

City of Flagstaff Expenditure Limitation and Permanent Base Adjustment

Background:

What is the City “expenditure limitation”?

The expenditure limitation is the maximum amount that the City may spend each year, even if it has more money available to spend. The expenditure limitation is recalculated by the State on an annual basis. For FY 2019-20 the City’s expenditure limitation is \$162,133,141.

Why is there a limitation?

We have an expenditure limitation because in 1980 Arizona voters approved an amendment to the Arizona Constitution, that set an annual expenditure limitation on all cities, counties, towns, and community college districts. The purpose of the expenditure limitation is to limit spending.

How is the expenditure limitation calculated?

The formula for calculating the expenditure limitation is found in the Arizona Constitution, Article IX, Section 20: the limitation “shall be determined by adjusting the amount of actual payments of local revenues for [the City] or fiscal year 1979-1980 to reflect the changes in the population of [the City] and the cost of living. The City “base expenditure limitation” was \$15,122,966 in 1980. Our current base limitation is \$22,522,966. The state Economic Estimates Commission (EEC) uses the base limitation to calculate our annual expenditure limitation by evaluating changes for population and inflation, per A.R.S. § 41-563.

Is there is a process for changing the expenditure limitation?

If a municipality needs to spend more revenues to meet community needs, the expenditure limitation may be changed by approving a “permanent base adjustment” under the Arizona Constitution, and A.R.S. § 41-563.03. At least 2/3 of the City Council members must pass a resolution referring the question to the voters. The City will then send a detailed analysis to State Auditor General. After the State Auditor General’s review, the question will be put on the ballot. A permanent base adjustment must be approved by a majority of the qualified electors voting in an election. Permanently increasing a city’s base expenditure limitation often is necessary when there is an increase in revenue, like the addition or increase of a city tax for example.

What happens if the City were to exceed the expenditure limitation, without authorization?

If the City were to exceed its expenditure limitation without authorization, the State will withhold shared income tax revenues from the City as follows:

- If the City’s excess expenditures are less than 5 percent of the limitation, the amount withheld is equal to the excess expenditures.
- If the excess expenditures are between 5 percent and 10 percent of the limitation or are less than 5 percent of the limitation but it is at least the second consecutive instance of excess expenditures, the amount withheld is equal to 3 times the excess expenditures.
- If the excess expenditures are equal to 10 percent or more of the limitation, the amount withheld is equal to 5 times the excess expenditures or one-third of its allocation of State income tax, whichever is less.

In case of disaster, however, that penalty would not apply.

Has the City changed its expenditure limitation in the past?

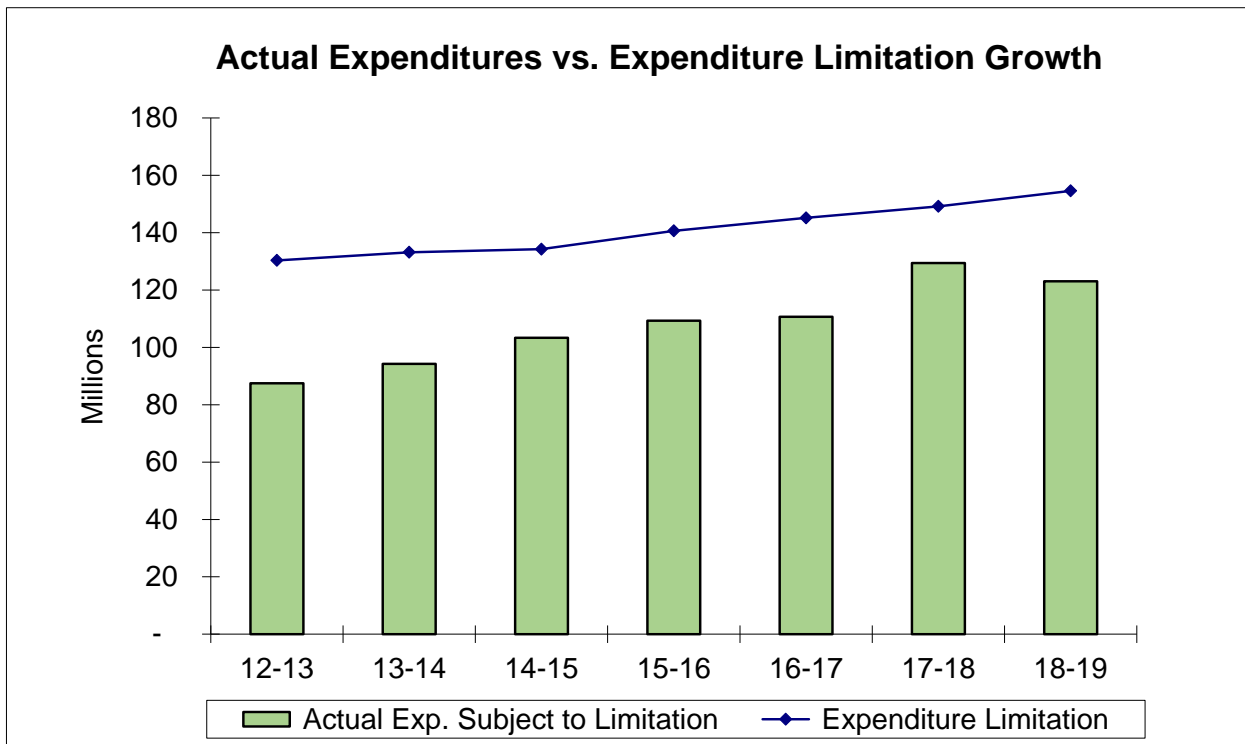
The City has been able to change its expenditure limitation in the past.

- In 1988 the City received a permanent base adjustment of \$1.9 million to allow for the expenditure of funds resulting from the addition of the 2% Bed, Board & Beverage tax.
- In 2006 the City received a permanent base adjustment of \$5.5 million which increase the total FY 2006-2007 expenditure limitation by \$25 million due to a 49.8% increase in primary property tax collections, a 26.4% increase in City sales tax, a 34.1% increase in auto lieu tax, a 37.4% increase in pay-as-you go capital, and an \$8 million increase in transportation tax.

Actual Expenditures vs. Our Expenditure Limitation – the Gap is Shrinking

As you can see from the graph below, City expenditures have grown by an average of 6% since 2012-2013, with a range of \$35.6 million. The growth is in both governmental and enterprise funds. In the same period, the maximum expenditure limitation only grew by an average of 3% with a range of \$24.2 million. In 2012-2013, a \$42.8 million gap existed between the City’s expenditure limitation and reconciled expenditures. The gap has gradually decreased and for 2017-2018, it was \$19.7 million. For 2018-2019, the gap was \$31.5 million. The gap increased in FY2018-2019 due the timing of key capital projects. We anticipate the gap to shrink further in FY2019-2020.

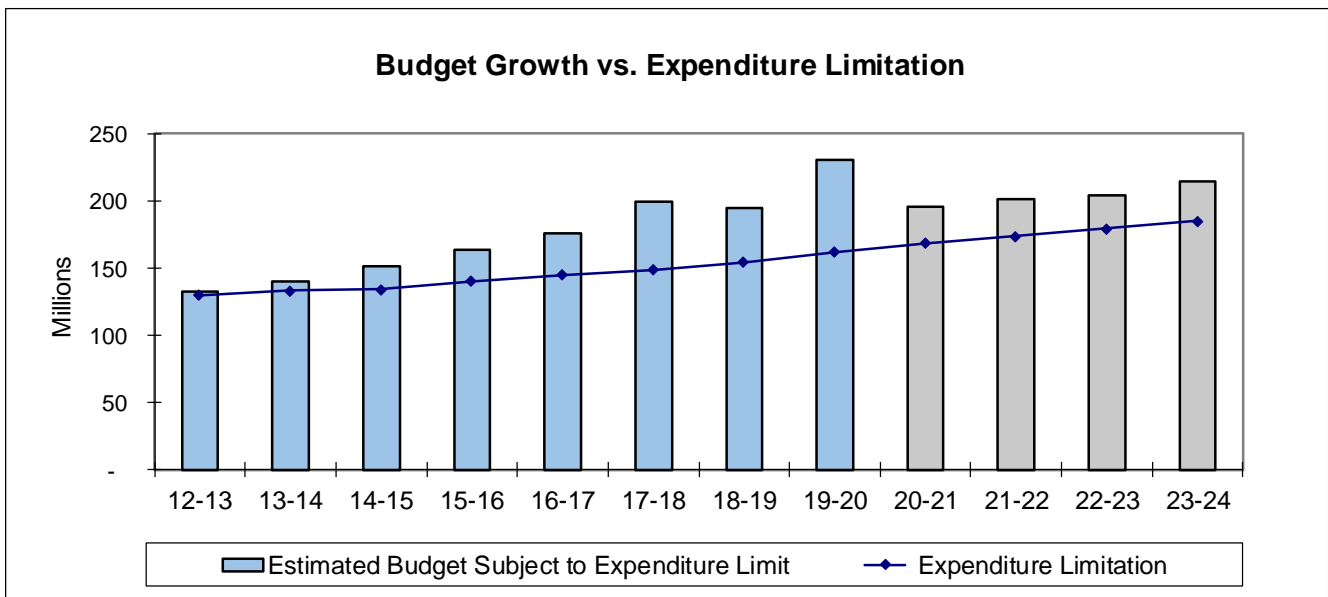
The City may be at risk for exceeding the expenditure limitation in the next few years, unless it slows down work on the pay as you go capital improvement project work using tax revenues approved by voters and/or Council approved fee increases.



The process of calculating the amount of City expenditure for the expenditure limitation report consists of reconciling base operating expenditure amounts by adding certain categorical items including capital and debt principal payments, deducting depreciation, bad debt, landfill post-closure costs, and

finally excluding bond proceeds, debt service requirements, grants, some Highway User Revenue Fund revenue, and contract revenue with other political subdivisions.

The graph below reflects the total operational budget, which consists of operating expenses, equipment, and pay-as-you-go capital. Debt and grant funded capital and other certain expenditures are not shown as they are excludable on the expenditure limitation. The graph indicates the possible risk of expenditure limitation increases each year especially in FY 2019-2020 (\$69 million over) and into the future. Since FY 2012-13, The City’s overall budget growth has been 37%, or over \$90.7 million. Furthermore, the operating budget increased 46% or \$41.5 million and pay as you go capital increased 135% or over \$56 million since 2013. Conversely, the expenditure limitation has only grown by 24% or \$31.8 million. The future year projections are based on overall budget growth at 5% per year; pay as you go capital as depicted in the FY 2019-2020 budget 5-year capital plan; and expenditure limitation growth at 3.2% based on average increase since FY2012-13. These budget projections for FY 2020-21 through FY2023-24 average approximately \$27 million over the estimated expenditure limitation.



Since 2006, the City has adopted the following new revenues and taxes or experienced significant increases in expenditures that is causing the budget to exceed the expenditure limitation. They total \$45.9 million and include:

- New Road Repair & Street Safety taxes - \$7 million
- New Parking District - \$1.5 million
- Stormwater increase - \$3.6 million (since FY 2005-2006)
- Water Service Rate increases \$14.1 million (since FY 2005-2006)
- Flagstaff Housing Authority - \$1.9 million
- New Butler/Route 66 Bridge taxes - \$4.8 million
- Pension cost increase \$13 million (since FY 2005-2006)

As of FY 2018-2019, the City has accumulated carryforward amounts that can be used to abate exceeding the expenditure limitation. However, in evaluating longer term scenarios, the carryforward is likely not adequate to cover long term overage in the expenditure limitation. The current carryforward amounts are:

| | |
|--------------------|--------------|
| Governmental Funds | \$37,854,384 |
| Enterprise Funds | \$19,022,674 |
| Fiduciary Funds | \$835,149 |

Conclusion and Recommendation:

Due to increases in both operating and pay-as-you-go capital which are supported by local tax and other revenue increases, the City needs to permanently increase its base expenditure limitation to avoid invoking future penalties which could have significant revenue implications.

It is recommended that:

- The City request an additional \$4.0 million base adjustment as related to increases in local tax and other revenue increases as listed previously. This base adjustment would subsequently increase the expenditure limit \$30 million to an estimated \$205 million for FY 2021-2022.
- Ask the Flagstaff voters whether or not they wish to approve a permanent base adjustment to our expenditure limitation, for consideration at the August 4, 2020 election.

Next Steps:

1. City Council adopts a resolution for a permanent base adjustment.
2. A summary analysis and detailed analysis must be submitted to the Auditor General by the City at least 60 days before printing the publicity pamphlet and the election.
3. A review must be completed within 15 working days once received. Additional information may be requested by the Auditor General to clarify or correct the analyses. No revision may be made to the documents after the Auditor General review.
4. The City must provide a publicity pamphlet presenting the proposed permanent base limit adjustment to be voted upon.

A tentative timeline for this process is reflected below:

| Sample Timeline | | | | | | |
|--|--------------|--------------|------------|-------------|-------------|---------------|
| | March | April | May | June | July | August |
| Present to Council | | | | | | |
| Forward information to Auditor General | | | | | | |
| Receive response from Auditor General | | | | | | |
| Complete/mail publicity pamphlet | | | | | | |
| Election | | | | | | |