Review of the Submitted Budget for Fiscal Year 2009

March 2008

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City Auditor's Office

City of Kansas City, Missouri

03-2008

March 5, 2008

Honorable Mayor and Members of the City Council:

This year's budget review focuses on current and future financial pressures the city faces. To improve service levels, the city must carefully examine major expenditure categories, establish priorities, and begin addressing the chronic structural budget imbalance.

- **Expenditures are growing faster than revenues.** Revenues in funds supported by the general fund are expected to grow 3 percent in 2009 while expenditures are expected to grow 11 percent. Between 2010 and 2013, expected revenue growth is two percent per year in these funds and expected expenditure growth is four percent. When revenue sources are inadequate to fund the ongoing cost of services, the city's long-term financial condition is weakened.

- **The fund balance is extremely low.** In 2009 the fund balance is budgeted at 3.3 percent, far below the city's 8 percent benchmark. A low fund balance diminishes the city's ability to respond to unanticipated events.

- **Capital asset maintenance is deferred/underfunded.** Despite efforts to better fund capital maintenance, funding is still below the estimated $80 million needed to adequately maintain the city's capital assets. Total funding for capital maintenance is expected to increase from $54 million in 2009 to $81 million by 2012 and then decrease to $56 million after the authority to issue capital infrastructure bonds is exhausted.

- **Employee-related costs continue to rise.** Although personal services costs are budgeted to increase about $28 million in 2009, another $14 million in salary and benefit costs were not included in the submitted budget and must be absorbed within each department's budget. In addition, the city is not contributing the required amount to the pension systems. In 2007, the city contributed the required amounts to the two city pension systems, but contributed less than 70 percent of the required amount to the two police pension systems. The city also faces additional financial pressures to address the liability on health care for retirees.

- **Public safety requests are exceeding the city's funding ability.** Police and Fire are two of the largest expenditure categories in the city budget, $212 million and $102 million respectively. The majority of funding for both departments comes from the city's general fund. Although a portion of their funding comes from the public safety and fire sales taxes, the taxes are set to expire in less than 10 years.

- **TIF/STIF expenditure growth exceeds the growth in supporting revenues.** Funding available for public programs is decreasing as the portion redirected to TIF and STIF projects increases. TIF and STIF reimbursements grew almost 120 percent, six times more than the growth in revenue sources supporting the reimbursements. Between fiscal years 2005 and 2009, the funds redirected or budgeted to be redirected to TIF and STIF projects total about $137 million, while revenue growth in these funds totals only $119 million.

- **Debt burden continues to grow.** In January 2008, bond rating agencies noted that the city's debt burden is high. Debt service as a percent of general municipal revenues is expected to grow to 11.3 percent in 2009, the highest level in the last 12 years. Debt service payments in 2009 will total about $120 million on outstanding debt of $2.6 billion. City-backed debt for a number of economic development projects will obligate additional city funds if revenues from those projects do not cover the debt service.

- **Resources are still needed for unfunded commitments.** The city committed to three capital projects (American Royal improvements, the American Royal master plan, and a portion of the Performing Arts Center) estimated at $92 million without identifying funding sources. The city committed to these projects outside the normal capital improvement budget process. The Council will need to prioritize these projects against other planned or future capital projects such as sewer/stormwater replacement, road maintenance and replacement, and a light rail system.

- **Snow removal, energy and fuel, and transportation costs are likely to increase**. The proposed budget underfunds snow removal by providing about one-half of the funds likely needed in 2009. The city may also need to identify additional funding if fuel prices increase above the budgeted amount of $2.50 per gallon. Public transportation needs could also present budgetary challenges in the near future.

During fiscal year 2008, the city adopted important policies on city debt and economic incentives and improved the timeliness of the monthly financial reports. To further strengthen its financial condition, the city should continue developing additional financial policies and improving its financial reporting. Currently the City Council's budget priority sessions could occur too late in the budget process to provide guidance to the city manager and departments when developing the budget. Priority setting that occurs early in the budget process can help the city better deal with the budgetary challenges.

We discussed a draft of this report with the city manager and budget officer, but we did not ask for written responses. We would like to thank city staff for their courtesy and cooperation. The audit team for this project was Brennan Crawford, Linna Hung, Nataliya Kurtucheva, Renata Matos, Jason Phillips, Julia Talauliker, and Douglas Jones.

Gary L. White
City Auditor

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Introduction

Objectives

This performance audit, a review of the city manager's submitted budget, provides the City Council with information about the city's financial condition and the fiscal year 2009 submitted budget. Resolution 911385 directs the city auditor to review and comment on the city manager's budget. This is our 18th budget review.

We conducted this audit under the authority of Article II, Section 216 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the city auditor's primary duties.

A performance audit systematically examines evidence to independently assess the performance and management of a program against objective criteria. Performance audits provide information to improve program operations and facilitate decision-making.[1]

This report is designed to follow up on the financial issues we identified in last year's budget review. We also provide information to the City Council to address the chronic structural imbalance and to consider in future budget deliberations.

Scope and Methodology

Our review focuses on the city manager's submitted budget for fiscal year 2009 and follows up on issues raised in last year's budget review. Our methods included:

- Updating financial analyses from prior budget reviews;
- Analyzing data on cost of personnel and other programs provided to us by city staff;
- Reviewing the submitted budget and five-year financial forecast;

[1] Comptroller General of the United States, *Government Auditing Standards* (Washington, DC: U.S. Government Printing Office 2003), p. 21.

- Reviewing reports and analyses provided by staff and other organizations; and

- Interviewing city staff.

We conducted this audit in accordance with generally accepted government auditing standards. No information was omitted from this report because it was deemed privileged or confidential. We discussed the report with the city manager and budget officer, but we did not ask them for written responses to the report and recommendations.

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Findings and Recommendations

Summary

The city faces a long-term structural budget problem. The city's expenditures are projected to grow faster than revenues. The city's general fund balance is far below the recommended levels. For years the city has not dealt with the long-term imbalance in the budget. Instead, the city used short-term solutions to balance the budget such as one-time resources, across the board reductions, staff reductions, deferring capital maintenance, and tapping into the reserves.

To improve service levels, the city must carefully examine major expenditure categories, establish priorities, and address the chronic structural budget imbalance. Increasing employee-related costs and public safety requests; revenues redirected to economic development projects; the funding gap in capital maintenance; commitments to special projects without funding sources; and the increasing costs of commodities prevent the city from offering all current program and services at an adequate level. Postponing dealing with these issues will only worsen the structural imbalance, increasing the funding gap in future years.

In fiscal year 2008, the City Council adopted important policies on city debt and economic development. To further strengthen the city's financial oversight, the city should implement additional financial policies recommended by the Government Finance Officers Association. While the timeliness of the monthly financial reports significantly improved, the city's annual financial report has not been released in a timely manner, limiting the ability to monitor the city's financial condition on an ongoing basis.

Currently the City Council budget priority sessions could occur too late in the budget process to provide guidance to the city manager and departments when developing the budget. As a result, when departments begin budget preparations, they do so without adequate information as to what stakeholder concerns, needs, and priorities are for the upcoming year. Goals, objectives and priorities form a foundation for the budget process. Priority setting that occurs early in the budget process can help the city better deal with the budgetary challenges.

While many governments used more traditional measures to deal with budgetary shortfalls, some local and state governments are taking steps to find creative ways to deal with fiscal challenges. Budgeting for results and outcomes, an approach recommended by the Government Finance Officers Association (GFOA), helps entities decide which activities or programs can best achieve the desired results. With resources linked to objectives, the focus shifts to outcomes.

To improve the city's financial condition, the city manager should prepare a comprehensive set of financial policies for council consideration; ensure recently developed debt and economic development policies are followed; improve the timeliness of financial reporting; and address rising employee-related and public safety expenditures; and the expiration of the public safety and fire sales taxes. In addition, the City Council should consider conducting budget priority sessions earlier in the budget process to improve their usefulness.

City Must Deal with Long-standing Fiscal Challenges

The city faces a long-term structural imbalance. Expenditures are projected to grow faster than revenues and the general fund balance is far below the recommended level. For years the city postponed dealing with the long-term imbalance in the budget using short-term solutions such as one-time resources, across the board reductions, and staff reductions; and by deferring capital maintenance and using reserves to balance the budget. In his transmittal letter, the city manager acknowledged that that the structural budget problem persists.

To be able to improve service levels and address council priorities, the city must carefully examine major expenditure categories, establish priorities, and address the chronic structural budget imbalance. Increasing employee-related costs and public safety requests; revenues redirected to economic development projects; the funding gap in capital maintenance; commitments to special projects without funding sources; and the increasing costs of commodities prevent the city from offering all current program and services at an adequate level. Postponing dealing with these costs would only worsen the structural imbalance and increase the funding gap in future years.

City Faces Long-term Structural Imbalance

The submitted budget is not structurally balanced and if not addressed, can only worsen. Future expenditure growth exceeds revenues resulting in a long-term funding gap. The general fund balance for fiscal year

2009 is projected at less than half a month of regular operating expenditures and capital maintenance has been deferred.

The submitted budget is not structurally balanced. For the budget to be structurally balanced, the city needs to meet the following conditions:

- Current expenditures should equal current revenues;
- Revenue growth is equal to or greater than expenditure growth in coming years;
- An adequate fund balance is maintained; and
- Capital maintenance expenditures are not deferred.

In fiscal year 2005, the city manager acknowledged the structural problems in the budget and recommended structural changes. In his 2009 budget transmittal letter, he reports dealing with the challenge through workforce attrition efforts and better aligning employee salary increases closer to annual revenue growth. He also acknowledges that the structural budget problem persists.

For many years the city used short-term solutions and quick-fix strategies to remove funding gaps. The city used one-time resources, across the board reductions, staff reductions, and reserves and deferred maintenance to balance the budget. Not dealing with the long-term imbalance in the budget only worsens the structural imbalance, increasing the funding gap in future years.

The city's future expenditures are expected to grow faster than future revenues. According to the five-year financial forecast, revenues in funds supported by the general fund are expected to grow at about 3 percent and expenditure growth in these funds is expected at 11 percent in 2009. Between 2010 and 2013, revenues are expected to grow at 2 percent per year and expenditures at 4 percent, resulting in a long-term funding gap. When revenue sources are inadequate to fund the ongoing cost of services, the city's long-term financial condition is weakened. (See Exhibit 1.)

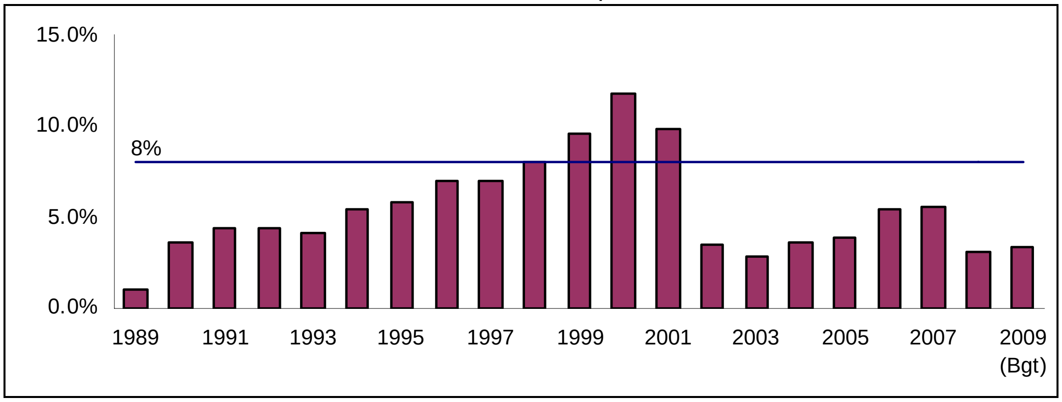
Exhibit 1. Revenue Growth Compared to Expenditure Growth

Fiscal Year	Revenue Growth Rate	Expenditure Growth Rate	Funding Gap
2009	3%	11%	-8%
2010	2%	4%	-2%
2011	2%	4%	-2%
2012	2%	4%	-2%
2013	2%	4%	-2%

Source: Five-year Financial Forecast, 2007.

The general fund balance is inadequate. The Government Finance Officers Association (GFOA) recommends that governments establish a formal policy on the level of unreserved fund balance in the general fund. At a minimum, general purpose governments should maintain a general fund balance at 5 to 15 percent of operating revenues or no less than one to two months of regular general fund operating expenditures. The general fund balance for 2009 is budgeted at 3.3 percent, less than half a month of regular general fund operating expenditures and well below the city's 8 percent minimum benchmark. (See Exhibit 2.) A low fund balance diminishes the city's ability to respond to unanticipated events, such as natural disasters and uneven cash flow.

Exhibit 2. General Fund Balance as Percent of Expenditures



Source: Adopted Budgets 1989 – 2008 and Submitted Budget 2009.

In June 2004, the city promised to take steps to rebuild its fund balance at a presentation to bond rating agencies. At that time, the city agreed to fully restore the fund balance to 8 percent in four to five years. The city manager also recommended last year that the City Council adopt a policy of maintaining a minimum fund balance of 10 percent of expenditures. The budget office has developed a draft policy that would require the city to maintain a general fund balance of 10 percent of expenditures, but it has not been presented to the City Council. The city manager should submit a draft policy on the appropriate level of general fund balance to the City Council as soon as possible and develop a strategy to rebuild the fund balance to the required level.

The city has deferred capital maintenance. The city is only funding a portion of what departments have estimated is needed for maintaining capital assets and has used capital maintenance funds to balance the budget in the past. Deferring capital maintenance saves money in the short run but creates higher costs in the long run, as structures can deteriorate to the point where relatively minor repairs grow into major capital improvements. Crumbling infrastructure also affects people's perceptions about living and working in the city.

Employee-related Costs Continue to Rise

Although personal services costs are expected to grow by more than six percent in fiscal year 2009, that does not reflect the true employee related costs as some cost increases are not funded and are to be absorbed within each department's budget. In addition, the city pension systems continue to put pressure on city resources. The city's actuarially required contributions almost doubled over the last eight years and the city faces additional pressure to fund the liability on health care for retirees.

Growth in the city's employee-related costs continues to drive expenditure growth. Employee-related costs constitute more than 57 percent of the city's total operating expenditures. In 2007, citywide personnel expenses grew 6 percent for all city funds. The growth in 2008 is projected to be 10.7 percent and the growth for 2009 is 6.4 percent. (See Exhibit 3.)

Exhibit 3. Personal Services Expenditures, All Funds

	2006	2007	Estimated 2008	Budgeted 2009
Personal Services	$382,068,120	$404,931,405	$448,081,548	$476,620,695
Percent of Growth from Prior Year		6.0%	10.7%	6.4%

Source: Submitted Budget 2009.

The increase in personal services costs in 2009 does not reflect the true employee salary and benefit costs as some cost increases are not funded. Per the city manager's directive, merit increases, salary adjustments, health insurance cost increases, and resources to recruit employees totaling about $14 million are to be absorbed within each department's 2009 budget. In effect, this is a hiring freeze, which could affect the level of city services provided to the public.

Although the city's funding for the city pension systems has improved, the city is not contributing the actuarially required amount. The city contributed the required amount into the pension systems until about 2002, after which contributions declined. Starting in 2005, the city has made an effort to increase its contributions toward the recommended amount. The difference between actual funding and the actuarially required amount decreased from $15.5 million in 2006 to $7.2 million in 2007. In 2007, the city contributed the actuarially required amount for city employees' and firefighters' pension systems, but contributed less than 70 percent of the required amount for the police retirement systems. As a result, the funded level[2] for the police

[2] Funded level – an actuarial value of assets divided by actuarial accrued liability.

retirement systems is lower than for the city employees' and firefighters' systems. (See Exhibit 4.)

Exhibit 4. Funded Level for City and Police Pension Systems

Funded Ratio	May-01	May-02	May-03	May-04	May-05	May-06	May-07
Police	97.5%	95.7%	89.5%	84.7%	81.6%	82.0%	86.0%
Police Civilian	99.7%	97.9%	82.1%	78.4%	74.5%	74.4%	81.0%
City Employees	108.7%	100.5%	88.3%	84.7%	82.6%	93.1%	97.1%
City Firefighters	93.9%	87.4%	82.3%	83.0%	84.6%	87.9%	92.1%

Sources: Actuarial Reports for the Employees' Retirement System, Firefighters' Pension System, Police Retirement System, and Civilian Employees' Retirement System.

The long term financial health of the pension systems is dependent, in part, on the systematic funding of the plans. The city's actuarially required contributions - contributions needed to keep the systems funded at an adequate level - almost doubled over the last eight years from $27 million to more than $52 million. As funding requirements to keep the systems in good standing continue to increase, more and more pressure will be put on city resources. The city manager should address the risks of growing retirement costs by studying the feasibility of moving to a defined contribution system as well as consolidating the four pension systems.

How the city will handle future obligations associated with health care for retirees is unknown. In addition to increases in employee salary and benefit costs, the city faces unknown future obligations associated with health care for retirees. The City Council still does not know the impact of other post-employment benefits (OPEB) and how the liability will be funded. Accounting standards require the city to recognize the costs of non-pension benefits to retirees, such as health insurance beginning in fiscal year 2008.[3]

The city has some options to address this requirement. It can choose to fully fund the costs, continue to operate on a "pay-as-you-go" basis, modify benefits, or increase employee and/or retiree contributions. It is important for the city to adequately address this issue because additional resources might need to be set aside to deal with the liability and because how the city funds OPEB liabilities could affect bond ratings.[4]

The Finance Department has a draft report completed by a consultant hired to do an actuarial study to determine the city's liability, including the liability for Police Department retirees, but has not presented this

[3] Governmental Accounting Standards Board Statements 43 and 45 on financial reporting and accounting of other post-employment benefits issued in June 2004.
[4] The rating agencies look for information on how management plans to address the cost of liability arising from providing these benefits and at the issuer's financial flexibility to address these costs.

report to the City Council. The city manager should present the report and a recommended strategy for dealing with the liability to the City Council as soon as possible.

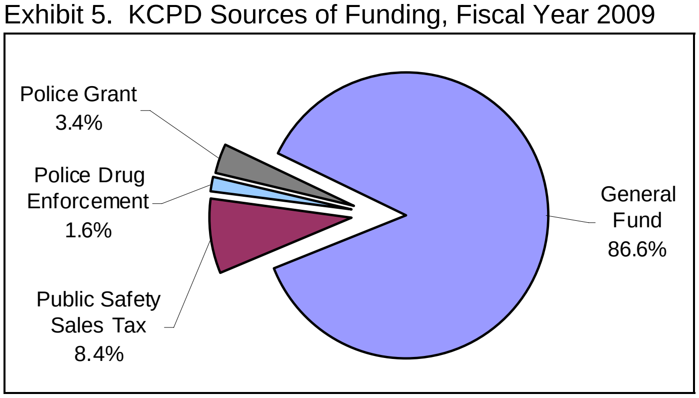
City Unable to Keep up with Public Safety Requests

Police and Fire are two of the largest expenditure categories in the city budget. Funding for Police is budgeted at $212 million for 2009, and funding for Fire is budgeted at $102 million, but these amounts are less than the departments requested. General fund revenue is the largest source of funding for both departments, above 80 percent, and dedicated sales tax is the second largest revenue source. The city has come to rely on dedicated tax revenues to help support operations in both departments. The public safety and fire sales taxes expire in 2011 and 2017 respectively. Expiration of these taxes would further erode the city's ability to keep up with the growing requests from Police and Fire.

Police is the largest expenditure category in the city budget, heavily relying on general fund revenue. The city is providing the Police Department with 28.5 percent of the city's total general revenues, which is above the state-mandated 20 percent of general revenues.[5] Even with the current allocation of funds, the city is unable to keep up with the department's financial requests.

The Police Department requested $271 million to support operations in fiscal year 2009. The submitted budget provides $212 million, an increase of $11 million from 2008. The majority of the increased funds will be used to support salary and benefit increases for uniformed officers and civilian positions. The general fund is the largest source of funding ($184 million) for Police operations. The public safety sales tax and grants provide additional funding for the department. (See Exhibit 5.)

Exhibit 5. KCPD Sources of Funding, Fiscal Year 2009



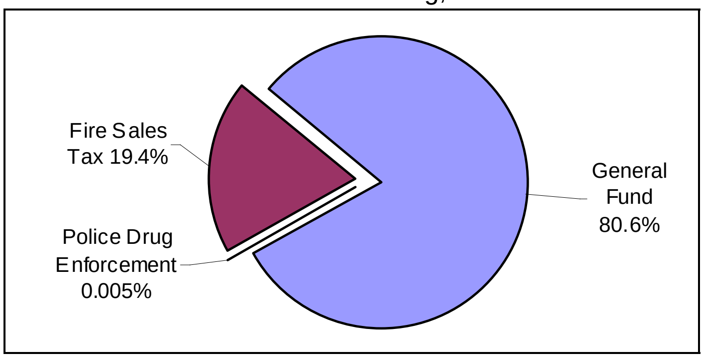
Source: Submitted Budget 2009.

[5] RSMo 84.730.

Fire is third largest expenditure category in the city budget and also relies on general fund revenue. The 2009 submitted budget provides the Fire Department $102 million, about a 5 percent increase from 2008. The funding level is slightly less than the department's request. The additional funding will cover salary and benefit increases.

The Fire Department also relies heavily on the general fund, but receives a higher percentage of its funding from sales tax revenues than the Police Department. (See Exhibit 6.) In 2009, the city shifted staffing costs of $1 million to fire sales tax, offsetting the need for additional general fund resources.

Exhibit 6. KCFD Sources of Funding, Fiscal Year 2009



Source: Submitted Budget 2009.

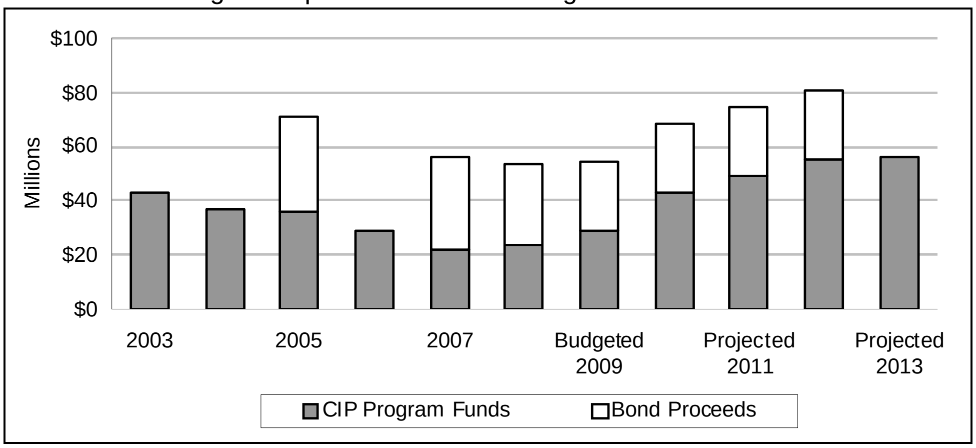
The public safety and fire sales taxes are set to expire in 2011 and 2017. Although the general fund remains the primary source of funding for the Fire and Police departments, the city has come to rely on dedicated tax revenues to support public safety needs such as capital, equipment upgrades, and additional firefighters. Expiration of these taxes would further erode the city's ability to keep up with the growing requests from Police and Fire. Before they expire, the city needs to renew both taxes, find another source of income, or reduce spending. The city manager should begin addressing the sunset of these taxes and determine a strategy for dealing with the growing public safety requests.

Capital Maintenance Is Underfunded

While the city has made an effort to increase funding for capital maintenance in the last few years, the city is only funding a portion of the estimated capital maintenance needs provided by departments. In addition, the city does not have a readily available consolidated list of all city assets, condition standards for all capital asset types, or a replacement schedule for all assets. Since capital assets enable delivery of public services, their adequate maintenance and replacement is essential for the future health, safety, and economic development of the city.

The city made an effort to increase funding for capital maintenance in the last few years. Total funding for capital maintenance is expected to increase over the next several years from $54 million in 2009 to $81 million in 2012. More than one-third of the future capital funding is projected to come from bond proceeds; however, the city's authority to issue bonds will be exhausted in 2012. Total funding in 2013 is expected to drop back to $56 million. (See Exhibit 7.)

Exhibit 7. Funding for Capital Maintenance Programs



Sources: Adopted Budgets 2003 – 2008; Submitted Budget 2009; and Budget Office data on bond proceed spending.

Besides bonds proceeds, capital maintenance funding includes revenues from the capital improvements sales tax[6] and an additional $5 million per year from non-sales tax resources, reflecting the council's commitment to increase capital maintenance funding. Despite efforts to increase capital maintenance funding, the funding level is still below $80 million, the amount city staff estimates is needed to adequately maintain capital assets.

The city's system for planning, budgeting, and assessing capital maintenance needs could be improved. Currently the city does not have a readily available consolidated list of all city assets and did not keep track of such assets prior to 2003.[7] The city does not use PeopleSoft to track capital assets because assets can not be broken down by fund. The city also does not have condition standards for all capital asset types, nor does it maintain a replacement schedule for all assets.

[6] The city's maintenance program will receive approximately an extra $9 million per year beginning fiscal year 2010 from the capital improvement sales tax, due to changes made on the ballot renewing the one cent sales tax.
[7] In 2003 the city had to perform an inventory of assets in order to comply with GASB 34.

Since capital assets enable delivery of public services, adequate maintenance and replacement is essential for the future health, safety, and economic development of the city. The city's capital improvements process should include developing strategies to address the growing gap in maintenance and replacement of city assets. GFOA recommends that governments:

- develop and maintain a complete inventory of all assets;
- develop a policy requiring periodic measurement of the physical condition of assets;
- establish condition performance standards for asset groups;
- develop financing policies for capital maintenance and replacement;
- allocate sufficient funds to a multi-year capital plan;
- annually report condition ratings, replacement lifecycle, change in asset value, and performance data on capital maintenance; and
- report trends in the spending and replacement cycle.

To improve the city's system for planning, budgeting, and assessing capital maintenance needs, the city manager should direct staff to adopt GFOA recommended practices on capital asset monitoring and reporting and begin developing strategies to address the gap in maintenance of city assets. As more funding is devoted to capital maintenance, the city should also develop some meaningful outcome measures to monitor the results of increased spending.

Revenues Redirected to TIF and STIF Projects Significantly Reduce Revenues Available for City Programs

Funding for public programs is decreasing as the portion redirected to TIF and STIF projects increases. Funding going to TIF and STIF comes from city sales and property tax revenues that support capital improvements, convention and tourism, public safety, transportation, and other city programs. Between fiscal years 2005 and 2009, the funds redirected or budgeted to be redirected to TIF and STIF projects from these taxes was about $137 million, while revenue growth in these funds was only $119 million. TIF and STIF reimbursements grew almost 120 percent (six times more than the growth in revenue sources) between 2005 and 2009. As public safety, capital maintenance, and public transit expenditures continue to grow, decreases in dedicated funds available due to TIF and STIF reimbursements will put additional pressure on the general fund.

Funding for public programs is decreasing as the portion redirected to TIF and STIF projects increases. Funding going to TIF and STIF projects for reimbursements of eligible costs to developers, such as public improvements, comes from city tax revenues. The taxes that support TIF and STIF include sales and property taxes that support the capital improvements fund, convention and tourism fund, fire sales tax fund, KCATA sales tax fund, public safety sales tax fund, public mass transportation fund, and the general fund. Funding available to city programs supported by these revenues sources is decreasing due to larger portions of these funds being redirected to specific TIF and STIF projects.

Between fiscal years 2005 and 2009, the city redirected or budgeted to redirect about $137 million in tax revenues to TIF and STIF projects while revenue growth in these funds was only $119 million. While the city revenues supporting TIF and STIF reimbursements increased 20 percent, TIF and STIF reimbursements for the same period grew almost 120 percent, six times more than the revenue sources. (See Exhibit 8).

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Exhibit 8. Growth in Tax Revenues Compared to Growth in Revenues Redirected to TIF and STIF

Fund	Five Year Revenue Growth	Five Year Growth in TIF/STIF	Redirected Revenues 2005-2009 (Millions)	Purpose of Fund
Capital Improvements	-8%	81%	$32.0	Financing capital improvement projects.
Convention and Tourism	35%	286%	$19.8	Accounts for revenues and expenditures related to Bartle Hall expansion. Includes receipts from Bartle Hall operation as well as the convention and tourism tax.
Fire Sales Tax	12%	84%	$8.0	Provide capital improvements, construction of a new CAD system, and additional firefighters.
General Fund	26%	113%	$46.5	The primary operating fund of the city. Can be used to finance any activity in which the city engages.
KCATA Sales Tax	23%	218%	$11.1	For the Kansas City Area Transportation Authority to develop, operate, maintain, equip, and improve a transit system.
Public Mass Transportation	12%	63%	$11.7	To support the public mass transportation system; construct and maintain streets, roads and bridges; acquire land and rights-of-way; and for related planning and feasibility studies.
Public Safety Sales Tax	13%	83%	$8.0	To address public safety facility needs of the Police Department, like the new training academy, an additional police station north of the Missouri River, renovations to all existing police facilities, and the replacement of the department's Computer Aided Dispatch and Records Management systems. This tax also supports equipment purchases for ambulance services (MAST) and provides funding for additional emergency warning sirens and a new emergency operations center.

Source: Adopted Budgets 2003 – 2008 and Submitted Budget 2009.

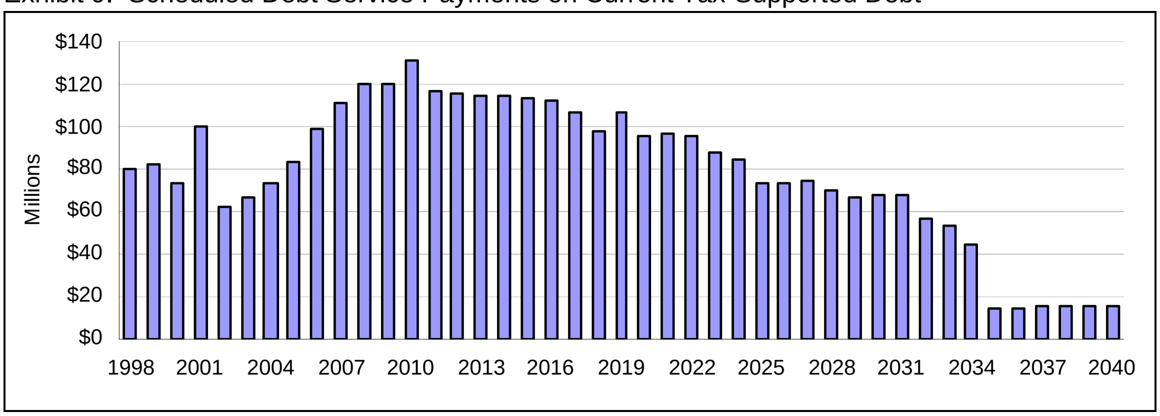
As expenditures for public safety, capital maintenance, and public transit continue to grow, decreases in dedicated funds available due to TIF and STIF reimbursements could put additional pressure on the general fund. The city should study the effect of financing development through tax increment financing on city programs. The city manager should analyze, project, and report on the future impact that TIF/STIF reimbursements will have on city revenues as directed by Resolution 011726 adopted by the City Council in February 2004.

Debt Burden Continues to Grow

Bond rating agencies noted in their January 2008 reports that the city's debt burden is high. Debt service as a percent of general municipal revenues is expected to reach 11.3 percent in 2009, the highest level in the last 12 years. Limited obligation debt, issued for economic development projects, is the largest debt category. While the city made progress in dealing with risks associated with economic development debt by adopting crucial policies and reducing interest rate risk and exposure on such debt, underperforming projects raise the risk of exposure. Large economic development projects like KC Live and East Village have low debt service coverage, and six other projects are not generating enough revenue to cover debt service payments. When projects backed by city bonds underperform, the city must make up the difference, and resources are diverted from other city services or projects.

Debt obligations have increased. Total debt principal and interest outstanding as of January 2008 is almost $2.6 billion, an increase of almost $40 million since December 2006. The city's debt service payments in 2009 total about $120 million. (See Exhibit 9.)

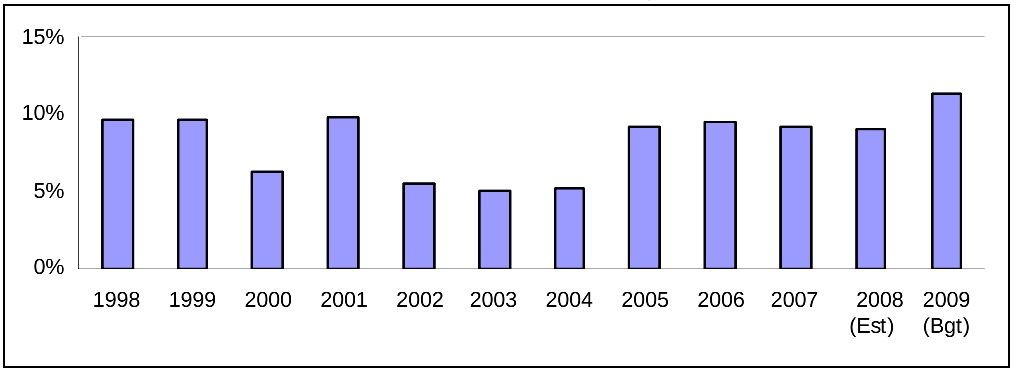
Exhibit 9. Scheduled Debt Service Payments on Current Tax-Supported Debt



Source: Debt Manual payment schedules.

Debt service as a percent of budgeted general municipal revenues is expected to reach 11.3 percent in 2009, the highest level in the last 12 years. (See Exhibit 10.) The city's new debt policy defines an acceptable debt range of between 5 and 15 percent debt to general municipal revenues.

Exhibit 10. Debt Service as Percent of General Municipal Revenues



Source: Adopted Budgets 1998 – 2008 and Submitted Budget 2009.

Rating agencies think the city's debt burden is high. In their January 2008 reports, three bond rating agencies noted that the city's debt burden is high.[8] Although two of the rating agencies noted that the city's outlook is stable, their outlook is based on the expectation that the city will maintain balanced financial operations and rebuild its reserves as the local economy expands. The third agency changed their outlook on all bonds to negative, based on a recent general fund operating deficit coupled with an economic slowdown. According to that agency, if these pressures continue, they would consider lowering the city's ratings on general obligation and appropriation-backed bonds.

Low debt coverage on limited obligation debt projects raises risks of exposure. Limited obligation debt is the largest portion of total tax-supported debt. Limited obligation debt outstanding as of January 2008 was $1.3 billion, or about 50 percent of total city-backed debt. (See Exhibit 11.) Limited obligation bonds are backed by the city's annual appropriation pledge and are issued for economic development projects such as KC Live, the Sprint Center, the Hotel President, and 909 Walnut. If these projects do not perform, the city is obligated to pay any debt service not covered by operating revenues from the project for which the bonds are issued.

Exhibit 11. Scheduled Debt Service Payable by Type of Debt

Type of Debt	January 2008
Limited Obligation Bonds	$1,292,446,152
Leasehold Revenue Bonds - KCMAC	761,308,064
General Obligation Bonds	426,735,552
Lease Purchase Agreements & Other Loans	79,305,170
Total	$2,559,794,938

Source: Debt Manual payment schedules.

[8] Moody's Investors Service, Standard & Poor's, and Fitch Ratings.

Several city-backed economic development projects, however, have low debt coverage, raising risks of additional exposure. The projected revenues on the KC Live project and the East Village project are only available to cover debt obligations by 1.04 times and 1.11 times respectively. In addition, the Americana STIF, Blue Parkway STIF, Chouteau TIF, Muehlebach STIF, Prospect North TIF, and the Uptown TIF, which are backed by city bonds, are not generating enough revenue to cover debt service payments. The total deficit for these six underperforming projects is about $29.2 million. When projects backed by city bonds underperform, the city must make up the difference, and limited resources are diverted from other city services or projects.

The city reduced some of the risks related to economic development debt. In October of 2007, the City Council adopted a debt policy that includes most of GFOA’s recommended practices. The policy outlines debt limitations and sets benchmarks to measure debt capacity including setting minimum debt coverage of 1.25 on debt service for limited obligation debt.

In addition, city staff took actions to reduce the city’s exposure to limited obligation debt. Finance staff told us they limited the city’s risk exposure by reducing the amount of variable rate bonds and removing the city’s annual appropriation pledge from debt issued for the Sprint Center.

The city also adopted an Economic Development Incentives policy in September of 2007. The policy corresponds to GFOA’s recommended practices. The policy allows city staff and other stakeholders to have early input on project discussions and discourages the use of city-backed debt. The policy outlines 22 specific criteria or outcomes that are used to evaluate projects. The policy also requires a continuous review over the life of a project to compare benefits against the promises made in the application. Staff from the city, the Economic Development Corporation, and the statutory agencies are currently working on the policy implementation plan.

The city’s efforts to improve debt management practices were recognized by the bond rating agencies. Two rating agencies praised the adoption of the debt and economic development policies and the city’s efforts to hedge a portion of its variable rate debt and to reduce the amount of debt supported by the city's appropriation.

To mitigate the risks of exposure with existing city-backed projects and to keep the debt level at an optimum level, the city manager should continue efforts to reduce debt risks and closely follow the established debt and economic development policies.

Commitments Made outside Budget Process Strain Existing and Future Resources

The city has not identified an adequate funding source for three capital projects the city committed to outside of the capital improvement budget process. The city committed to about $126 million for five capital projects in the last few years that were not part of the adopted Capital Improvement Plan. Two of these projects are now fully funded and one is partially funded. About $92 million in unfunded commitments remains. (See Exhibit 12 for the status of project funding.) Finding resources to finance these unfunded projects puts pressure on the city's already tight budget. The Council will need to prioritize these projects against other planned or future capital projects such as sewer/stormwater replacement, road maintenance and replacement, and a light rail system.

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Exhibit 12. Capital Projects Committed to Outside the Budget Process

Project	Project Description	Funding Amount	Status
American Royal Improvements	The city will facilitate the needs of the American Royal Association to continue operating after the loss of a portion of the Liberty Street lot for redevelopment of the Mexican Customs Facility. Ordinance No. 051401 and 071068	$8-10 million	*Not funded.* The city amended the agreement to remove the Liberty Lot from consideration and enabling SmartPort to seek other sites for the Mexican Customs facility.
American Royal Master Plan	The city manager was directed to work with the American Royal Association to develop financing for their master development plan. Resolution 051400.	$35 million	*Not funded.*
Police Academy Road Improvements	The project would rebuild Shoal Creek Parkway, Pleasant Valley Road, and a portion of Searcy Creek Parkway to facilitate travel around the new Kansas City Police Academy and Shoal Creek Patrol Station as well as boost development in the area. Resolution No. 050924 and Ordinance No. 060990.	$10 million	Funded through the public safety sales tax, Shoal Creek TIF revenues, Public Improvement Advisory Committee Capital Improvement Plan, and Water Services. The city appropriated $1 million to Southeast Community Center.
Performing Arts Center	The city made a $62 million financial commitment to the new performing arts center. Resolution No. 030372 and Ordinance No. 071045.	$62 million	*$47 million not funded.* $15 million funded toward the purchase of land and grading at 16th St. for the new Bartle Hall Ballroom. The city is considering funding the remaining garage improvements through revenue bonds and advancing $6 million to begin excavation, grading and design.
Music Hall	The project improves the Music Hall's stage to facilitate larger touring productions of Broadway shows as well as improvements to the backstage area and audience seating. Twenty-five percent of the total project cost or a minimum of $2.5 million was to be funded by private contributions. Resolution No. 051010, Ordinance No. 060310, Ordinance No. 060311, and Ordinance No. 070801.	$9 million	Funded by refunding of Bartle Hall bonds. Final project cost to the city as of the last recorded amendment is $15,747,193. Private contributions documented to date: $1.5 million.

Source: Resolutions, Ordinances and Office of Management and Budget.

City Should Adequately Plan for Likely Increases in Other Costs

Snow removal, energy and fuel, and transportation costs are likely to increase. Between 2005 and 2008, the city consistently under budgeted snow removal, and the proposed budget only provides about one-half the funds likely needed in 2009. If the price of fuel increases from the budgeted amount of $2.50 per gallon, the city may need to identify a few million dollars in additional funding. In addition, future public transportation needs such as the bus system and a possible light rail system could also be a budgetary challenge for the city.

Underfunding annual snow removal depletes the contingency fund. The city consistently under budgeted snow removal between fiscal years 2005 and 2008. While the city budgeted on average $1.2 million, expenditures for snow removal in the same period averaged over $2.5 million. In fiscal year 2008, the city spent over $3 million[9] for snow removal. The 2009 budget does not provide adequate funding to keep up with the increasing costs of snow removal. In his transmittal letter, the city manager states that total funding for snow removal expenses will require the city to tap into its contingent appropriation, which is not appropriate as contingency funds are to be used for unanticipated events.

Increasing energy costs should be factored into program budgets. In his transmittal letter, the city manager states that fuel price increases are the primary cost drivers in the city's supply budget. According to the Budget Office, the city purchases 2.8 million gallons of fuel a year and every jump in price by ten cents per gallon results in a $280,000 cost increase. If the price of fuel increases from the budgeted amount of $2.5 per gallon to $3.5 per gallon, the city would need to identify $2.4 million in additional funding.

Funding future transportation needs will be a challenge. The Kansas City Area Transportation Authority will need a new funding source when the 3/8-cent sales tax expires in 2009. The city is putting a 15-year renewal of this sales tax on the April 2008 ballot. The tax provides about half of the city funding for public transportation in the city. The city is also exploring building a light rail system that will require substantial planning and funding in the future. In addition to construction costs, the city should also consider the cost of operating such a system and identify the needed revenue sources before construction begins.

To be better prepared to deal with snow removal costs, increasing energy and fuel costs, and future transportation needs, the city manager should direct staff to begin quantifying the impact of these costs on the city's long-term financial condition.

City's Fiscal Challenges Impact Service Delivery

In this year's transmittal letter, the city manager asked departments to absorb unfunded costs in their operating budgets. He stated that the budget may not be able to support city programs at the needed levels.

[9] According to PeopleSoft expenditures and encumbrances for snow removal totaled $3.1 million, as of February 25, 2008.

While citizens' overall satisfaction with city services improved by over three percent in the last two years after a general decline, across the board cuts may negatively impact citizens' satisfaction with city services in the years to come.

The imbalance limits the city's current and long-term flexibility, making it difficult to sustain growing funding needs for city programs. The challenges of increasing city employee-related costs and public safety requests; revenues supporting programs going to fund economic development projects; the funding gap in capital maintenance; commitments to special projects without funding sources; and the increasing costs of commodities prevent the city from offering all program and services at an adequate level.

Improvements in Financial Oversight and Reporting Should Continue

In fiscal year 2008, the city adopted important policies on city debt and economic development. To further strengthen the city's financial oversight, the city should implement additional financial policies recommended by the Government Finance Officers Association. While the timeliness of the monthly financial reports significantly improved, the city's annual financial report has not been released in a timely manner, limiting the ability to monitor the city's financial condition on an ongoing basis.

City Needs Comprehensive Financial Policies

In fiscal year 2008, the city adopted several important policies including a debt policy and an economic development policy. However, the city needs a comprehensive set of written financial policies, including financial planning policies, revenue policies, and expenditure policies. (See Exhibit 13.) A comprehensive set of written financial policies would guide staff, facilitate decision-making for elected officials, and improve controls over the city's financial activities. Written financial policies are also useful for communicating the city's direction with respect to financial planning and management to the bond markets. GFOA recommends that the jurisdiction's adopted financial policies be used to frame major policy initiatives and be summarized in the budget document.

Exhibit 13. GFOA and NACSLB Recommended Financial Policies

Financial Planning Policies	Description
Balanced Budget	Define a balanced operating budget, encourage commitment to a balanced budget under normal circumstances, and provide for disclosure when a deviation from a balanced operating budget is planned or when it occurs.
Long-Range Planning	Support a financial planning process that assesses the long-term financial implications of current and proposed operating and capital budgets, budget policies, cash management and investment policies, programs, and assumptions.
Asset Inventory	Adopt a policy to inventory and assess the condition of all major capital assets. This information should be used to plan for the ongoing financial commitments required to maximize the public's benefit.
Revenue Policies	**Description**
Revenue Diversification	Encourage a diversity of revenue sources in order to improve the ability to handle fluctuations in individual sources.
Fees and Charges	Identify the manner in which fees and charges are set and the extent to which they cover the cost of the service provided.
Use of One-time Revenues	Discourage the use of one-time revenues for ongoing expenditures.
Use of Unpredictable Revenues	Specify the collection and use of major revenue sources considered unpredictable.
Expenditure Policies	**Description**
Reserve or Stabilization Accounts	Maintain a prudent level of financial resources to protect against the need to reduce service levels or raise taxes and fees due to temporary revenue shortfalls or unpredicted one-time expenditures.
Operating/Capital Expenditure Accountability	Periodically compare actual expenditures to budget (e.g., quarterly) and decide on actions to bring the budget into balance, if necessary.

Source: Recommended Practice: *Adoption of Financial Policies*, GFOA, 2001.

The city should continue efforts to ensure that policies recommended by GFOA and the National Advisory Council on State and Local Budgeting (NACSLB) are developed and implemented. The city manager should direct staff to conduct policy research and submit draft financial policies for City Council consideration. The city manager should also direct staff to incorporate the city's financial policies into financial documents and establish a review process to ensure that policies remain relevant.

Timeliness of City Financial Reports Should Improve

While the timeliness of monthly financial reports has significantly improved during fiscal year 2008, the timeliness of releasing the city's annual financial reports has been an ongoing issue. The annual financial report for fiscal year 2007 was presented 10 months after the end of the

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fiscal year. The 2005 CAFR was released about nine months after the end of the fiscal year, and the 2006 CAFR was released about six months after the end of the fiscal year.

The city has not released its annual financial reports timely in recent years. Finance presented the 2007 Comprehensive Annual Financial Report (CAFR) ten months after the end of the fiscal year. The new city charter states "the results of the annual audit will be presented to the City Council Committee designated to oversee financial matters for the City within thirty (30) days of completion of audit field work."[10] The fiscal years 2003 and 2004 CAFRs were released almost a year after the end of the fiscal year. The 2005 CAFR was released about nine months after the end of the fiscal year, and the 2006 CAFR was released about six months after the end of the fiscal year. To keep the council informed about the city's financial condition, the city manager should ensure that the city meets the city charter's requirements and improves the timeliness of the CAFR release.

Timeliness of monthly reports has significantly improved during fiscal year 2008. Finance has been regularly presenting the monthly financial reports to the City Council since 2006. These statements are prepared to keep council members informed of the financial condition of the city. Although six of the seven monthly financial reports presented by Finance for this fiscal year were late, timeliness has improved. The first report was 24 days late, but the most recent report was three days early. In general, each monthly report was presented earlier than the preceding monthly report. The new city charter requires the director of finance to submit monthly financial reports to the city manager and City Council no later than 20 days after the close of each month.[11]

The city manager should take steps to ensure that the director of finance presents the CAFR to the City Council within the timeframe required by the city charter.

Goals and Priorities Setting Should Begin Early in Budget Process

Goals, objectives, and priorities should be the foundation for the city's budget process. Currently the City Council budget priority sessions may occur too late in the budget process to provide guidance to the city manager and departments when developing the budget. As a result, when departments begin budget preparations, they may do so without

[10] City Charter, Article VIII, Section 836.
[11] City Charter, Article VIII, Section 837.

adequate information about Council and stakeholder concerns, needs, and priorities for the upcoming year. Priority setting that occurs early in the budget process can help the city better deal with budgetary challenges.

Goals, Objectives and Priorities Form Foundation for Budget Process

Priority setting helps allocate scarce resources among competing demands for services efficiently and effectively. Priority setting is a process by which an entity articulates the functions or programs considered most important to the attainment of service goals[12] and objectives[13] for the upcoming year. It is a useful and effective tool for translating broad organizational objectives into practical guidelines. In its budgeting series on priority setting published in 2001, GFOA lists five recommended practices for priority settings developed by NACSLB.

NACSLB's Recommended Practices on Priority Setting

1. Identify stakeholder concerns, needs, and priorities.
2. Identify broad goals.
3. Disseminate goals and review with stakeholders.
4. Identify opportunities for stakeholder input.
5. Monitor, measure, and evaluate stakeholder satisfaction.

Source: Roland Calia, *Priority-Setting Models for Public Budgeting*, GFOA Budgeting Series, Volume 4, 2001.

City Needs to Prioritize Its Goals and Objectives

While management acknowledges budgetary challenges, prioritizing goals and objectives can help address these challenges. In his transmittal letter, the city manager describes major budgetary challenges the city faces in fiscal year 2009 including increasing employee-related costs and public safety requests; revenues that support vital programs going to fund economic development projects; a growing backlog in capital maintenance; and increasing costs of services and commodities. The city manager also identified specific initiatives and possible future solutions to address the budget problems including ways to manage growing public safety needs, identifying dedicated revenue sources for city programs, and looking at reforming the city's revenue structure. Although these strategies can be helpful to the city, without clear

[12] The condition or state that one is striving to achieve. Usually long-term and may be beyond what might reasonably be expected to achieve.
[13] A statement of the condition one expects to achieve. An objective should be realistic, measurable, generally within the control of the organization, and time constrained.

direction and prioritization from the City Council these efforts might be less effective.

Priority Setting Should Occur Early in Budget Process

Currently the City Council budget priority sessions could occur too late in the budget process to provide guidance to the city manager and departments when developing the budget. The current budget process requires that the City Council meets on or before November 15 of each year to consider funding priorities, which is the same date the city departments submit their budget requests to the city manager.[14] As a result, when departments begin budget preparations, they may do so without adequate information as to what Council and stakeholder concerns, needs, and priorities are for the upcoming year.

To assist the city manager and department staff in evaluating and developing programs, improving the allocation of resources, and preparing their budget requests, the City Council could establish multi-year goals, funding priorities, and annual objectives at the beginning of the budget process or earlier in the fiscal year. The City Council should consider conducting its budget priority sessions before the city manager and departments begin the annual budget process. The city code should be revised to reflect this change.

Local and State Governments Explore New Approaches to Balance Budgets

While many governments have used more traditional measures to deal with budgetary shortfalls, some local and state governments are taking steps to find creative ways to deal with fiscal challenges such as budgeting for results and outcomes. With resources linked to objectives, the focus shifts to outcomes.

Budgeting for Results and Outcomes Integrates Performance in the Budget Process

Budgeting for results and outcomes integrates performance with the budgetary process. GFOA recommends that governments consider budgeting for results and outcomes as a practical way to achieve the NACSLB objective of integrating performance into the budgetary process. Budgeting for results and outcomes identifies available revenues and desired results then decides which activities or programs

[14] Code of Ordinances, Article III, Section 2.52 and City Charter, Article VIII, Section 803.(a). Section 2.52 of the code was revised by Ordinance 071195 on November 20, 2007, which outlined a revised budget process timeline.

can best achieve the desired results. This approach links strategic planning, long-range financial planning, performance measures, budgeting, and evaluation. With resources linked to objectives, the focus is on outcomes rather than organizational structure.

GFOA's Eight Steps to Budgeting for Results and Outcomes

1. Determine how much money is available.
2. Prioritize results.
3. Allocate resources among high priority results.
4. Conduct analysis to determine what strategies, programs, and activities will best achieve desired results.
5. Budget available dollars to the most significant programs and activities.
6. Set measures of annual progress, monitor, and close the feedback loop.
7. Check what actually happened.
8. Communicate performance results.

Source: Recommended Practice: *Budgeting for Results and Outcomes*, GFOA, 2007.

Budgeting for Outcomes Emphasizes Accountability

Budgeting for outcomes is an approach that could help deliver results at the price citizens are willing to pay. Some state and local governments across the country are adopting new approaches to budgeting. One approach, advocated by Osborne and Hutchinson, is budgeting for outcomes, which was introduced several years ago.[15] The budgeting for outcomes approach consists of seven core steps and should involve various stakeholders to be successful.

Core Steps of Budgeting for Outcomes

1. Set the price of local government.
2. Set the priorities of government.
3. Set the price of each priority.
4. Develop a purchasing plan for each priority.
5. Solicit offers from providers to see who can deliver the desired results.
6. Buy the best, leave the rest.
7. Negotiate performance agreements with the chosen providers.

Source: *Budgeting For Outcomes: Better Results for the Price of Government*, International City/County Management Association, 2004.

The potential benefits of budgeting for outcomes are focusing on programs kept, not programs cut and ensuring that the 90 percent of the budget that will continue to be spent buys as much for citizens as

[15] Budgeting for outcomes approach was introduced by David Osborne and Peter Hutchinson, authors of the book *The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis* published in 2004.

possible. Budgeting for outcomes also produces a budget document that allows the organization to:

- Buy results, not costs;
- Put the general interest of citizens first, before any special interests;
- Emphasize performance accountability;
- Promote continual reform and improvement; and
- Communicate in common-sense language.

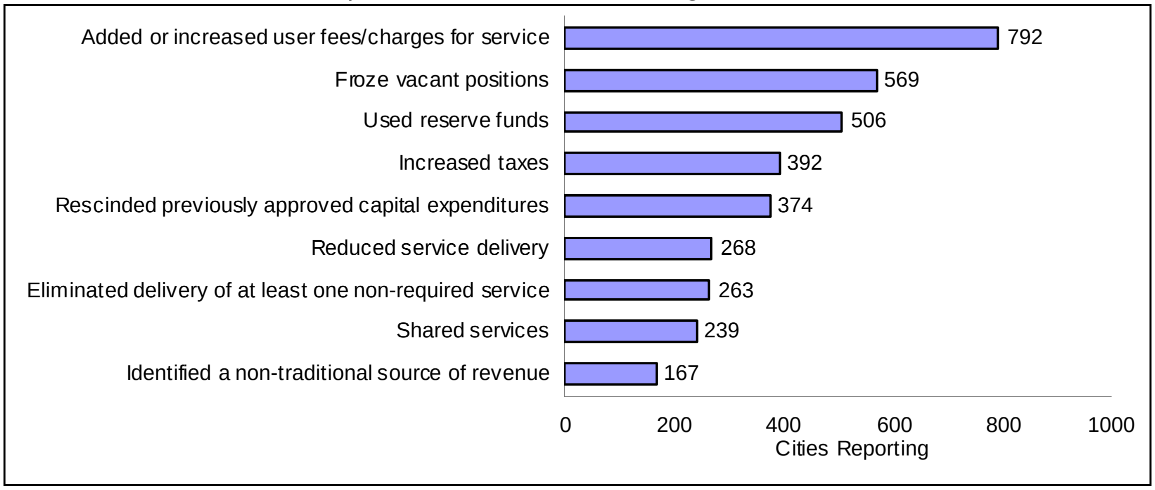
Success of the approach depends on involvement of various stakeholders. The approach should involve:

- Citizens who would provide advice or feedback on the process;
- Knowledgeable people from agencies involved in the relevant policy area;
- Members of the budget and finance staff;
- Staff whose role is to solicit feedback from citizens and employees;
- A strategic team to provide overall guidance, training, and feedback to each team in the development of its specific deliverables; and
- Elected officials and chief executives who retain their traditional role of making ultimate decisions on what to include in the budget, however they should confirm that they would follow recommendations emerging from the process. Elected officials should look at the cause-and-effect theories and scrutinize program rankings to decide whether the programs chosen are truly the ones most likely to achieve the desired results.

Local Governments Handle Budget Shortfalls in Different Ways

Many governments increased user fees and froze vacant positions to deal with fiscal challenges. Kansas City's budget situation is not unique as other jurisdictions have had to deal with shortfalls or structurally imbalanced budgets. The International City/County Management Association conducted a survey in 2003 to find out how local governments were responding to cutbacks in state aid and other financial pressures and what actions were implemented or considered to address budget shortfalls. (See Exhibit 14.) Two measures were reported by at least 50 percent of the survey respondents: adding or increasing user fees and freezing vacant positions.

Exhibit 14. How Other Municipalities Have Dealt With Budget Shortfalls



Source: *Budget Shortfalls: How Some Local Governments are Responding*, International City/County Management Association, 2004.

When adding or increasing fees and charges, some local governments reported an across-the-board increase while others reported increases in specific programs such as permits, inspections, recreation activities, and solid waste collection. Other cities increased their property, sales, or telecommunications taxes. Several local governments said they postponed or rescinded previously approved capital expenditures for public works, roads, and vehicle purchases. Reported service reductions included fewer operating hours and recreation services. Cultural events, parks and recreation activities, and tree planting were reported as non-required services that were eliminated. Services shared by local governments included animal control and 911 services. Non-traditional revenues identified by some of the cities included contracting services to neighboring municipalities, donations for capital improvement projects from interested groups, and auctioning property.

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Recommendations

1. The city manager should submit a draft policy on the appropriate level of general fund balance and a strategy to rebuild the fund balance to the required level to the City Council.

2. The city manager should evaluate the feasibility of changing the city's pension systems to a defined contribution system as well as consolidating the four pension systems.

3. The city manager should present the consultant's report on the impact of other post-employment benefits and a strategy for addressing the liability to the City Council as soon as possible.

4. The city manager should address the sunset of the public safety and fire sales taxes and develop a plan to manage growing public safety expenditures.

5. The city manager should adopt GFOA recommended practices for capital project monitoring and reporting and develop strategies to address the gap in maintenance of city assets.

6. As directed by Resolution 011726, the city manager should analyze and project the future impact TIF/STIF reimbursements will have on city revenues.

7. The city manager should continue efforts to reduce debt risks and closely follow the established debt and economic development policies.

8. The city manager should direct staff to begin quantifying the impact of under-budgeted costs on the city's long-term financial condition.

9. The city manager should draft and submit a comprehensive set of financial policies, as recommended by the Government Finance Officers Association and the National Advisory Council on State and Local Budgeting, to the City Council.

10. The city manager should ensure that the Comprehensive Annual Financial Report is presented to the City Council within the timeframe required by the city charter.

11. The City Council should consider conducting its priority sessions before the city manager and departments begin the annual budget process and revise the city code to reflect this change.

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