Advisory Working Group Memo Template

Advisory Working Group Name: Financial Contingency Planning
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<u>Objectives</u>:

- Identify the legal authorizations and approvals required to establish a permanent financial contingency fund.
- Determine the recommended size of the fund and evaluate potential sources of funding.
- Develop set of rules that would govern the establishment and usage of the fund.

<u>State of Play</u>:

- Santa Fe's ability to generate revenues to meet operating and debt service needs is significantly dependent on GRT collections - 69% of the 2018/19 budget.

- GRT revenues are seasonal and highly cyclical. When the economy slows down, tax collections decline—but the need for important public services (especially services for low and middle-income taxpayers) continues, resulting in short-term budget deficits.

- Establishing a **financial contingency fund or "rainy day fund" (RDF)** helps smooth out cyclical highs and lows by setting aside surplus revenue generated in good years or proceeds from other specified funding sources to offset shortfalls from revenue declines in bad years.

- In addition to mitigating the volatility of sales tax income and the city's vulnerability during an economic downturn, the city should also examine potential financial exposure to unexpected emergencies such as repairing or replacing public infrastructure (buildings, bridges, storm drains etc.) that fails unexpectedly or is damaged or destroyed by a natural disaster.

- Either a separate fund dedicated to cover emergency infrastructure expenses or an increase in the size of a single RDF may be appropriate. Analysis should include evaluation of the vulnerability of the city's infrastructure to major losses, assessment of the replacement cost of the city's infrastructure, and the amount of insurance or other reserves available to offset disaster-driven losses. Analysis for this contingency was considered to be beyond the scope of our mandate.

<u>Action Items</u>:

- **Fund Structure** – We recommend establishing a local government permanent fund as authorized and described in New Mexico state statute 6-6-19. A resolution establishing this fund and the terms governing its use would have to be approved by a majority of registered voters. The legal path and precedent for creating such a fund is established in state law and offers the clearest path to successful completion.
- **Fund Size** - We recommend an RDF equal to 20%-25% of annual general fund revenues. Although the city maintains a reserve of 10% of annual fund expenditures, which is 1.7% greater than the 8.3% required by the state, a larger reserve is prudent given the city's reliance on volatile GRT collections. This reserve would have been adequate to cover the $20 million or 21% decline in GRT revenue between 2008/2010 and could have helped mitigate the revenue shortfalls in the last recession when it took 10 years for GRT revenue to return to its previous high of 2007. Our

recommendation is consistent with debt rating agency "best practices" and exceeds the 16% reserve that the Government Finance Officers Association considers to be a baseline minimum.
- **Source of Funding** - State law dictates that funds deposited into the local government permanent fund must be sourced from the unappropriated general fund surplus generated in any fiscal year that is in excess of fifty percent of the prior fiscal year's budget. Although it may be possible to draw funds from existing enterprise funds, proceeds from asset sales, or other dedicated taxes or use fees, our preliminary assessment is that routing funds from such sources through the city's general fund and capturing them through the resulting unappropriated surplus would be the path of least resistance.
- **Fund Usage Rules and Requirements** - Conditions under which withdrawals can be made and for what purpose should be clear, codified into law, and tied to significant measurable declines in revenue. Designing rules that govern fund use is a balancing act. When withdrawals are fairly unrestricted, entities may make shortsighted use of funds and have insufficient funds available when emergency strikes. When the rules are too restrictive, the city may be unable to access reserves when they are most needed. Rules for replenishment should also be enacted.

  One approach to consider is instating a trigger to automatically authorize use of the RDF if revenue collections in any fiscal year fall below the prior 3-year running average ***and*** a budget gap exists for the current year. (NOTE: Measuring revenue decline vs. a 3-year average is a volatility trigger and the gap to current year budget is a forecast error trigger. The double trigger is important, as it avoids authorization of a draw if the decline in revenue is anticipated and the city is able to respond to the lower budgeted revenue using other means such as cost cutting. In addition, the formula for calculating the revenue decline must be indexed to remove any income fluctuations caused by changes in taxation policy.)

Supporting action steps:

- Work with the office of the city attorney to develop a process and timeline for implementing a plan to seek voter approval to establish the fund.
- Consider various funding sources (increase in property taxes, asset sale proceeds, increase in fees for services, collection of outstanding receivables etc.) to create the surpluses necessary to fund the RDF over time.
- Analyze the city's exposure to event-related risks and determine whether or not to address those risks and, if so, to do so through an increase in the size of the permanent contingency fund or a separate dedicated fund.
- Develop an investment plan for the funds assets that is consistent with the fund's purpose and state statutes.

Viewpoints:

There are many legal, financial and political issues to be evaluated in the process of developing and implementing a viable plan for an RDF. Appropriate members of the city's legal and finance staff, the city council, and the city's bond counsel should be consulted and made part of this process.

Process:

6-month:
Assess city's risk associated with catastrophic events and evaluate risk mitigation alternatives eg. insurance, emergency fund, etc.
Finalize determination of fund(s) size.
Finalize choice of fund(s) structure and determine required state and local authorizations.
Finalize determination of source of funding and projected timeframe for achieving funding goal..
Develop detailed plan and timeline for implementing fund approval process

9-month:
Secure necessary approvals from state and local governing bodies.
Prepare voter approval documents and conduct approval referendum.
Incorporate contingency fund funding goals into the annual budgeting process.

12-month:
City finance staff to incorporate fund monitoring and fund authorization triggers into its financial reporting to the mayor and city council.

<u>4-year vision:</u>

The city will have a fully funded voter approved contingency fund and documented processes for utilizing it to protect the city from disruptions caused by significant unexpected shortfalls in revenue collections and/or unexpected emergencies.

<u>Resource People</u>:

Michael Belsky, Executive Director for Municipal Finance, Harris School of Public Policy, The University of Chicago
Richard Anklam of the New Mexico Tax Research Institute
Jon Clark, Chief Economist for the New Mexico Legislative Finance Committee
The Government Finance Officers Association