improve productivity to avoid declines in service quality.

- **Restructuring:** Opportunities exist to increase productivity while reducing staffing levels through technology, automation, and functional consolidations. For example, investments in library circulation automation, municipal court electronic case processing, and worker's compensation administration have enabled annual operating cost reductions of $1.5 million. Substantial consolidation of information technology functions, combined with staff realignments within the Department of Administration saves approximately $700,000 annually.

  Restructuring has also extended to financial matters, with an emphasis on stabilizing annual pension funding, reducing the employer share of employee health benefit costs, diversifying revenues through user charges, and decreasing the reliance on levy supported debt to finance capital improvements. An actuarially approved modification to the employer pension contribution method has stabilized funding as a percentage of payroll over five years, avoiding potentially destabilizing annual volatility. In addition, accelerated payment of required plan year contributions is estimated to save approximately $4.3 million a year in avoided interest charges. Restructuring of employee health benefit cost sharing, the decision to self-fund all health benefit costs, incentives for utilization of quality providers, and the return on investment in wellness have enabled a 2017 appropriation that is $23.4 million lower than 2011 actual expenditures. User charges for solid waste services, snow and ice operations, and storm water management in the Department of Public Works offsets the cost of approximately 520 FTE positions, while making available more than $65 million in property tax revenue for services, such as public safety, libraries, and public health. Most of the forestry capital program is now funded via cash from the storm water charge, avoiding levy supported debt of $3.6 million in 2017.

- **Reinvesting:** In many cases effective resizing and restructuring require investments in equipment, data applications, process improvements, and people. For example, investments in technology, training, and planning have stabilized the budget for workers' compensation expense. These investments have essentially flattened out the program budget, saving at least $4 million annually compared to continuation of the 2011 baseline trend.

In addition, economic development investments will improve the city's capacity to grow and spread the cost of city services over a larger tax base. During 2015, the city added $440 million of real estate value to its tax base due to development, redevelopment, and other construction investments in real property. This 1.72% increase in "net new construction" was the third highest rate of increase among the 19 Milwaukee County communities. Milwaukee's net new construction increase was also 15% higher than the rate of change in the state of Wisconsin as a whole. This performance is expected to continue in future years as a result of the city's investment in tax increment finance projects such as the Brewery, Park East, Reed Street Yards, Northwestern Mutual Life, and Century City, among others. Over the last three years, the city has experienced over $1 billion of equalized value property growth due to net new construction. This performance demonstrates the confidence that property owners and investors have in Milwaukee's future.

Progress on Sustainability

During 2013, the Department of Administration's Budget and Management Division (BMD) projected the need to achieve $65 million to $75 million of structural improvement in order to achieve ongoing budget sustainability by the end of 2016. The projection was based on the combined amount of revenue increases and expense reductions needed by 2016 for structural balance.

Since that time, the following changes from a 2013 baseline contributed to achieving structural balance to the city's 2016 budget:

- Property tax revenues: $6.4 million;
- Other general fund revenues: $17 million;
- Departmental expense reductions from 2013 baseline: $18 million;
- Employee health care benefit and workers compensation cost reductions: $6.7 million, plus approximately $40 million in trend line decreases; and
- Pension cost reductions due to contribution pre-payment: $4.3 million annually.

This improvement over the last four years incorporated sustainable approaches that will continue to yield future benefits. This is crucial given the emerging challenges to structural budget balance.

Financial Performance Measures

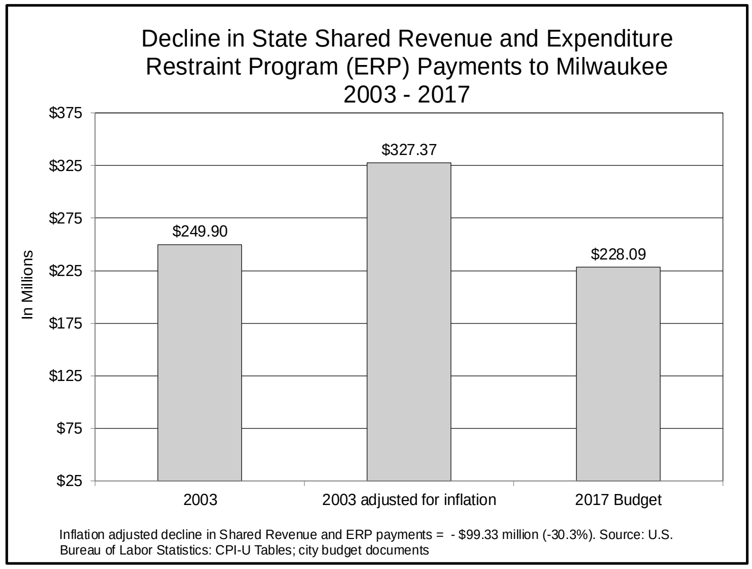
Effective financial planning begins with objectives and identifies factors that pose challenges and opportunities to structural budget balance. The Administration's two primary financial objectives are:

- Provide mission critical city services through annual budgets that limit the impact of tax levy and municipal service charge changes on the average valued residential property to 3% or less a year.
- Manage long term obligations such as core infrastructure, debt, and pension benefits in a manner that stabilizes ongoing funding requirements and minimizes transfer to future generations.

BMD has identified the following primary challenges to the city's ability to meet these objectives on an ongoing basis:

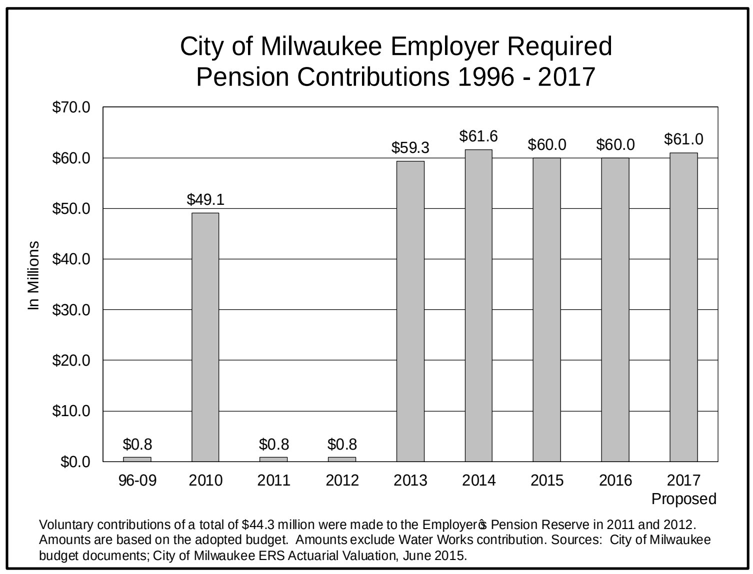
1. State intergovernmental aid funding reductions have reduced the city's fiscal capacity significantly. As Figure 1 illustrates, shared revenue (including expenditure restraint program aid) has declined $99.3 million in inflation adjusted terms since 2003 ($21.8 million in nominal terms). This decline has resulted in an increased proportion of the city's operating budget to be financed from local sources. For example, in 2003, state aids were essentially equal to the combined operating budgets of the Police and Fire departments. By 2017, these aids are expected to be $195 million less than these same two budgets. The city's state aid reductions stand in stark contrast to the 59% increase ($6.32 billion) in state general purpose revenues (GPR) during this same period.

Figure 1



2. The city's budget has entered a "new normal" era for employer contributions to the City of Milwaukee Employes' Retirement System (CMERS). Between 1996 and 2009 the plan's funded status allowed the discontinuation of employer pension contributions. However, the 2007-2008 Global Financial Crisis (GFC) altered CMERS finance for the foreseeable future. Beginning in 2010, the city resumed making an employer contribution for pensions. This places considerable pressure on structural balance, especially given the aforementioned impacts of the state's shared revenue policy.

Figure 2



Currently, tax levy contributions equivalent to approximately 17.3% of covered payroll ($61 million in 2017) are required under the stable contribution policy and will continue at this level through the 2017 plan year. This equates to approximately 23% of the 2017 total tax levy.

Recent developments in the financial markets may have a significant bearing on employer contributions beginning with the 2018 plan year. A major factor in the calculation of the employer contribution is the assumed rate of investment return. This rate is used to discount the amount of future benefit obligations into the present. A relatively higher rate results in relatively lower annual contributions, compared to a relatively lower discount rate. Currently, the CMERS deploys an 8.25% discount rate, which is scheduled to return to the previously established rate of 8.5% in 2018. The average discount rate used in 2015 by 150 large Public Employee Retirement Systems (PERS) is 7.6%.

Some financial market analysts have questioned the feasibility of PERS achieving their assumed rates of return over the next ten years. The Annuity and Pension Board determines the various actuarial assumptions, including the assumed rate of investment return, for CMERS. The board will reset these assumptions for the 2018 plan year. A modest modification of 25 basis points could add at least $6 to $8 million to the city's annual employer contribution. This amount is equal to the amount of tax levy increase proposed for 2017. The impact of larger discount rate decreases would be very destabilizing, and similar in effect to the post-2003 decline in state intergovernmental aids.

Figure 3

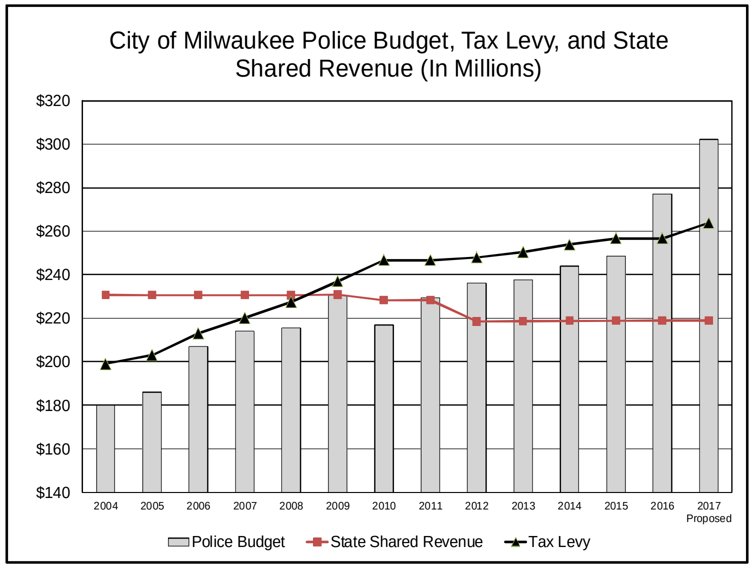
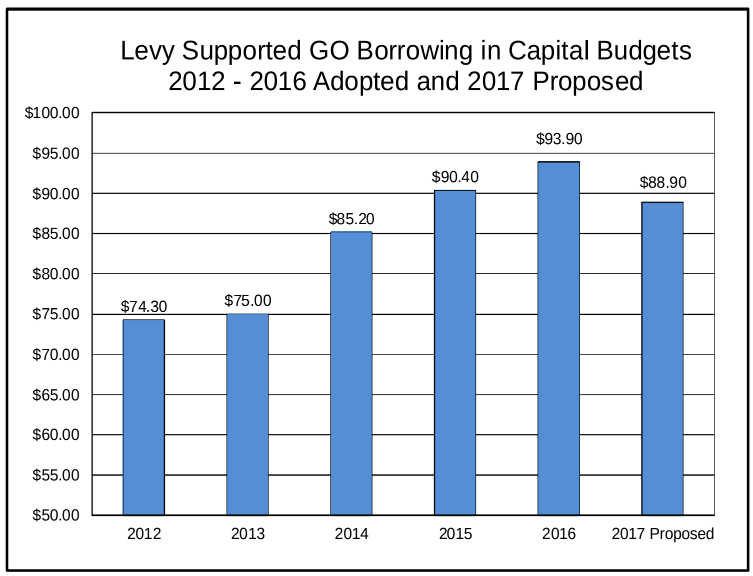


Figure 4



In addition, the CMERS plan assets have a high risk exposure, given the 55% allocation to public equities. Since 1900, 32 "bear markets" have occurred in the United States. This condition is defined as a situation in which securities prices fall and widespread pessimism causes the stock market's downward spiral to be self-sustaining. A rather "garden variety" bear market loss of 20% would generate a $1 billion loss on a mark-to-market basis. Although asset gains and losses are smoothed over a five year period to avoid destabilizing the city budget, such a loss could cause an annual contribution increase approaching $10 million initially, with the potential to grow considerably higher until a positive rebound occurred. The city's primary response to such an event would of necessity be severe budget reductions.

1. Between 2005 and 2012, the amount of annual new budget authorizations for levy supported debt remained at an essentially stable level of between $72 and $74 million. However, the need to finance two large facilities projects (City Hall foundation and the Police Administration Building), combined with the Strong Neighborhoods Plan and the continuing commitment to improved infrastructure and neighborhood libraries, resulted in a $93.9 million level in 2016. The 2017 debt service levy of $65.3 million consumes 25% of the total proposed 2017 levy. There is a need to manage the level of new authorizations so that the tax levy for debt service remains manageable.

   The 2017 proposed budget reduces new levy supported authorization to $88.9 million. The administration's Capital Improvements Plan gradually lowers these annual amounts until the city hall and police facilities projects are completed. The Budget and Management Division projects that resetting the recurring "new authority" level to approximately $75 million by 2022 is sustainable given current revenue estimates. This will require difficult choices among competing priorities.

4. Milwaukee's drinking water is clean and safe to drink. But lead can dissolve from lead plumbing. Lead is not found in Milwaukee's source water, Lake Michigan, and it is not found in water as it leaves the drinking water treatment plants. Milwaukee's water meets all Environmental Protection Agency standards for water quality.

   Years ago, lead was used in paint, plumbing, and other products. The most common source of lead is from paint in older homes. Guidance from the United States Environmental Protection Agency (EPA) indicates that it is likely that the federal lead and copper safety rule will develop more prescriptive mandates requiring the removal of lead plumbing lines that serve drinking water customers.

While lead is not found in Milwaukee's treated water, lead may be introduced into the water from lead service lines and plumbing fixtures owned by our customers, especially when water stands unused for several hours. To control lead dissolving into the water, Milwaukee Water Works (MWW) treats the water with a compound that forms a protective coating inside pipes.

The EPA rule revision is expected to provide for a timeline for the removal of lead service lines. The 2017 proposed budget includes approximately $3.9 million for the lead service line replacement program. This includes $3.6 million for replacement of the utility owned portion of approximately 600 service lines. The remaining $300,000 will fund one new position to coordinate programming for service line replacement, one chemist position for additional sampling, and will cover costs of filters and bottled water for properties experiencing service disruption as a result of work related to lead service lines.

Future years will involve a significantly greater budget commitment. Combined with the need to continue an ambitious water mains replacement program, lead service line removal will have a substantial impact on the MWW capital budgets for decades. In addition, city subsidies to assist property owners with the cost of replacing the privately owned service lines represent a new financial commitment. In total, the implications of capital investments in MWW, and assistance to their customers, will generate significant pressure on both water rates and city tax levies.

BMD has also identified positive factors that it will use to manage these challenges in a fiscally responsible manner.

1. A number of initiatives have improved significantly the current baseline for employee health care benefit (EHCB) expenditures, as well as projections for annual growth. Premium cost sharing changes, migrating insured member benefits to self-funding, utilization changes, and the initial return from investments in the city's wellness program have reduced 2017 projected expenditures that are $23.4 million lower than the 2011 actual expenditures. Annual increases going forward are projected to be 3% to 4%, compared to 9% prior to 2012.

2. Recent collective bargaining agreements have resulted in all police and fire sworn employees becoming responsible for their entire 7% member contribution for pensions. Previously the city made these payments on behalf of the affected employees. This change will result in an annual $14 million reduced tax levy for retirement provisions. While the collective bargaining agreements included partial wage offsets associated with this change, the resulting arrangement makes ongoing pension financing somewhat less imposing.

3. The city's reserves are in sound condition and will assist in making the transition to more challenging budget conditions. The proposed reserve use in 2017 is less than that of 2016, and preserves the entire existing balance of the Employer's Pension Reserve for future budgets.

2017 Budget Bottom Line

The 2017 proposed budget provides for a tax levy increase of 2.7%, $7 million over 2016. The proposed tax rate will increase seven cents, or about 7/10 of 1%. Under the proposed budget, the owner of an average valued residential property will experience an estimated city government tax levy increase of $26.40, compared with 2016. The proposed tax levy increase is needed primarily to fund the ongoing costs of maintaining police strength, financing the city's increased capital budget commitments, and funding pension costs (the fundamental driver of which is police) responsibly.

The 2017 municipal service fees will increase by $10.86 for the typical residential owner. On a combined basis, the 2017 levy and municipal service charge combined changes result in an estimated increased cost of approximately $37.26, or 2.5%, to the typical residential property owner with one garbage cart, compared with 2016. This cost for the typical homeowner is within the parameters of the administration's financial objective.

Conclusion

The 2017 proposed budget capitalizes on the city's improved structural budget balance while delivering on key priorities to taxpayers. The restructuring of health care benefits and pension finance has generated a stabilizing influence on the annual budget. Moderate reserve use will assist in resolving future years' budget challenges.