

# FY 2010 BUDGET FIRST QUARTER REPORT



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# Summary

## ECONOMIC CONDITIONS

**Unemployment (page 11):** The W.E. Upjohn Institute's 2010 First Quarter Outlook forecasts a drop of 1.2 % in employment compared to 2009 levels for the 2010 forecast.

2009 unemployment levels ended the year at 12.3% and positioned the Kalamazoo-Portage Metropolitan Statistical Area as the third best labor market in the state according to the WE Upjohn quarterly report.

Leading indicators suggest that the economy is gaining positive momentum and while the numbers still point negative in the near term, job losses seem to have slowed and businesses have been adding new jobs. Productivity also has slowed significantly in April 2010, which may presage job growth,

**Auto Sales (page 17):** In the State of Michigan, April 2010 vehicle production is up nearly 48,000 units over April 2009 while January – April 2010 production is up nearly 131,000 vehicles produced over the same period in 2009. These statistics point to increased demand with a direct benefit to Michigan and the "Detroit Three" manufacturers. Less than two dozen units were produced by non-Detroit Three companies.

**Consumer Price Index (page 18):** Deflation has dropped from the list of likely scenarios, leaving potential inflation or stagflation:

1. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;
2. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.

**Stock Market (page 20):** The current assumption is that domestic and global equities are now more than 1 year into a sustained growth cycle. It would be pure speculation to try and predict whether the long-term trend will approach that of the last 25-75 years or not.

**Construction Activity (Page 22):** The economy has been expanding since the 3<sup>rd</sup> Quarter of 2009, but construction activity is still lagging. Construction is generally a "coincident" indicator of economic activity, so this seeming disconnect may be an indicator of weak economic growth and/or latent and leftover overcapacity in industrial, commercial and housing facilities from the last economic cycle.

**Mortgage Rates (page 24):** The pending sunset of federal tax credits for first-time homebuyers on April 30<sup>th</sup> accelerated purchases while lenders increased mortgage rates, as seen in the long range graph. It is anticipated that more traditional lending standards will increase mortgage rates.

**Pension (page 27):** At the assumed 7.5% Rate of Return, the City would be required to contribute more than \$350 thousand to the Pension Trust Fund in 2028, and \$1.5 million in 2029. This amount would continue to increase indefinitely. Changes in the smoothing policy do not appear to be advisable at this time, although we will revisit this issue periodically.

## REVENUE

**General Fund Total Revenue, end-of-year 2009:** the final pre-audited revenue for 2009 is \$52.5, as opposed to the \$52.9 million projected for establishing the beginning fund balance for FY 2010 – 11. This is a \$400 thousand loss versus the FY 2010 – 11 Budget fiscal plan.

**General Fund Total Revenue, 1<sup>st</sup> Quarter 2010:** the amount of revenue for the 1<sup>st</sup> Quarter of 2010, net of interfund transactions, was \$4.1 million. The revenue for the same period in 2009 was \$3.5 million.

**Projected General Fund Total Revenues for 2010** is \$51.75 million, which is roughly \$40 thousand less than the FY 2010 budgeted amount of \$51.79 million. In addition to the items outlined below, we are also anticipating \$100 thousand of new CDBG grant dollars for the construction of LaCrone Park, which would offset programmed General Fund dollars for that project to finance part of the increase in the Summer Youth Program.

**Projected General Fund Total Revenues for 2011** is \$51.33 million, which is \$140 thousand less than the FY 2010 budgeted amount of \$51.47 million.

**Property Taxes (page 29):** The final FY 2010 Assessment Roll will create a \$290 shortfall in tax revenues when compared to the FY 2010 budgeted amount.

- **2011 Residential:** At this point, the data points to a projected 3% drop in Taxable Value. This would amount to a \$500 thousand loss in General Fund revenue.
- **2011 Commercial/Industrial:** sales of commercial property for the first 6 months of the study period (October 2009 - March 2010) are directly on track with 2010 values. Current nominal inflation would project a slight increase in commercial property Taxable Value.
- **2011 Personal Property:** annual depreciation of personal property assets will create a projected loss of \$7 million of Taxable Value. At this time, we are not projecting any offset based on new equipment purchases. This would amount to a \$100 thousand loss in General Fund revenue.

The projection for FY 2011 is for a decrease of roughly \$900 thousand in tax revenue versus what was projected in the FY 2010 – 11 Budget, inclusive of the \$290 thousand shortfall in FY 2010 repeated in FY 2011, plus roughly \$500 thousand of loss based on the projected drop in residential value and \$100 thousand of projected losses in personal property.

**Stated Shared Revenue (page 34):** now that the State House of Representatives has passed a 1% increase, and the State Senate's Appropriations Committee has passed a 4% decrease, and Governor Granholm has adopted a preference for no change, it seems prudent to use the 5% decrease assumption above, which would also allow a little negative buffer in case of payment timing issues. This would result in an improvement of \$38 thousand for FY 2010, and \$755 thousand for FY 2011 over FY 2010 – 11 Adopted Budget projections.

**Act 51 Revenue (page 36):** A shortfall of roughly \$60 - 80 thousand of Act 51 revenue is projected in the City's FY 2010 Major and Local Street Funds as compared to their combined FY 2010 Adopted Budget amounts for Act 51 revenue. Shortfalls in the road funds would have to be made up by reductions in road service levels and/or additional appropriations from the General Fund.

**Interest Income (page 36):** The General Fund should be on target to receive the budgeted amount of interest earnings in 2010 versus the Adopted 2010 Budget.

## EXPENDITURES

**General Fund Total Expenditures, end-of-year 2009:** the final pre-audited expenditures for 2009 is \$53.2, as opposed to the \$52.9 million projected for establishing the beginning fund balance for FY 2010 – 11. This is a \$300 thousand negative variance versus the FY 2010 – 11 Budget fiscal plan.

**General Fund Total Expenditures, 1<sup>st</sup> Quarter 2010:** the amount of expenditures for the 1<sup>st</sup> Quarter of 2010, net of interfund transactions, was \$9.6 million. The expenditures for the same period in 2009 was \$9.6 million.

**Projected General Fund Total Expenditures for 2010:** the current projection for General Fund expenditures is \$52.8 million, compared to the FY 2010 -11 budgeted amount for FY 2010 of \$52.7 million, a \$100 thousand net increase. This includes current projected savings listed below of roughly \$500 thousand in energy, overtime, travel/conferences and telephones, offset by anticipated increases of \$150 in the Summer Youth Initiative (as State funding has not materialized), and \$500 in decreased positive vacancy variance, based on the overall reduction of staff and related vacancy savings.

**Projected General Fund Total Expenditures for 2011:** the current projection for General Fund expenditures for FY 2011 is \$53.7 million, as compared to the FY 2010 – 11 budgeted amount for FY 2011 of \$53.2 million, an increase of \$500 thousand, due to the aforementioned decreased positive vacancy variance, based on the overall reduction of staff and related vacancy savings.

**Health Care (page 38):** Savings realized since FY 2007 have created an unencumbered balance of \$4.5 million in the City's internal Insurance Fund. Other opportunities exist for the City to realize significant health care savings. Chief among them is mandating participation among KPSA and KPSOA retirees in the federal Medicare Part B program (which is currently optional in the respective collective bargaining agreements for these groups). Savings of 5% of the City's annual retiree health care cost could be realized by this one change alone.

**Energy (page 39):** General Fund energy totals \$391 thousand for the first quarter of 2010, a 14% reduction versus the 1<sup>st</sup> Quarter of 2009. If the last three quarters see the same percentage reduction as the 1<sup>st</sup> quarter, projected over time for 2010 would total \$275 thousand less than the budgeted amount for 2010. If the same dollars for energy are spent as were spent for the last three quarters of 2009, the General Fund will save \$139 thousand versus the budgeted amount for 2010.

**Overtime (page 39):** Public Safety OT: Public Safety overtime totals \$182 thousand for the first quarter of 2010, a 12% reduction versus the 1<sup>st</sup> Quarter of 2009. If the last three quarters see the same percentage reduction as the 1<sup>st</sup> quarter, the projected overtime for 2010 would total \$169 thousand less than the budgeted amount for 2010. If Public Safety spends the same dollars in overtime as it did for the last three quarters of 2009, it will spend \$39 thousand more than budgeted in 2010.

**Travel/conferences (page 39):** The projected amount for 2009 is roughly \$83 thousand, compared to the budgeted amount of \$219 thousand. This projects to a budgetary savings of \$136 thousand for 2010.

**Telephones (page 40):** If the same percentage increase is realized for the rest of the year as in the 1<sup>st</sup> Quarter, the total amount of projected expense would be roughly \$82 thousand less than budgeted for 2010. If however the same amount of dollars are spent for the rest of the year as was spent for the same period in 2009, savings would total \$113 thousand versus the budgeted amount for 2010.

## NET REVENUE

**Net revenue for the 1<sup>st</sup> Quarter of 2010** is \$5.5 million.

**Net projected revenue for 2009** is negative \$725 thousand, as compared to the \$0 net revenue in the FY 2010 – 11 Adopted Budget for FY 2010. This is a net change of negative \$725 thousand.

**Net projected revenue for 2010** is negative \$1.05 million, as compared to the negative \$900 thousand in the FY 2010 – 11 Adopted Budget for FY 2010. This is a net change of negative \$150 thousand.

**Net projected revenue for 2011** is negative \$2.34 million, as compared to the negative \$1.7 million in the FY 2010 – 11 Adopted Budget for FY 2011. This is a net change of negative \$640 thousand.

**Total net projected revenue for 2009 – 11** is negative \$4.1 million, as compared to the negative \$2.6 million in the FY 2010 – 11 Adopted Budget for FY 2011.

**The above analysis totals to a net revenue change of negative \$1.5 million for FY 2009 – 2011, as compared to the FY 2010 – 11 Fiscal Plan.**

## RESERVES

### GENERAL CIP RESERVES

\$2.2 million of capital reserves, comprised of:  
    \$1.575 million in capital bond reserves;  
    \$625 thousand in capital cash reserves.

### GENERAL FUND RESERVES

\$2.2 million of health care savings accumulated in the Insurance Fund due to the General Fund.

\$1.95 million of Budget Stabilization and Capital Contingency reserves.

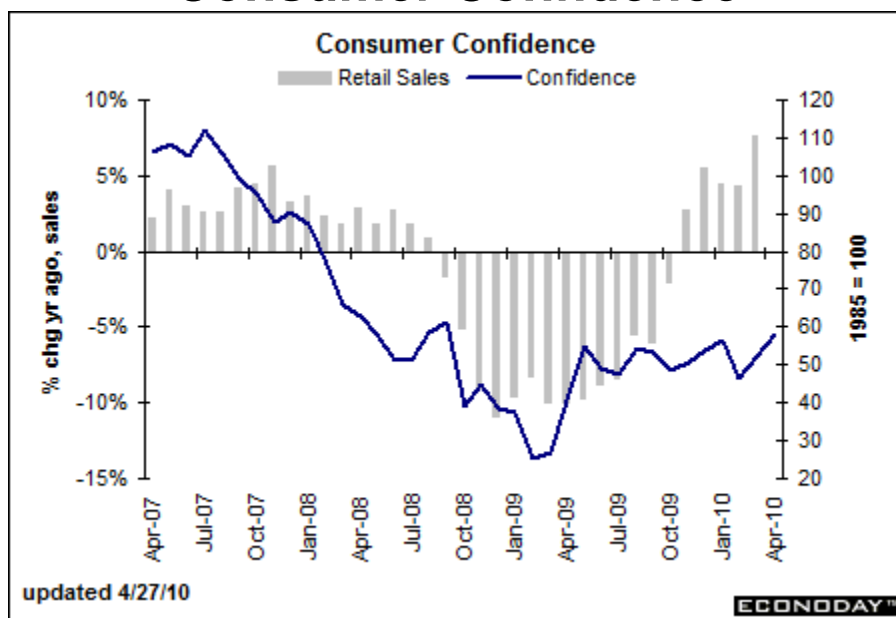
\$900 thousand of fund balance beyond the 13% minimum Commission policy requirement.

**TOTAL UNENCUMBERED RESERVES AVAILABLE TO THE GENERAL FUND AS OF 1/1/2010: \$7.3 MILLION**

These amounts have been programmed in the FY 2010 – 11 Budget to stabilize against unforeseen circumstances, as well as to “smooth” the budget as it approaches the new fiscal “normal”, in order to maintain service levels to the greatest degree practicable.

# Consumer Indicators

## Consumer Confidence



<http://mam.econoday.com/showimage.asp?imageid=19081>  
Source: Econoday.com

**Table 1**  
**Description**

The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. Questions focus on respondents' outlook on their economic condition, the general economic condition, the business environment and employment. This is a lagging indicator.

### Expert Testimony

The slide seen in the mid-month consumer sentiment index is not confirmed by the Conference Board's consumer confidence report which rose strongly for a second straight month, up about 5-1/2 points in April to 57.9. The gain is centered in expectations which jumped 7 points to 77.4, reflecting rising optimism over business conditions and easing pessimism for employment and income.

The assessment of the present situation also improved with the index rising more than 3-1/2 points but to a still severely depressed level of 28.6. But pessimism is easing with fewer describing current business conditions as bad and fewer describing jobs as hard to get (45.0 percent vs. March's 46.3 percent).

Other details show a jump in buying plans for cars and major appliances though buying plans for homes are still under water. Inflation expectations, despite the month's rise in gasoline prices, eased slightly.

This report is very positive, in line with gains seen underway in the retail sector and hinting at solid improvement for April payrolls.

- Econoday.com, April 27, 2010

Says Lynn Franco, Director of The Conference Board Consumer Research Center: "Consumer confidence, which had rebounded in March, gained further ground in April. The Index is now at its highest reading in about a year and a half (Sept. 2008, 61.4). Consumers' concerns about current business and labor market conditions eased again. Their outlook regarding business conditions and the labor market was also more positive than last month. Looking ahead, continued job growth will be key in sustaining positive momentum."

Consumers' appraisal of present-day conditions was more positive in April. Those claiming conditions are "good" increased to 9.1 percent from 8.5 percent, while those claiming business conditions are "bad" declined to 40.2 percent from 42.1 percent. Consumers' appraisal of the labor market also improved. Those saying jobs are "plentiful" increased to 4.8 percent from 4.0 percent, while those saying jobs are "hard to get" decreased to 45.0 percent from 46.3 percent.

Consumers' outlook was brighter in April. The percentage of consumers expecting business conditions will improve over the next six months increased to 19.8 percent from 18.0 percent, while those expecting conditions will worsen declined to 12.6 percent from 13.6 percent.

Consumers were also more optimistic about the job outlook. The percentage of consumers anticipating more jobs in the months ahead increased to 18.0 percent from 14.1 percent, while those anticipating fewer jobs declined to 20.0 percent from 21.4 percent. The proportion of consumers anticipating an increase in their incomes declined to 10.3 from 10.8 percent.

- *Conference-Board.org, April 27, 2010*

The April reading, released Tuesday, is the highest since September 2008's 61.4, before the index headed into freefall following the bankruptcy of Lehman Brothers and ensuing cascade of financial collapse.

Still, the reading is well below the 90 that's considered healthy.

More consumers in the Conference Board survey said they planned to buy autos or appliances, but plans to buy homes fell from March, suggesting the housing market remains uncertain and could be a drag on a robust economic recovery.

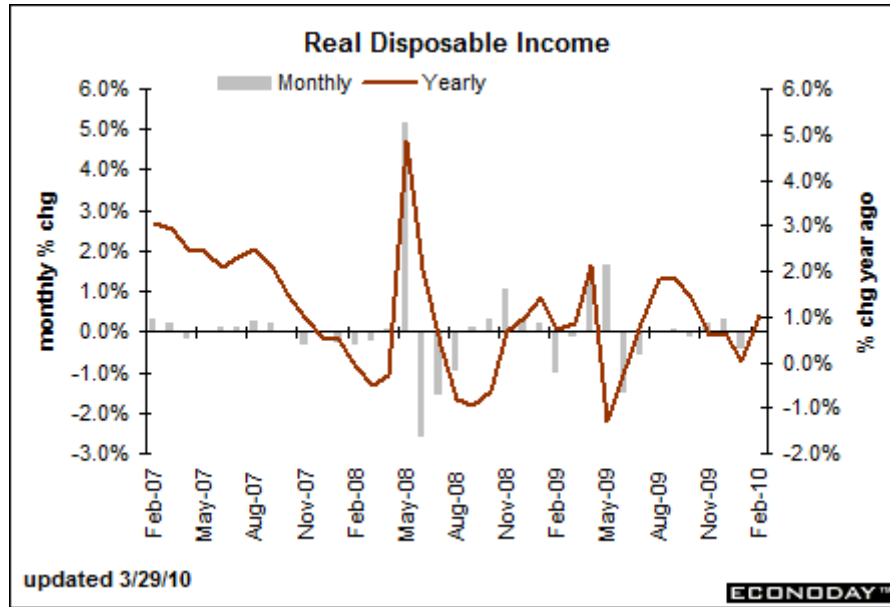
- Anne D'Innocecenzio / Associated Press The Detroit News: 4-28-2010

<http://www.detnews.com/article/20100428/BIZ/4280338/1001/Economy-shows-signs-of-strength#ixzz0mPvBhwt9>

## Looking Ahead

Overall advances over the last year have been slow and uneven. As a lagging indicator, consumer confidence will not show gains into positive territory (over 80) until the public feels that the recovery is well underway, which will likely be after business investment and jobs begin recovering.

# Disposable Income



Source: Econoday.com

**Table 2**  
**Description**

Changes in taxes or social security cost of living adjustments can cause some sharp variations in monthly disposable income growth. However, on the whole, monthly changes in disposable income fluctuate less than monthly changes in personal consumption expenditures.

## Expert Testimony

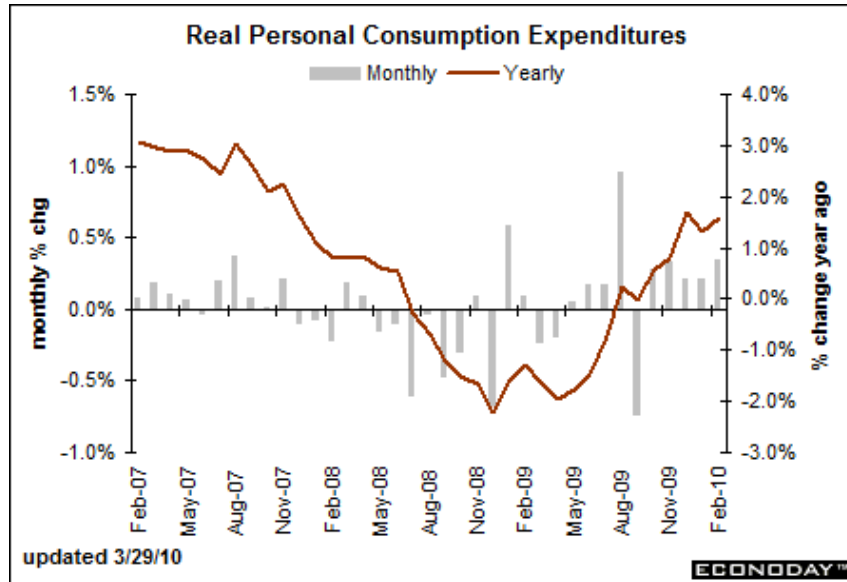
February was tepid for the consumer as personal income was held down by weakness in wages and salaries while personal spending was softened by a dip in auto sales. Personal income was flat in February, following a 0.3 percent rise the month before. The important wages & salaries component also was unchanged in February after jumping 0.4 percent in January.

Overall, personal consumption advanced 0.3 percent, following a 0.4 percent boost in January. By components for the latest month, durables fell 0.4 percent, nondurables gained 0.7 percent, and services increased 0.3 percent. Durables were pulled down by a drop in motor vehicle sales while nondurables appear to have been propped up by higher gasoline prices.

Year on year, personal income growth for February came in at up 2.0 percent, rising from up 1.2 percent in January. Year-ago headline PCE inflation eased to plus 1.8 percent from 2.1 percent in January. Year-ago core PCE inflation came in at up 1.3 percent, compared to up 1.5 percent in January.

– *Econoday.com*

# Consumer Spending



Source: Econoday.com

**Table 3**  
**Description**

Monthly changes in personal consumption expenditures are usually skewed by large changes in spending on durable goods. Spending on nondurable goods and services tend to be less volatile from one month to the next.

## Expert Testimony

Spending in February likely was held down by severe snow storms during the month and likely will bounce back in March. Also, if economists and analysts are correct that March will see a sizeable gain in payroll employment in Friday's employment situation, then personal income also will likely get a lift for the month.  
— *Econoday.com*

Consumers are spending again, delivering a strong boost to first-quarter corporate sales and profits, prodding some companies to rehire laid-off workers and others to start raising prices again.

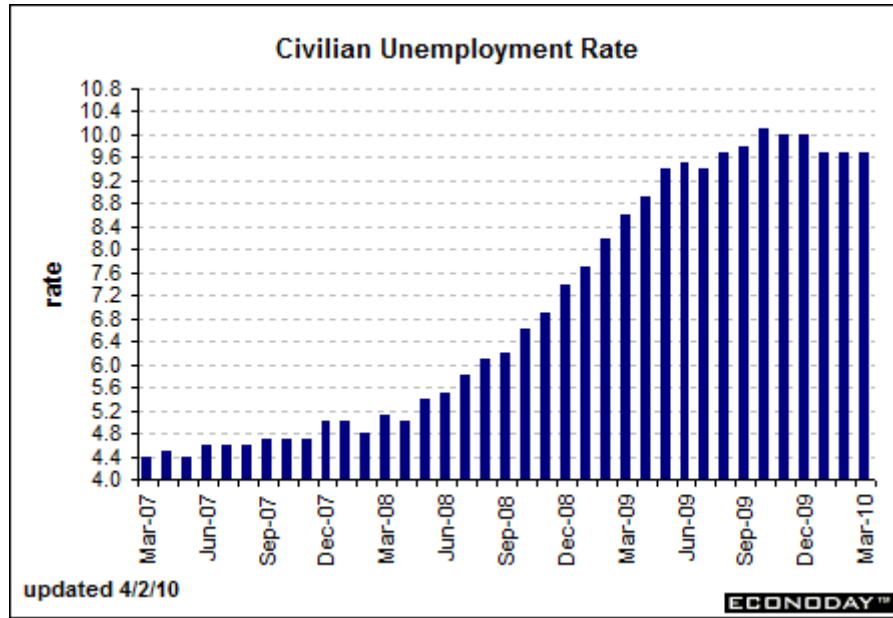
From restaurants, including The Cheesecake Factory Inc., which posted its first increase in sales at stores open at least a year in two years, to high-tech bellwethers such as Intel Corp., which reported its best-ever first-quarter sales and operating income on strong consumer PC sales, buyers returning to their old ways are powering results.

One factor in the upgraded forecasts: The government said earlier this month that retail sales—at stores, grocers, restaurants, auto dealers—were up an encouraging 1.6% in March from February, and were 7.6% above year-ago levels; these figures aren't adjusted for inflation.

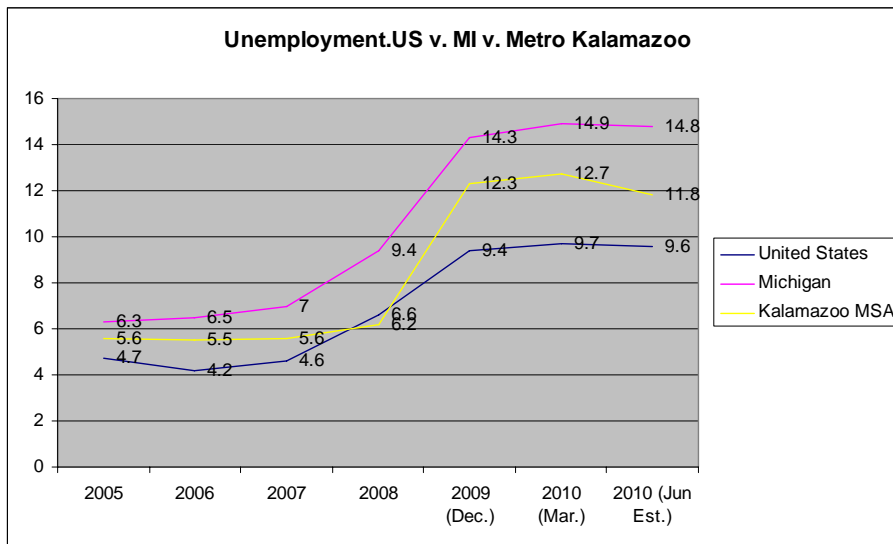
Some analysts worry that lean inventories and supply chain consolidations are creating false-positive signals. "The question in my mind is where is this growth coming from?" said Alexander Blanton, an analyst who covers machinery-makers for Ingalls & Snyder LLC. "People are just assuming that the recovery is under way and there won't be any hiccups."

- Paul Vigna – Wall Street Journal, April 26, 2010

# Unemployment



**Table 4**



**Table 5**  
**Description**

The civilian unemployment rate is a lagging indicator. The Bureau of Labor Statistics counts as unemployed “those who were not employed during the reference week (based on the definition above), had actively looked for a job sometime in the 4-week period ending with the reference week, and were currently available for work...as a percentage of the labor force.” <http://www.bls.gov/news.release/metro.tn.htm>

## Expert Testimony

Census hiring was not as strong as expected but private payrolls were healthy, posting a third consecutive gain. Nonfarm payroll employment in March rebounded 162,000, following a revised 14,000 decline in February and revised rise of 14,000 for January. The March gain came in below analysts' forecast for a 200,000 jump in employment. Importantly, the February and January revisions were up a net 62,000, inclusive of moving January from negative to positive territory.

While the headline payroll number was disappointing, the detail was positive. Private payrolls (which discount Census hiring and other government changes) jumped 123,000 in March, following an 8,000 rise in February and a 16,000 gain in January. Census hiring was up 48,000 in March, meaning that ex-Census, payroll jobs were up 114,000 for the month.

Goods-producing jobs rebounded 41,000 after a 47,000 drop in February. Manufacturing employment was up 17,000, following a 6,000 boost in February. Notably, construction jobs rose 15,000 after a 59,000 drop the month before. This was the first gain in construction since June 2007. Mining advanced 8,000 in the latest month.

Private service-providing employment jumped 82,000 in March, following a 55,000 gain the month before. Temp jobs were up 40,000, following a 37,000 rise in February. Health care jumped 37,000 in March while leisure & hospitality gained 22,000. Retail trade increased 15,000 in March as wholesale trade was up 9,000. On the negative side, financial activities fell 21,000 in March.

On a year-ago basis, payroll jobs improved to minus 1.8% in March from minus 2.4% in February.

Wage inflation in March fell to a 0.1 percent decline from a 0.2 percent gain the month before. The consensus had expected a 0.2 percent advance. The average workweek (traditional series for production and nonsupervisory workers) improved to 33.3 hours in March from 33.1 the previous month. For all workers, the average workweek edged up to 34.0 hours from 33.9 hours in February.

From the household survey, the unemployment rate was unchanged at 9.7% in February and matched expectations.

– *Econoday.com*

## Looking Ahead

The W.E. Upjohn Institute's 2010 First Quarter Outlook forecasts a drop of 1.2 % in employment compared to 2009 levels for the 2010 forecast.

2009 unemployment levels ended the year at 12.3% and positioned the Kalamazoo-Portage Metropolitan Statistical Area as the third best labor market in the state according to the WE Upjohn quarterly report.

Leading indicators suggest that the economy is gaining positive momentum and while the numbers still point negative in the near term, job losses seem to have slowed and businesses have been adding new jobs. Productivity also has slowed significantly in April 2010, which may presage job growth,

# Housing Starts and Existing Home Sales

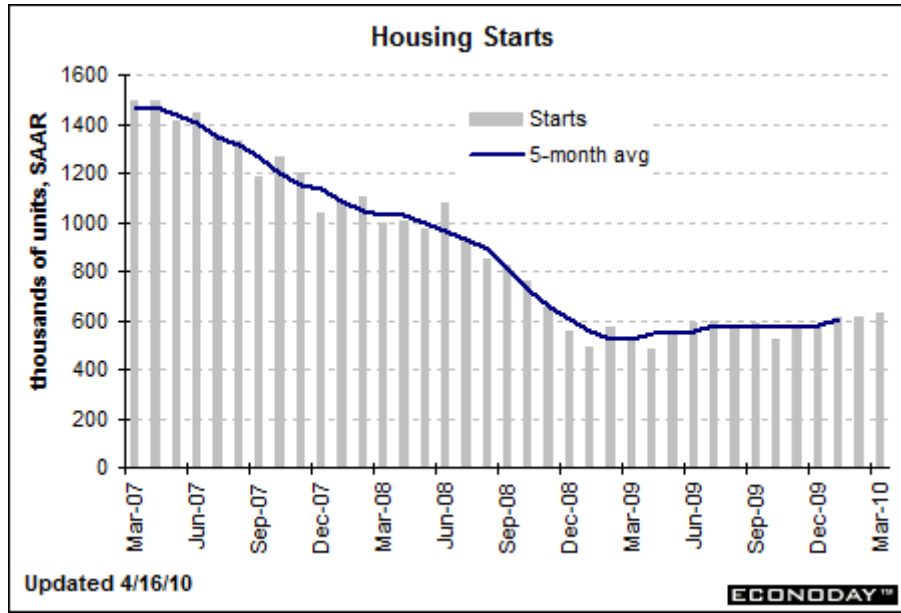
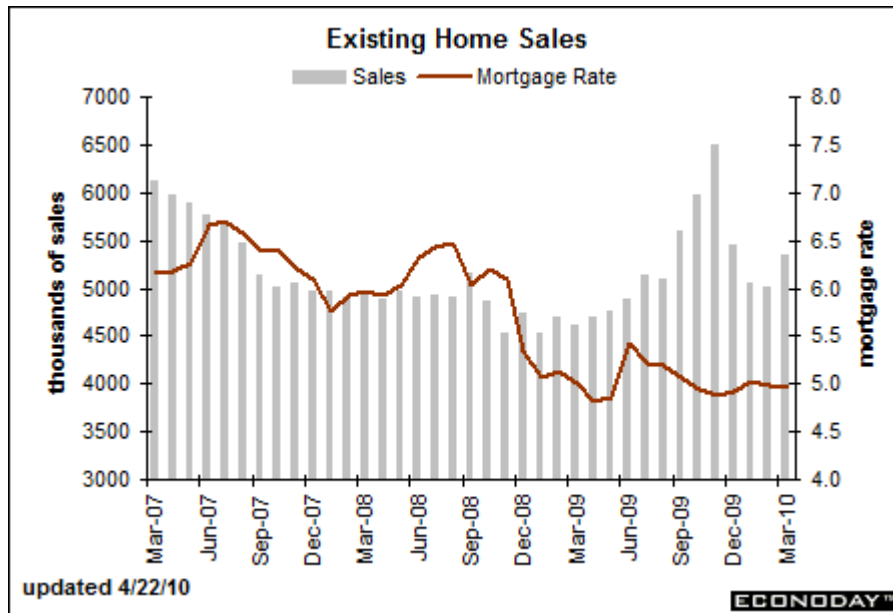


Table 6



Source: Econoday.com

Table 7  
Description

This table shows a change in the historical pattern involving mortgage rates and home sales. Typically, a distinct reverse relationship exists between home sales and mortgage rates. Mortgage Rates traditionally move in the same direction as the Federal Reserve Bank's discount rate policy.

Many banks now will not offer mortgages with principal amounts above 80% of the property's value (LTV ratio), whereas a year ago it was possible to obtain jumbo loans for 95% or more of the property's value.

## Expert Testimony

Housing in March strengthened from snow bound February-with permits pointing toward even better improvement than starts. Housing starts in March rebounded 1.6 percent after a snow storm damped 1.1 percent rise in February. The February number was revised up from an original estimate of a 5.9 percent drop. The March annualized pace of 0.626 million units came in above analysts' projection for 0.605 million units and was up 20.2 percent on a year-ago basis. The boost in March was led by an 18.8 percent jump in multifamily starts, following a 21.6 percent fall in February. The single-family component edged down 0.9 percent after a 5.7 percent boost the month before.

The impact of weather on February's numbers clearly was seen again in March as the latest surge was entirely from a rebound in the South which was battered by snow storms the prior month. By region, the March boost in starts was led by an 18.2 percent rebound in the South after an 11.8 percent drop the month before. For the latest month, declines were seen in the Midwest, down 28.4 percent; the Northeast, down 8.3 percent; and the West, down 2.1 percent.

Permits were even more positive, jumping 7.5 percent, following a 2.4 percent advance in February. The March pace of 0.685 million units annualized was up 34.1 percent versus one year ago.

Today's numbers indicate that housing is not slipping back into recession although this sector is still getting support from homebuyer tax credits that are about to expire.

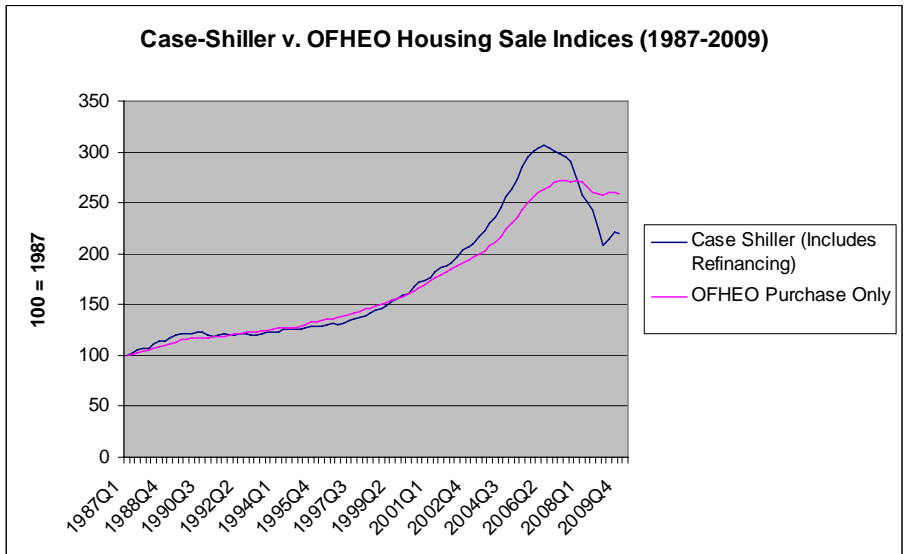
– *Econoday.com*

## Looking Ahead

Based on this analysis, it can be concluded that some regions of the country are seeing improvements. Local permit data suggests that construction permits will be down by an estimated 12.5% and 14.7% compared to 2009 and 2007 levels, respectively. The decline in permits also highlights the decreased anticipated investment in the community based on state value of the permitting data. Compared to the average from 2002 - 2008, the investment levels in Residential, Commercial, Industrial and Total of all categories have declined by 46%, 58%, 76% and 67% respectively.

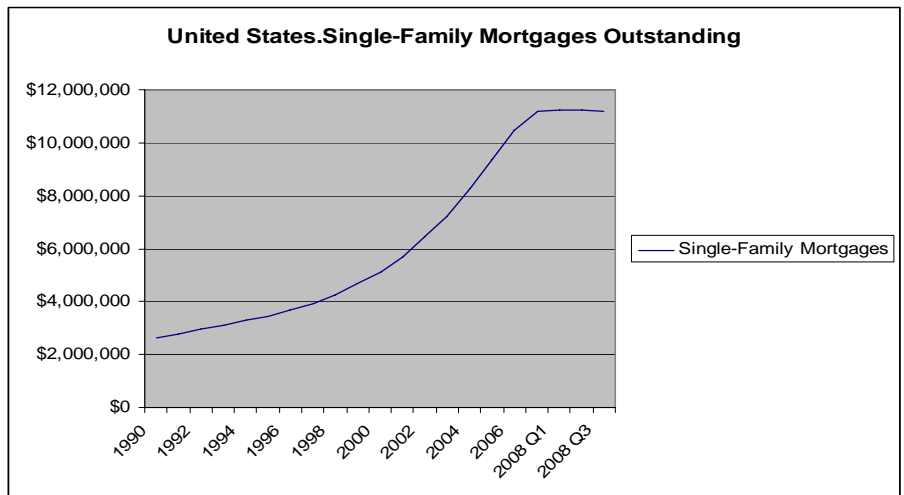
The declines in capital asset investments may reflect tightened credit markets and a sense of austerity that is slowing investments by individuals and businesses to be more cautious and sustainable going into the future in response to the events of the last 18 months.

The Federal Reserve eased lending rates throughout 2008 to counteract the onset of a recession. However, the rate easing did not overcome a huge drop in demand for housing. Despite the easing of interest rates based on the recession, tightening of mortgage requirements at financial institutions around the country have held sales volumes down with the recent upticks in October and March likely attributable to public policy.



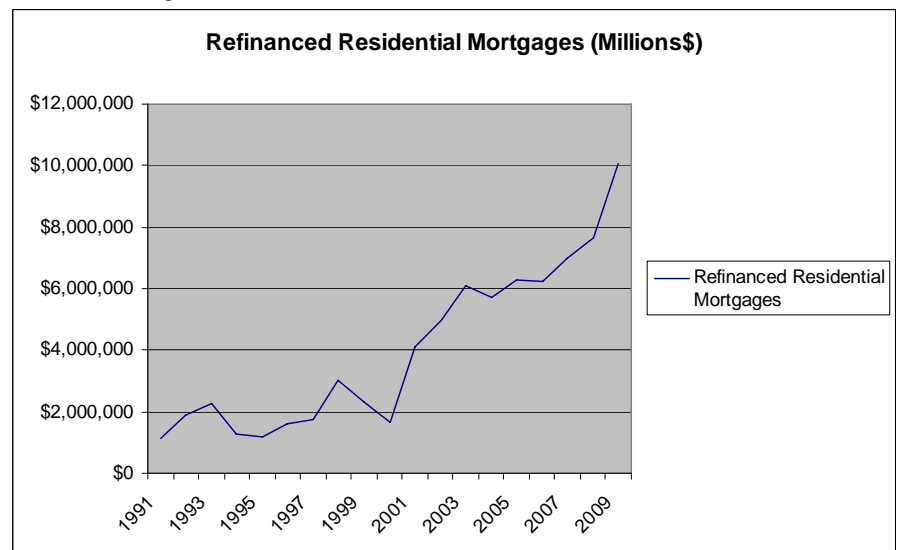
Source: <http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/> and <http://www.fhfa.gov/webfiles/15452/finalHPI22510.pdf>

**Table 8**



Source: fhfa.gov

**Table 9**



Source: fhfa.gov

**Table 10**

## Analysis (Tables 8 – 10)

The Case-Shiller index measures the value attached to residential property. It includes sales and financing. By contrast, the OFHEO Purchase-Only index only includes sales. The presence of appraised values used for refinancing mortgages most likely caused the recent bubble in the Case-Shiller curve.

Staff recently completed a sampling of 50 randomly selected foreclosed residential properties from 2006-2008, in order to assess their current status and estimate how much excess foreclosed inventory may still be awaiting a post-foreclosure sale (which would directly impact future residential sales studies).

As of October 1, 2009, 6 of the selected 50 properties remain with the foreclosing organization. Given that there have been roughly 500 foreclosures above the norm in the last four years, it suggests that there may be 50 properties in the City at this time that are “holdovers” from previous foreclosure processes and awaiting disposition. As these are recycled into the normal marketplace, they will likely cause some drag on the sales study – however, this is not a large enough number to cause major concern at this point.

The resetting of adjustable-rate (ARM) subprime mortgages under the current “traditional” tight mortgage standards (the vast majority of which were initiated under relaxed credit standards prior to the 2008 financial crisis) represents another potential supply of future residential foreclosures.

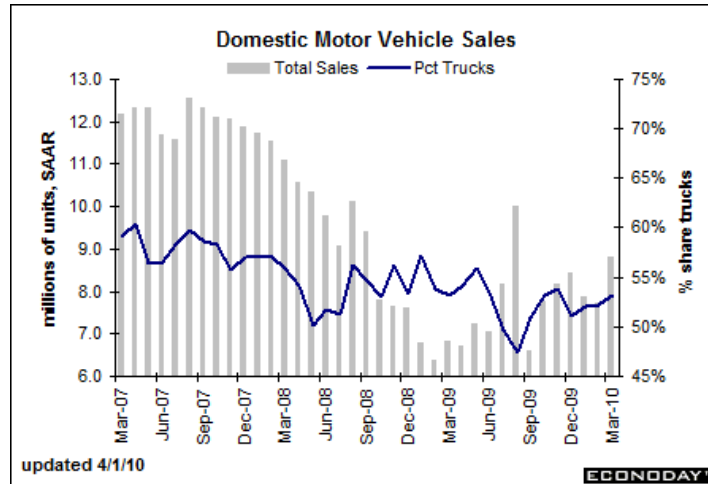
As of the January 2009, subprime ARMs represent about 1% of all housing units in the United States, and about ½ of those were behind in their payments or in foreclosure. A similar percentage of residential properties are due to have their loans reset by the end of 2010. Translated to Kalamazoo, given that there is a higher level of subprime mortgages, this would suggest that there are several hundred properties that face a realistic danger of being in foreclosure due to resetting subprime ARMs by the end of 2010.

According to a study done by at the end of 2009 and published in the *Federal Reserve Bank of St. Louis Review*, economist Rajdeep Sengupta, Alt-A ARMS represented approximately 48% of the market in housing loans at the end of 2007 with nearly 90% of those loans Owner Occupied. Because newer mortgages have a higher default rate, the resets for mortgages may increase the number of foreclosures and/or so-called “short sales”, where a buyout of the owner by the lending institution is negotiated at a steeply discounted price.

The above samplings seem to indicate that there will continue to be higher-than-normal foreclosure levels for at least another year or two (through 2012) in Kalamazoo, although the potential for a major spike in foreclosures seems unlikely as banks are holding back inventory so as not to further undercut the value of their own assets, which are steeply and irrationally discounted by the nature of foreclosures, particular as it relates to property damage and the carrying costs associated with bank-held properties.

**It would appear at this point that the residential price pressures caused by foreclosures have largely abated in Kalamazoo and the surrounding areas.**

# Auto Sales



Source: Econoday.com

Table 11

## Description

This chart represents unit sales of domestically produced cars and light duty trucks (including sport utility vehicles and mini-vans). Individual manufacturers report sales on the first business day of the month. Motor vehicle sales are good indicators of trends in consumer spending.

## Expert Testimony

Vehicle sales in March proved much stronger than February, the first solid indication of what looks to be a strong month for retail sales. Sales of domestic-made cars and light trucks rose to an annual unit rate of 8.8 million, up more than 15 percent vs. February's 7.6 million rate. Improvement was broad based among manufacturers but was centered at Toyota where aggressive incentives led to a major jump for the troubled manufacturer. New car sales make up about 12 percent of total retail sales. Gasoline sales, which make up about 10 percent, also look to be strong in March given gains for demand, seen in the weekly EIA petroleum inventory data, and gains in price, also posted weekly by the EIA. Chain stores will round out the retail picture for March when they post results next Thursday. - *Econoday.com*

Monthly sales totals ... are expected to come at a seasonally adjusted selling rate of around 11.3 million cars and light trucks, according to people familiar with the figures, which would be slightly lower than the level of 11.78 million vehicles the industry reached in March, but a clear rise from the year-ago level of 9.72 million. The seasonally adjusted annual rate for the first quarter as a whole was 11 million vehicles annualized.

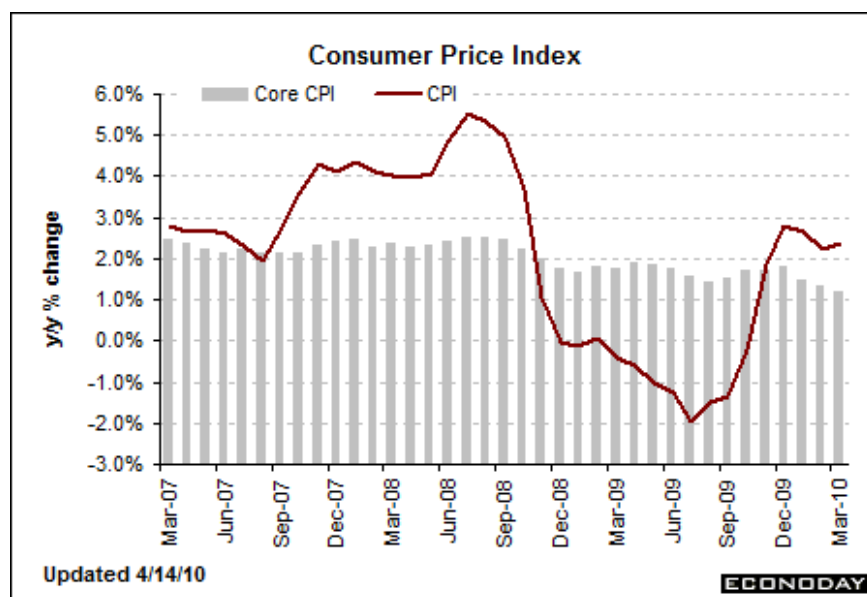
- *Sharon Terlep, Wall Street Journal*

## Looking Ahead

In the State of Michigan, April 2010 vehicle production is up nearly 48,000 units over April 2009 while January – April 2010 production is up nearly 131,000 vehicles produced over the same period in 2009. These statistics point to increased demand with a direct benefit to Michigan and the "Detroit Three" manufacturers. Less than two dozen units were produced by non-Detroit Three companies. - *Detroit Free Press, May 4, 2010*

# Economic Indicators

## Consumer Price Index



Source: Econoday.com

### Table 12 Description

The Consumer Price Index is a measure of the average price level of a fixed basket of goods and services purchased by consumers. Monthly changes in the CPI represent the rate of inflation.

### Expert Testimony

Fed inflation hawks got no help as consumer price inflation was nonexistent for March. Overall CPI inflation for March nudged up to 0.1 percent from no change the prior month. Core CPI inflation eased to no change from up 0.1 percent in March and coming in just under expectations. Food prices rose moderately while energy was flat. The core was held by declines in apparel, recreation and flat housing costs.

Looking at detail, the energy component of the CPI was flat after declining 0.5 percent in February after jumping 2.8 percent the month before. Gasoline dipped 0.8 percent, following a 1.4 percent decline in February. Food inflation rose 0.2 percent after a 0.1 percent gain the month before. Keeping the core soft in March were a 0.4 percent drop in apparel prices, a 0.1 percent dip in recreation, and no change in housing costs. Housing has been flat or negative for an unheard of four months in a row.

Year-on-year, overall CPI inflation firmed to 2.4 percent (seasonally adjusted) from 2.2 percent in February. The core rate edged down in March to 1.2 percent from 1.3 percent the month before. On an unadjusted year-ago basis, the headline number was up 2.3 percent in March while the core was up 1.1 percent.

- Econoday.com

There has been considerable concern about the recent increase in the money supply affecting inflation. However, the money supply has constantly lagged inflation for almost 50 years, rather than leading it. (<http://wfhumel.cnchost.com/inflationgraph.html>)

Both inflation forecasts that staff identified (forecast.org and croadvisory.com) indicated that inflation would remain well in check for the next 18 months, below 3%. Traditionally, cyclical activity in economic production, as expressed by movements in the Producer Price Index and seasonal cycles has been seen as the keys to forecasting inflation.

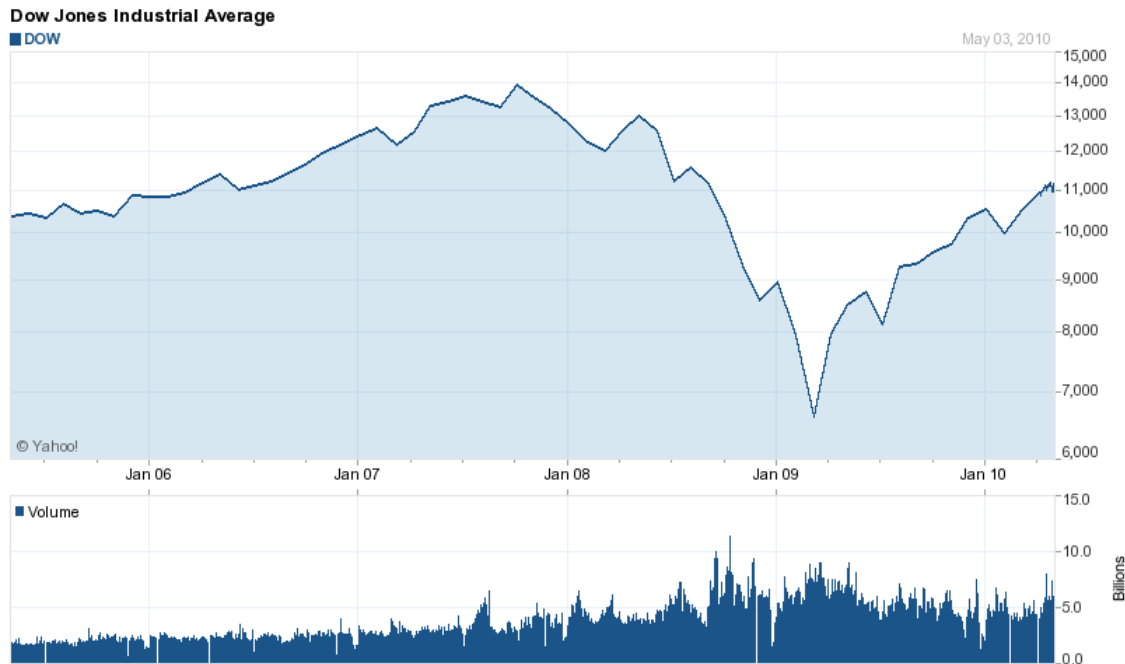
## Looking Ahead

Concern about inflation has hovered for years due in large part to the consistently large account balance between the United States and large exporting nations like China, Japan and India, and also because of the enormous Treasury holdings that China and Japan hold.

**Deflation has dropped from the list of likely scenarios, leaving potential inflation or stagflation:**

- 1. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;**
- 2. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.**

# Stock market



Dow Jones Industrial Average Index Historical Chart  
May 09 to April 2010

Table 13

## Expert Testimony

"[There will be a] bear market trend into mid July 2009. However it is increasingly unlikely that DJIA 6,600 will hold and therefore the bear market is targeting a trend towards a break of the lower target of 6,000."  
- *Dow Jones Stock Market Index Forecast 2009 – Update 1*, Nadeem Walayat, fxstreet.com, Feb. 25, 2009

"We are in a stocks stealth bull market that has already delivered a powerful 35% gain to date, so whilst a stock market correction is expected into the end of June, it is still just a correction against the trend."  
- *Stocks Stealth Bull Market Quick Update*, Nadeem Walayat,  
<http://www.marketoracle.co.uk/Article11074.html>, June 3, 2009

"Today's Market Lesson - Do not THINK too MUCH! Don't get lost in reasons of why the market must move, rather focus on what the market is doing on the price charts! AS you are trading the PRICE CHART and NOT the fundamental DATA! They can and DO move in OPPOSITE DIRECTIONS! Funnymentials are a RED HERRING that continue to sucker both the professionals and the inexperienced, whereas they should amount to no more than 10% to 20% of the your decision making process when trading rather than the over inflated 80% or more that many weight towards in depth Funnymentials studies into for instance corporate earnings forecasts. Your swing trading analyst is not too interested in what the funnymentials suggest."  
- *Stocks Bull Market Correction Continues*, Nadeem Walayat,  
<http://www.marketoracle.co.uk/Article13947.html>, October 4, 2009

"Economy - The economies are continuing to improve in terms of GDP growth as a consequence of unlimited money printing and stimulus, this will continue throughout 2010 and into 2011, which continues to paint a favorable stocks picture for the current year at least, therefore continues to support the stocks bull market target of 12,500 for this year as a consequence for the need for risk as a consequence of negative real interest rates." – *Stock-Markets / Stocks Bull Market*, Nadeem Walayat, Mar 23, 2010

“Even if the rally is destined to continue, it is likely that we will experience a short-term pull-back as the market prepares to break through the resistance.” – *Bear Market Rally*, Carl Swenlin, decisionpoint.com, Mar. 27, 2009

“Cracks are beginning to appear in the medium-term picture, and any correction should not be fully embraced as positive until it is clear that it is over.” - *Another Ascending Wedge*, Carl Swenlin, decisionpoint.com, June 15, 2009

“I hear that a number of people are expecting a crash, but I see no evidence that would make me anticipate anything more than a normal correction.” - *Support Still Holds Correcting Prices*, Carl Swenlin, decisionpoint.com, October 2, 2009

“The S&P 500 is still above the overvalue limit with a P/E of 23. By the end of the year, earnings are expected to improve, but still not enough to get valuations anywhere near fair value (15). If prices continue to advance, the market will remain extremely overvalued.” – *More Normal Earnings Picture*, Carl Swenlin, decisionpoint.com, April 1, 2010

“Based upon a 3/1/2010 Thrust/Trend Model buy signal, our current intermediate-term market posture for the S&P 500 is bullish.” - *Another Ascending Wedge*, Carl Swenlin, decisionpoint.com, April 16, 2010

## Looking Ahead

The posturing of the experts notwithstanding, the stock market has made a comeback which has not been seen since 1933 in terms of speed and size.

As was discussed in the Quarterly Reports for 2009, traditional chart analytics and similar wisdom have suggested since late March that the market would have one more significant correction before its last upward push to the starting point of the new long-term trend/cycle.

Indeed, the latest charts for the past year show a classic inverted head-and-shoulders curve from 9,200 in October 2008 down to 6,500 in March 2009 and back to 9,200 in August 2009, and continuing to rise to the 11,000 point mark in mid April 2010 resulting in a 13 month span climb back up again. Current market indexes are tracking back toward pre-crisis levels seen in 2006-07.

As the last expert analysis above indicates, the record-breaking run of the stock market since March 2009 has sparked fears of overvaluation in comparison to consensus estimates about corporate earnings for 2010. Historically, the ratio of the price of a share as compared to the estimated future net earnings of a corporation for the next 12 months (also known as “Future Price/Earnings Ratios” or FPE) are about 15:1.

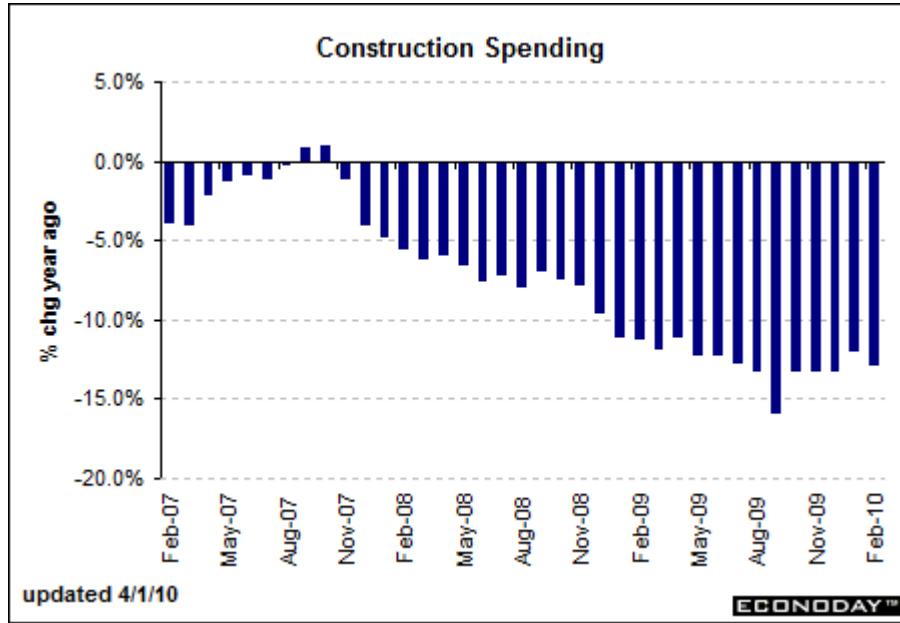
Currently, the FPE for 2010 Q1 is estimated to be about 18.3, which might suggest that the market is coming into line at this moment.

Potential major policy changes in monetary policy, banking, global trade and the environment are being pushed in Congress. These changes have been met with skepticism by the market, however in the wake of health care reform passage, the market has responded with steadiness rather than disruption.

**The current assumption is that domestic and global equities are now more than 1 year into a sustained growth cycle. It would be pure speculation to try and predict whether the long-term trend will approach that of the last 25-75 years or not.**

**Please see the Pension section of this report for more discussion on this topic.**

## Construction Activity



Source: Econoday.com

**Table 14**  
**Description**

“Construction spending” represents the dollar value of new construction activity on residential, non-residential, and public projects. This is a coincident indicator of economic activity, meaning that it moves with the economy as a whole.

### Expert Testimony

Construction spending in February continues to decline with all three major components tugging downward. But there is a hint that the weakness was weather related. Overall construction spending for February fell 1.3 percent, following a revised decline of 1.4 percent in January. The latest number was a little worse than the consensus forecast. The February decline was led by decreases in private residential spending and public outlays. Private residential spending fell 2.1 percent after a 1.0 percent gain the month before. Public outlays declined 1.7 percent after a 0.8 percent drop in January. Private nonresidential spending also slipped-down 0.4 percent after a 3.8 percent plunge in January.

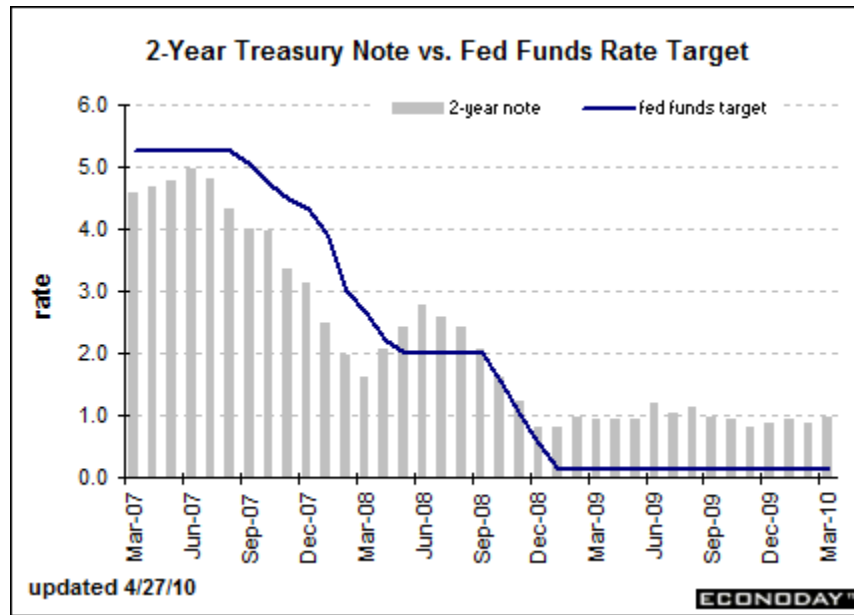
However, the private residential component was pulled down by the little-noticed improvements. New 1-family outlays only slipped 0.1 percent in February and new multifamily outlays unchanged. Residential spending on improvements dropped a sharp 4.3 percent and was likely due to weather.

On a year-ago basis, overall construction outlays slipped to minus 12.8 percent in February from minus 12.0 percent the previous month. - *Econoday.com*

### Looking Ahead

The economy has been expanding since the 3<sup>rd</sup> Quarter of 2009, but construction activity is still lagging. Construction is generally a “coincident” indicator of economic activity, so this seeming disconnect may be an indicator of weak economic growth and/or latent and leftover overcapacity in industrial, commercial and housing facilities from the last economic cycle.

## Treasury Indices



Source: Econoday.com

**Table 15**  
**Description**

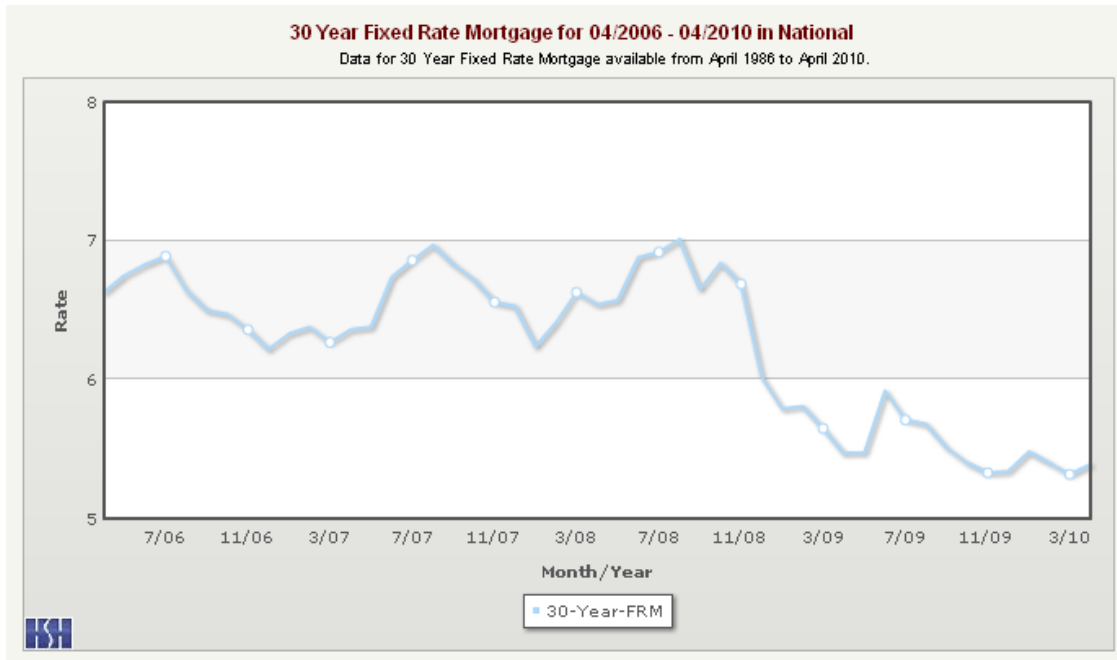
Treasury notes are sold at regularly scheduled public auctions. Competitive bids at these auctions determine the interest rate paid on each Treasury note issue.

### Analysis

Federal Funds Futures were heavily tilted since March 2009 towards the assumption that the Federal Reserve would enact a 25 basis point increase in its recent meetings. This rate change has not occurred. Volumes in the Federal Funds Futures market are low and trades in the six to nine month window signal little to no change is anticipated Federal Funds Rate. Much of this lack of trading is based on the anticipation Federal Reserves does not yet believe that inflation is enough of a concern to tilt rates upward, as they attempt to reverse job losses through monetary policy and achieve “full employment” goals.

Traditional monetary policy has been exhausted by the near zero federal funds rate. As stated in the previous reviews, there is a danger of extending cheap interest rates too far and encouraging risk in the bond market in response, much like what occurred in the development of the exotic credit instruments that have appeared on the market and are now the subject of much regulatory and legislative scrutiny.

# Mortgages and Mortgage Rates



HSH strives to provide reliable, useful information, but does not guarantee that the information above is accurate.

## Table 16 Description

HSH's Fixed-Rate Mortgage Indicator (FRMI) averages 30-year mortgages of all sizes nationwide, including conforming, the new expanded conforming, and jumbo.

## Expert Testimony

The average 30-year fixed-rate mortgage slipped 1 basis point, to 5.21 percent. Meanwhile, this week's average 15-year fixed rate -- a popular option for refinancing -- edged down 1 basis point, to 4.54 percent. The average jumbo 30-year fixed remained unchanged at 5.91 percent. Adjustable-rate mortgages split this week. The one-year adjustable-rate mortgage rose 3 basis points, to 4.89 percent. Meanwhile, the popular 5/1 ARM fell 5 basis points, to 4.37 percent.

Mortgage applications fell a seasonally adjusted 2.9 percent when compared to a week earlier, according to the Mortgage Bankers Association. For the week ending April 16, applications for new purchase rose 7.4 percent, while refinancing activity sank 8.8 percent.

Home prices nationwide recorded a modest 0.6 percent year-over-year gain in February, according to the S&P/Case-Shiller Home Price Index that measures 20 major metro areas across the country. It was the first such increase since December 2006.

New home sales skyrocketed in March, jumping 26.9 percent when compared to February, according to the U.S. Commerce Department. Sales were also up 23.8 percent year over year. Existing home sales also increased, rising 6.8 percent in March when compared to February, according to the National Association of Realtors. Sales were up 16.1 percent year over year. -- Chris Kissell

<http://www.bankrate.com/finance/mortgages/interest-rate-roundup-for-april-29-2010.aspx>

## Looking Ahead

The pending sunset of federal tax credits for first-time homebuyers on April 30<sup>th</sup> accelerated purchases while lenders increased mortgage rates, as seen in the long range graph.

It is anticipated that more traditional lending standards will increase mortgage rates.

# FY 2010-11 Budget Highlights

- **FY 2009-10 Budget Cost Containment:** Over \$500 thousand of cost reductions have been realized independent of reductions in staff and service level.
- **5-Year Fiscal plan:** this is the fourth Budget that contains a detailed projection of General Fund balances for five years beyond the target fiscal period.
- **2-Year Budget framework:** we have lengthened the budgeting perspective and shortened the fiscal perspective to align with uncertainty. This has provided for “smoothed” cuts in FY2009 and FY2010 that will hopefully minimize cuts for balancing the FY2011 budget.
- **Health Care cost containment:** the City negotiated agreements with our labor units that have saved the City approximately \$7 million in health care costs during FY2006 – FY2008. Savings realized since FY 2007 has created an unencumbered balance of \$4 million in the City’s internal Insurance Fund.
- **Budget Stabilization Fund:** by adding \$1.3 million in FY2009, this fund has a balance of \$1.6 million as of the end of FY2009;
- **Capital Contingency Fund:** this is estimated to have a balance of \$300 thousand by the end of FY 2009, to assist in the repair/replacement of unexpected City property damage and loss.
- **Tax Installments:** enactment of Public Act 512 by the Governor shortens the City Tax Installments from 12 payments to 6 payments (due December 31<sup>st</sup>).
  - The Summer 2009 tax billing cycle was a major success, accelerating current tax payments by over \$2.5 million, allowing the City to reduce TANs borrowing. The City will receive it’s first delinquent settlement check from the County Treasurer in June 2010 for 2009 delinquencies. The County Treasurer will also collect tax year 2000 – 2008 delinquent real property taxes, which will further accelerate delinquent tax payments. In 2009, delinquent tax payments were accelerated by over \$2 million, closing the difference between the City’s “GAAP” and “non-GAAP” General Fund unreserved balance.
- **Bond Ratings:** due to the quality of the City’s fiscal management, our bond rating has been renewed at AA with a stable economic outlook by both Fitch and Standard and Poor’s. The City realized savings of over \$160 thousand of debt service payments for each of the next 15 years on the 2009 Capital Improvement Project Bond, based both on the federal American Recovery and Reinvestment Act (ARRA) or “stimulus package”, which provided over \$1.27 million in capital grants to the City to reduce planned bonded indebtedness, but also low coupon rates of 4.06%, which were at least 25 basis points below expectations.
- **Tax Anticipation Notes:** due to the renewed bond ratings, the City realized savings of \$63 thousand of interest costs for 2010 TANs based on 0.48% interest rates from the competitive bid process, as well as the reduced TANs borrowing of \$3 million in FY2010.

# Pension Funding

**December 31, 2008:** Historic losses of \$150 million in 2008 (representing approximately 29% of the Pension Trust Fund market value) will have to be recognized over a five-year “smoothing” period. As of December 31, 2008, the Pension Fund had approximately \$368 million in market assets, and an actuarial value estimated at \$506 million.

**Experience in 2009:** A steep slide of an additional \$90 million of market value losses left the Pension Trust Fund at around \$280 million of market asset value as of March 1<sup>st</sup>. However, the market has recovered dramatically, and as of December 31, 2009, the Pension Trust Fund was at \$448 million of market value of assets, or about 24% higher than it was on January 1, 2009.

**Experience in 2010:** global markets have continued to move steadily upward in the first quarter. As of March 31, 2010, the Pension Trust Fund had roughly \$481 million of market value of assets, a 29% annualized increase.

**Projections: 2010 – 2029:** The Michigan Constitution requires that the normal cost of the benefits be paid to the Pension Trust Fund of the municipality each year. In application, the normal cost is adjusted up or down by an amortized portion of the current funded level to determine the actual contribution.

The normal cost of benefits is the value accrued in benefits by employees from a year of service. For the year ending 2008, the net normal cost for all active employees totaled a little more than \$6 million (when roughly \$1.5 million of employee contributions are netted out).

**For the purposes of comparison, it has been assumed that the Pension Trust Fund’s market value will achieve a rate of return of 7.5% for the balance of 2010, resulting in the Pension Trust Fund balance being 10 percent higher on December 31, 2010 (net of more than \$15 million in expenses) than it was on December 31, 2009, giving it an actuarial value of roughly \$514 million. The actuarial (smoothed) funding level would fall from 140% to 135%.**

The following rate of return scenarios are based on a range of reasonably foreseeable outcomes in the market over the next 20 years. It must be noted that level-percent rate of return assumptions are simplified scenarios for the purposes of problem identification:

- **5% Rate of Return:** the City would be required to contribute approximately \$600 thousand to the Pension Trust Fund in 2017, and \$3 million in 2018. This amount would continue to increase indefinitely.
- **7.5% Rate of Return:** the City would be required to contribute more than \$350 thousand to the Pension Trust Fund in 2028, and \$1.5 million in 2029. This amount would continue to increase indefinitely.
- **10% Rate of Return:** At 10%, the City would not be required to make any contribution for the foreseeable future.
- **12.5% Rate of Return:** At 12.5%, the City would not be required to make any contribution for the foreseeable future.

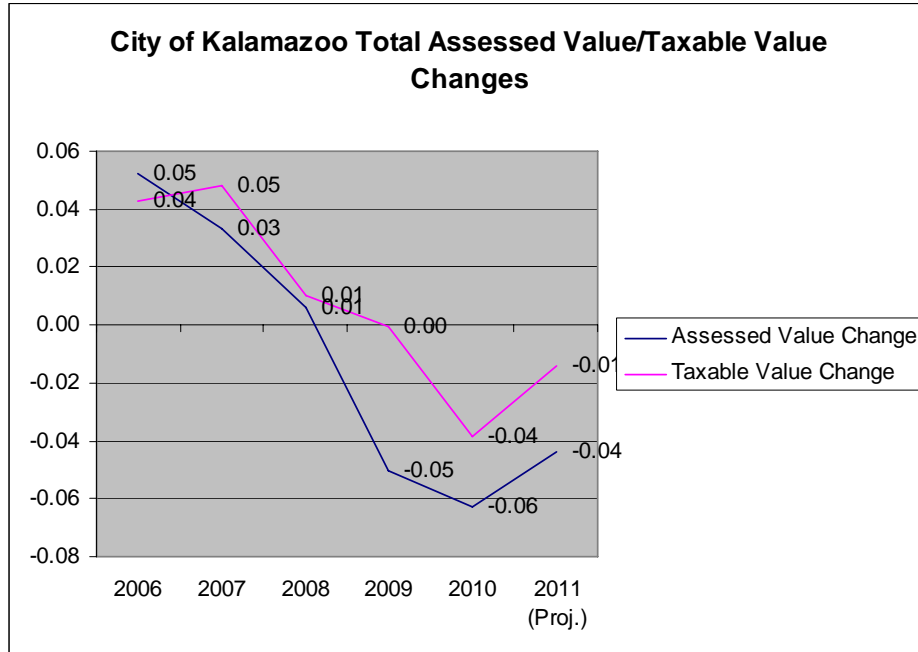
- **Average History:** this is a completely different approach of estimating returns. It involves using the “slope” of past recoveries during the 25 year history of the Retirement Investment Committee. There have been four stock market drops followed by recoveries over that period of time. Each year of recovery, from the first to the fifth, has been averaged to come up with a normal scenario. Using the approach, the City would avoid making contributions.

**Smoothing recognition of gains/losses to assets (5 years vs. 10 years):** The City has the option of changing the smoothing period for recognition of gains and losses in the portfolio. They currently utilize a 5-year smoothing period, which means that gains and losses are cut into 5 equal units and spread over a 5-year period. The vast majority of public pension systems utilize smoothing periods between 5 and 10 years.

**Changes in asset smoothing is not advisable at this time, although we will revisit this issue periodically.**

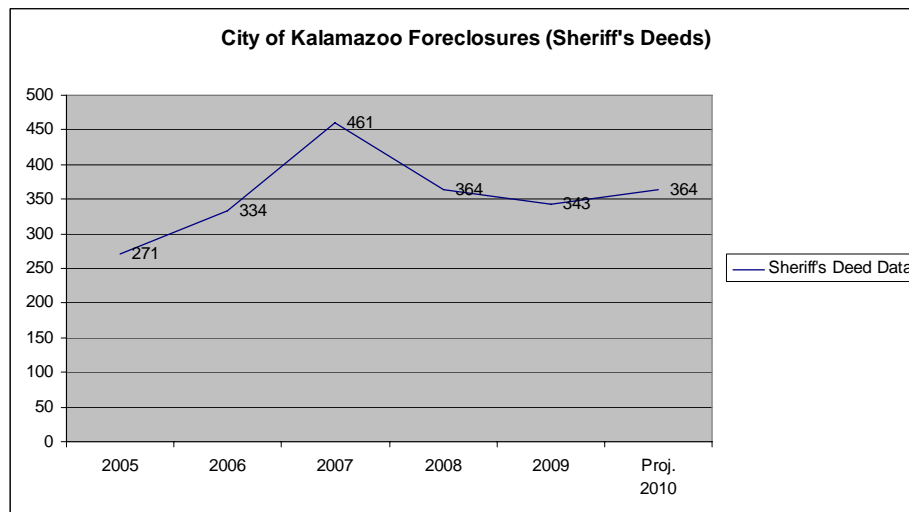
# Revenues

## Property Taxes



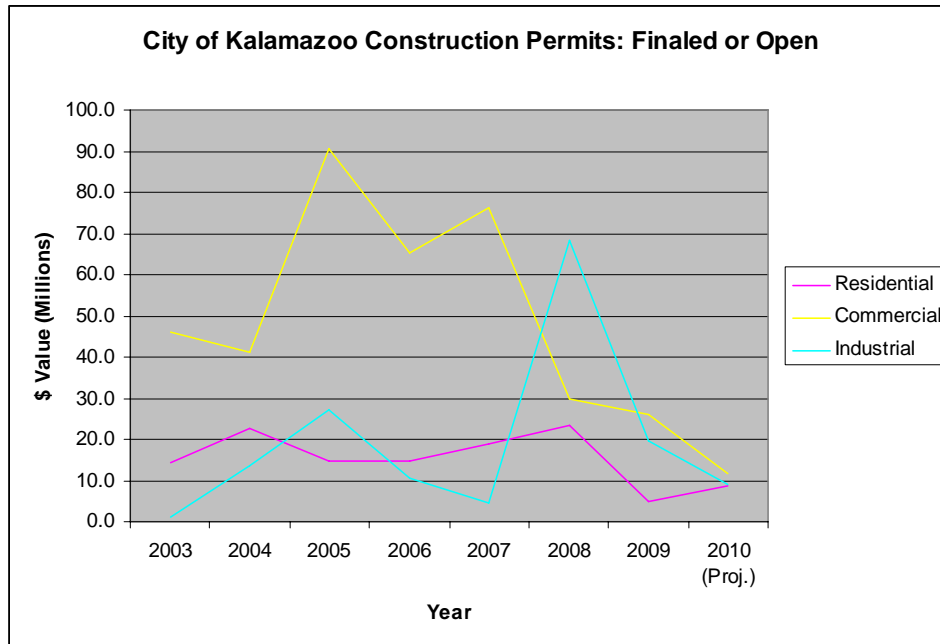
Source: City of Kalamazoo Assessor's Office

**Table 17**



Source: City of Kalamazoo Assessor's Office

**Table 18**



Source: City of Kalamazoo Assessor's Office

**Table 19**  
**Description (Tables 17 – 19)**

**2008 and prior:** Table 17 shows that City of Kalamazoo total assessed value (which is based on property sales and industrial appraisal studies, and moves with the market value of property) had been rising steadily at 5% (which is the City's historical average for the last 15 years), but increased only 3% for the 2007 roll and only 1% for the 2008 Assessment Roll.

**2009:** The 2009 Assessment Roll utilized a study period of October 1, 2007 – September 30, 2008, which showed a substantial loss of 5% compared to the previous Assessed Value. Because there was a substantial gap between the Assessed Value and the Taxable Value for most properties, this change did not cause a downturn in Taxable Value for 2009. In combination with inflation, the Taxable Value for the City's properties stayed relatively flat for 2009.

**2010:** The 2010 Assessment Roll was determined for Residential and Commercial property by utilizing sales data for the period of October 1, 2008 – September 30, 2009. The overall result is a drop in Assessed Value of roughly 6%, and a drop in Taxable Value of 4%.

The 4% drop in Taxable Value compares to the projected loss of 3% of Taxable Value from the Third Quarter 2009 Report, which was used to formulate the property tax revenue for the FY 2010 – 11 Budget. This unprojected negative difference (equal to roughly \$17 million of Taxable Value) was caused primarily by the following factors, all of which emerged in 2010:

- Net unanticipated reductions of \$4 million of Taxable Value in the personal property roll. Personal Property is valued based on affidavits filed by property owners in February -- in this case, February 2010. Based on the historical steadiness of Personal Property value (this amount has changed by less than 2% for each of the past 5 years, and has not lost value in recent history), budget projections have assumed no change in Personal Property value – this practice had resulted in a slightly conservative estimate, until this year.
- Net additional reductions of \$7 million of residential Taxable Value, beyond the reductions projected in the Third Quarter 2009 Report. This negative difference was due to a significant

unanticipated reduction in the final ratio of residential value as compared to historical residential value outcomes.

- A \$5 million reduction of Taxable Value in the March Board of Review. This was due to an error in the City's records involving Payments In Lieu of Taxes (PILOTs). The records indicated that a PILOT was expiring in 2009, which would return \$5 million of taxable value back to the Assessment Roll in 2010. The property owner was contacted in September 2009 to verify the expiration, according to standard procedure, but the property owner failed to notify the Assessor that the PILOT was not expiring. The mistake was not discovered until the property owner filed a March Board of Review claim. Therefore, the \$5 million had already been mistakenly placed on the ad valorem Assessment Roll for the purposes of setting the FY 2010 – 11 Budget estimate. As a result of the March Board of Review correction, the \$5 million had to be removed.

**Residential sales study:** Using the available data for sales from October 1, 2008 through September 30, 2009, the final number of qualified residential sales was a little over 350, down from the previous projection of 400.

For 2010: In the First Quarterly Report for 2009, it was reported that sales prices for October 2008 through February 2009 were slightly ahead of 2009 Assessed Values.

In the Second Quarterly Report for 2009, it was reported that residential sale prices dropped significantly to an average of 8% lower than 2009 Assessed Values for the Second Quarter.

In the Third Quarter Report for 2009, the final Residential Sales Study (which was validated later by the County Equalization Department) moderated the decline in Residential Value to 3.5% in Assessed Value, for a 1.5% drop in Taxable Value.

When the aforementioned unprojected reduction is factored in, Residential Assessed Value dropped by a total of 4.7%, while Taxable Value dropped by 2.5% versus 2009. The extra 1% loss in Taxable Value amounted to a loss of nearly \$140 thousand in annual revenue versus the FY 2010 budgeted amount.

For 2011: Residential sales for the first six months of the sales study year (October 2009 – March 2010) projects a drop of roughly 7.3% of Assessed Value for Residential Properties. This is fairly close to the 10% drop indicated by the first six months of sales data over the same time last year. This decline in Assessed Value is somewhat offset by the return to nominal inflation, which increases Taxable Value. However, in combination, this translates to a loss in Assessed Value of 7.3% and a decrease in Taxable Value of 3%.

#### **Commercial sales study:**

For 2009: Commercial real property (land and buildings) taxable value had increased from the 2008 to the 2009 Assessment Roll by 1.5%.

For 2010: the 1-year sales study produced a roughly 13% drop in Assessed Value for commercial property, and an 8% drop in Taxable Value. The amount of unprojected losses for commercial and industrial values of \$5 million equaled \$100 thousand of lost revenue for the General Fund versus the FY 2010 budgeted amount.

For 2011: sales of commercial property for the first 6 months of the study period (October 2009 - March 2010) are directly on track with 2010 values. Current nominal inflation would project a slight increase in commercial property Taxable Value.

**Table 18** shows that in 2007 a seemingly temporary spike in residential mortgage foreclosures occurred (as represented by Sheriff's Deeds). Historically we have seen 250-300 foreclosures a year. In 2007 we experienced nearly 450, after rising to 330 in 2006.

In 2008, the number of residential mortgage foreclosures fell to 365.

At the end of March 2009, Federal agencies Fannie Mae and Freddie Mac ended their moratorium on foreclosures, which has resulted in an industry-wide increase in foreclosures in April, May and June.

The pace of foreclosures fell in the second half of 2009, resulting in a projected 370 foreclosures for 2009.

Foreclosures have remained at the same projected pace for 2010 as was seen for 2008 and 2009.

While excess residential inventory will likely remain on the market for some time, the pace seems to have stabilized.

**Table 19** shows that the City experienced five strong years of combined construction from 2004 - 2008 totaling over \$470 million of value. Annual totals varied between \$77 million and \$121 million, driven primarily by commercial construction.

In 2009, Commercial construction began at a much higher pace than 2008, primarily because of the \$4.7 million Catheterization Lab project at Bronson Hospital. In the second half of 2009, permit activity slowed considerably, leaving 2009's \$25 million at less than ½ of the previous 5-year average of \$60 million.

Residential construction came to a screeching halt in 2009, with \$4.7 million representing only 1/4<sup>th</sup> of the previous 5-year average of \$19 million.

The total permit value for 2009 of \$50 million was only about ½ of the previous 5-year average.

In the 1<sup>st</sup> Quarter of 2010, permit value has started at a very slow pace in all three sectors:

- Residential has perked up a bit to an annualized projection of \$8.7 million for 2010, roughly double the 2009 pace, but still only about ½ of the previous 5-year average.
- Commercial permits have crashed to a non-existent \$11 million projection for 2010, less than half of the 2009 pace, and only 1/5<sup>th</sup> of the previous 5-year average.
- Industrial permits are projected at \$9 million for 2010, which would be fairly close to the \$11 million average of 5 of the last 6 years (excluding 2008, which was an extraordinary outlier year with \$68 million of industrial permits).
- Total permits for 2010 project to a moribund \$29 million, about 60% of the 2009 pace, and not even 1/3<sup>rd</sup> of the previous 5-year average.

## Looking Ahead

Housing prices in the City have been dropping since 2007, and foreclosed residential properties continue to represent excess low-price inventory that will dampen values for some time. The foreclosure situation seems to have stabilized, and should eventually return to normal, with home prices presumably following the same trend.

For the purposes of revenue generation, 2010 was the first year in at least 25 years with a negative inflation rate, which contributed to a decrease in 2010 Taxable Values. The inflation rate for 2011 projects to be nominally positive, which will help to offset a projected decline in residential values due to sales.

- **2009:** The “shift” in taxable value from the General Fund to the Brownfield Redevelopment Authority mentioned above has caused a drop in General Fund revenue of \$250 thousand versus what was budgeted for 2009.

The aggregate value of commercial appeals filed exceeds \$35 million of taxable value. In 2009, successful appeals to the State Tax Tribunal resulted in roughly \$90 thousand of lost tax revenue.

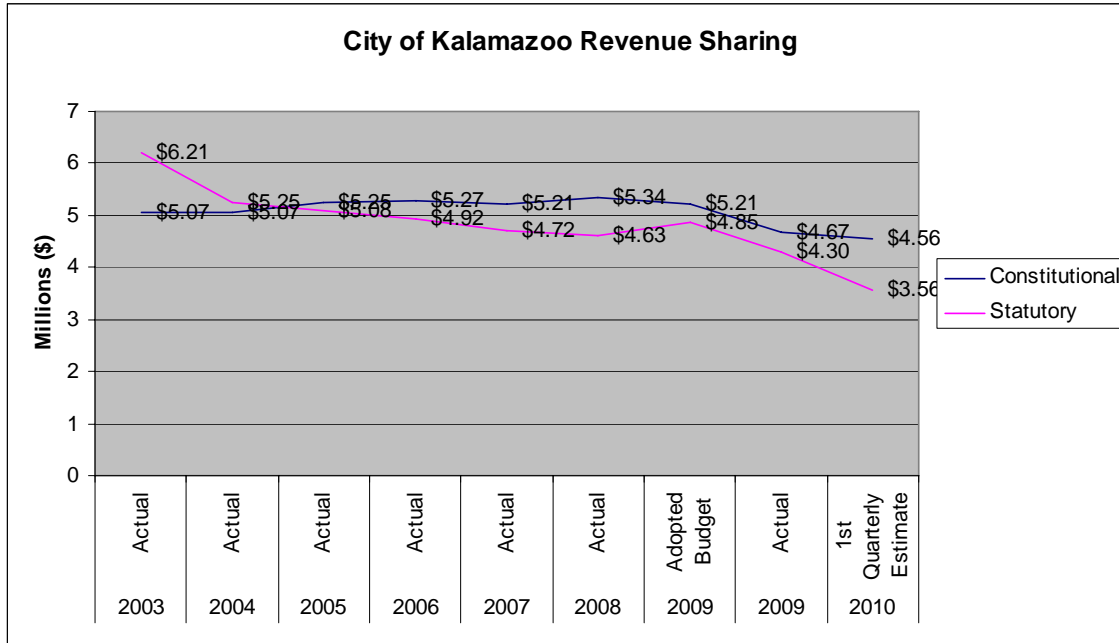
- **2010 Residential:** Residential Assessed Value dropped by a total of 4.7%, while Taxable Value dropped by 2.5% versus 2009. The extra 1% loss in Taxable Value amounted to a loss of nearly \$140 thousand in annual revenue versus the FY 2010 budgeted amount.
- **2010 Commercial/Industrial:** the 1-year sales study produced a roughly 13% drop in Assessed Value for commercial property, and an 8% drop in Taxable Value. The amount of unprojected losses for commercial and industrial values of \$5 million equaled \$100 thousand of lost revenue for the General Fund versus the FY 2010 budgeted amount.

**The final FY 2010 Assessment Roll will create a \$290 shortfall in tax revenues when compared to the FY 2010 budgeted amount.**

- **2011 Residential:** At this point, the data points to a projected 3% drop in Taxable Value. This would amount to a \$500 thousand loss in General Fund revenue.
- **2011 Commercial/Industrial:** sales of commercial property for the first 6 months of the study period (October 2009 - March 2010) are directly on track with 2010 values. Current nominal inflation would project a slight increase in commercial property Taxable Value.
- **2011 Personal Property:** annual depreciation of personal property assets will create a projected loss of \$7 million of Taxable Value. At this time, we are not projecting any offset based on new equipment purchases. This would amount to a \$100 thousand loss in General Fund revenue.

The projection for FY 2011 is for a decrease of roughly \$900 thousand in tax revenue versus what was projected in the FY 2010 – 11 Budget, inclusive of the \$290 thousand shortfall in FY 2010 repeated in FY 2011, plus roughly \$500 thousand of loss based on the projected drop in residential value and \$100 thousand of projected losses in personal property.

# State Revenue Sharing



Source: Treasury.gov and Michigan Department of Treasury

**Table 20**

<b>REVENUE SHARING ESTIMATES</b>			
	<b>Scenario #1: 13.4% Cut in State's FY 2010 – 11 Budget = change vs. City's FY 2009 – 2011 Estimated &amp; budgeted Amounts.</b>	<b>Scenario #2: 10% Cut in State's FY 2010 – 11 Budget = change vs. City's FY 2009 – 2011 Estimated &amp; budgeted Amounts.</b>	<b>Scenario #3: 5% Cut in State's FY 2010 – 11 Budget = change vs. City's FY 2009 – 2011 Estimated &amp; budgeted Amounts.</b>
<b>(Thousands \$)</b>			
<b>2009</b>	<b>-\$271</b>	<b>-\$271</b>	<b>-\$271</b>
<b>2010</b>	<b>-\$236</b>	<b>-\$129</b>	<b>\$38</b>
<b>2011</b>	<b>-\$0</b>	<b>\$300</b>	<b>\$755</b>
<b>Total</b>	<b>-\$507</b>	<b>-\$100</b>	<b>\$522</b>

**Table 21**

<http://www.senate.michigan.gov/sfa/Publications/BudUpdates/OverviewGovsRecFY11.pdf>

## Analysis

According to the Michigan Department of Treasury, the latest numbers from the January 2010 Revenue Estimating Conference show that sales tax collections for the state are expected to be down roughly 3.2% vs. the State's FY 09-10 budgeted amount. This has caused a shortfall in the last two 2009 distributions totaling \$271 thousand. The State Treasury estimates that \$114 thousand of this shortfall will be made up in the August 2010 "catch-up" distribution, netting a \$157 thousand loss in Revenue Sharing by August 2010 beyond what has been budgeted in the City's General Fund for 2009 and 2010.

## Looking Ahead

Early in 2010, Governor Granholm and others stated that it was possible that the State's General Fund and School Aid Fund could face a combined Budget deficit in their FY 2010 -11 exceeding 20% of FY 2009-10 revenues. The Governor's FY 2010 – 11 Executive Budget, however, pegs the projected General Fund shortfall at 13.4%. State Sales tax collections for the nine-month period that will be applied to funding FY 2010-11 State Revenue Sharing shows a decline of 4.6% vs. the same period for FY 2009-10. The Governor's Executive Budget proposes no decrease in Revenue Sharing.

In the FY 2009 – 10 Budget process, the State House of Representatives delayed action while the Speaker of the House and the Senate Majority Leader reached an "all-cuts" approach. In the case of FY 2010 – 11, however, the House of Representatives has taken the initiative to pass a 1% increase in Revenue Sharing. While the Governor's status quo proposal and the House's proposal for an increase are unlikely to pass the Senate, nevertheless the footing is more solid for cuts in Revenue Sharing to be sensitized to the needs of local governments.

**SCENARIO #1:** If the State's final FY 2010-11 Budget includes cuts in Revenue Sharing that are equal to the overall estimated drop in the State's General Fund (13.4%), Revenue Sharing for the City for FY 2010 would likely be \$236 thousand less than currently projected, whereas Revenue Sharing for the City for FY 2011 would be on target with current projections. In this case, total receipts for 2009 – 2011 would be approximately \$500 thousand less than current projections. This seems like a very unlikely scenario, given the Governor's and House's actions to-date.

**SCENARIO #2:** If the State's final FY 2010-11 Budget includes cuts in Revenue Sharing that are equal to our original estimated drop (10.0%), Revenue Sharing for the City for FY 2010 would likely be \$129 thousand less than currently projected, whereas Revenue Sharing for the City for FY 2011 would be \$300 thousand more than currently projected. In this case, total receipts for 2009 – 2011 would be approximately \$100 thousand less than current projections. This seems like the most reasonable "middle ground", given the Governor's commitment to the status quo, the House's action to support a slight increase, in combination with the public statements of various Senators indicating the need for Revenue Sharing cuts ranging from 5 – 20%.

**SCENARIO #3:** If the State's final FY 2010-11 Budget includes cuts in Revenue Sharing that are equal to the smaller decline in sales tax receipts (4.6%), Revenue Sharing for the City for FY 2010 would likely be \$38 thousand more than currently projected, whereas Revenue Sharing for the City for FY 2011 would be \$755 thousand more than currently projected. In this case, total receipts for 2009 – 2011 would be \$522 thousand more than current projections.

**LATE BREAKING DEVELOPMENT:** according to a Gongwers News Report, dated Wednesday, May 12, 2010, "A budget plan approved by the Senate Appropriations Committee that would cut [local government] revenue sharing payments from the state by 4 percent."

**Summary:** now that the State House of Representatives has passed a 1% increase, and the State Senate's Appropriations Committee has passed a 4% decrease, and Governor Granholm has adopted a preference for no change, it seems prudent to use the 5% decrease assumption above, which would also allow a little negative buffer in case of payment timing issues. This would result in an improvement of \$38 thousand for FY 2010, and \$755 thousand for FY 2011 over FY 2010 – 11 Adopted Budget projections.

## Act 51 Revenue

According to the latest analysis conducted by the Michigan House Fiscal Agency on February 11, 2010 (see: <http://house.michigan.gov/hfa/transportation.asp>), the State is receiving gas tax revenues for FY 09-10 at a rate 1.8% lower than last year. Act 51 disbursements for the 1<sup>st</sup> Quarter of 2010 from the state to the City of Kalamazoo year to date are down approximately 1% versus the 1<sup>st</sup> Quarter of 2009.

The State disbursed about \$344 million to cities in Act 51 money for the State's FY 2007-08.

The State distributed \$322 million to cities in Act 51 money for the State's FY 2008-09.

The House Fiscal Agency estimates that the State will distribute \$319 million for the State's FY 2009-10.

The Governor's Executive Budget for FY 2010 – 11 recommends distributions of \$319 million.

**The above disbursement figures project a shortfall of roughly \$60 - 80 thousand of Act 51 revenue in the City's FY 2010 Major and Local Street Funds as compared to their combined FY 2010 Adopted Budget amounts for Act 51 revenue. Shortfalls in the road funds would have to be made up by reductions in road service levels and/or additional appropriations from the General Fund.**

## Interest earnings

The City's General Fund is projected to receive \$500 thousand in interest earnings in 2010. The historically low Federal Funds rate, which has suppressed short-term interest rates, is expected to continue at least until inflationary pressures emerge. Inflationary pressures usually cause changes in the Federal Funds rate within the first 6-12 months of an economic recovery. Positive GNP has been experienced since the third quarter of 2009. It would be reasonable to expect inflationary pressures to cause rate adjustments in the near future. However, to-date, inflation has remained largely in check.

While the City generally keeps about 40% of its cash in liquid investments (which are basically tied to the Federal Funds rate), the City has been successful in maintaining a little more than \$20 million dollars in intermediate investments. As these investments come due over the next year, the City will keep more dollars short in an attempt to avoid locking in low rates any longer than necessary to maintain reasonable maturity diversification.

**The General Fund should be on target to receive the budgeted amount of interest earnings in 2010 versus the Adopted 2010 Budget.**

# American Recovery and Reinvestment Act

## General Fund Savings Due to ARRA

	2009	2010
Staff	\$72,586	\$842,426 *
Programs	\$150,000	\$150,000
CIP	\$1,201,244	\$1,492,000
Bond Savings	\$90,000	\$160,000
<b>TOTAL</b>	<b>\$1,513,830</b>	<b>\$2,644,426</b>

\* Includes \$633K of \$1.9M COPS Grant to be spent over three years

## Additional ARRA Funding for Programs to be Spent over the next 3 Years

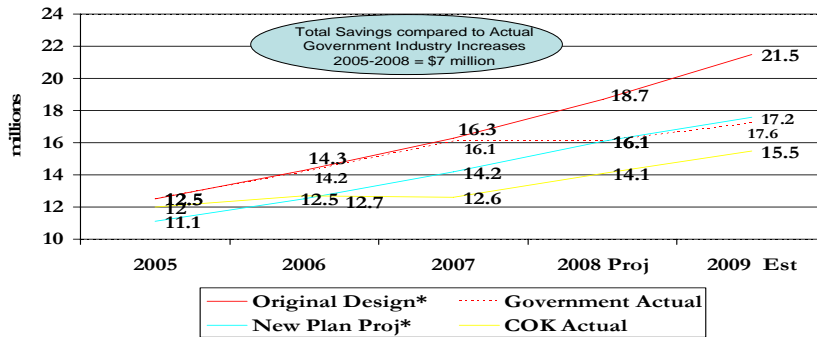
Neighborhood Stabilization Program 1 (NSP1)	\$1,700,000
Homeless Prevention & Rapid Rehousing Program (HPRP)	\$ 758,000
Community Development Block Grant (CDBG-R)	\$ 500,000
Neighborhood Stabilization Program 2 (NSP2)	<u>\$17,000,000*</u>
<b>TOTAL</b>	<b>\$19,958,000</b>

\* - this is a county-wide allocation.

# Expenditures

## Health Care

### Health Care Cost Comparison



\*Source: Mercer Health Benefits Report 1/26/07

**Table 22**

Between 2005 and 2008, the City saved over \$7 million dollars by virtue of consolidating the employee health care plans from three a la carte offerings to one, as well as increasing cost-sharing measures such as monthly employee health care contributions, as well as co-pays and deductibles for care visits. The new contract with the Amalgamated Transit Union (ATU), effective January 1, 2010, means that every employee and retiree of the City will be on one plan, saving significant administrative and plan-design related costs.

Changes in behavior have helped constrain general health care inflation that continuously outstrips our growth in revenues. In the latest round of bargaining, the following changes were made:

- **Retiree Health Care:** new hires in KMEA (and the non-bargained for group) will receive a monthly stipend of \$75 to place into a health savings retirement account through MERS. This will result in approximately \$5 – 10 thousand of new annual expenditures over the next five years. This money is pre-tax for the employee and its use for health care costs is also tax-free.
- **Pharmacy Initiative:** A pharmacy initiative has been agreed to. This pledges the employees to taking steps to replace their use of name-brand drugs with generic drugs that come at much lower prices. The City spends over \$1 million in prescriptions every year, and a full 85% of drugs purchased by our employees are name-brand products.
- **Cost-Sharing:** existing cost-sharing amounts have been inflated nominally.

**Savings realized since FY 2007 have created an unencumbered balance of \$4.5 million in the City's internal Insurance Fund.** Other opportunities exist for the City to realize significant health care savings. Chief among them is mandating participation among KPSA and KPSOA retirees in the federal Medicare Part B program (which is currently optional in the respective collective bargaining agreements for these groups). **Savings of 5% of the City's annual retiree health care cost could be realized by this one change alone.**

# Energy

Energy costs through April 2010 are down over 3% versus the same period last year, and are down 9% versus 2008 during the same period. The large drop when compared to 2008 versus is primarily due to the spike in prices for gasoline and diesel fuel in 2008.

According to the estimates of the Energy Information Administration (EIA) of the U.S. Department of Energy:

Gasoline: averaged \$3.26 per gallon in 2008, \$2.35 per gallon in 2009, are averaging Q1 was \$2.84, Q2-3 is forecast to average **\$2.92** per gallon during the peak driving season in 2010 and \$2.96 in 2011.

<http://www.eia.doe.gov/steo>

Diesel: averaged \$3.80 per gallon in 2008, \$2.46 in 2009 and 2010 forecast is **\$2.95** a gallon and are projected to average **\$3.12** in 2011. <http://www.eia.doe.gov/steo>

Natural Gas: averaged \$13.89/mcf in 2008, averaged \$11.97, **\$11.59** in 2010 and are projected to average \$12.54 in 2011. <http://www.eia.doe.gov/steo>

Electricity: averaged 11.26 cents/kwh in 2008, averaged 11.55 cents/kwh 2009 and are projected to average 11.50 cents/kwh in 2010, and forecast to be 11.74 in 2011. <http://www.eia.doe.gov/steo>

**General Fund energy totals \$391 thousand for the first quarter of 2010, a 14% reduction versus the 1<sup>st</sup> Quarter of 2009. If the last three quarters see the same percentage reduction as the 1<sup>st</sup> quarter, projected over time for 2010 would total \$275 thousand less than the budgeted amount for 2010. If the same dollars for energy are spent as were spent for the last three quarters of 2009, the General Fund will save \$139 thousand versus the budgeted amount for 2010.**

# Overtime

Public Safety OT: Public Safety overtime totals \$182 thousand for the first quarter of 2010, a 12% reduction versus the 1<sup>st</sup> Quarter of 2009. **If the last three quarters see the same percentage reduction as the 1<sup>st</sup> quarter, the projected overtime for 2010 would total \$169 thousand less than the budgeted amount for 2010. If Public Safety spends the same dollars in overtime as it did for the last three quarters of 2009, it will spend \$39 thousand more than budgeted in 2010.**

Non-Public Safety OT/non-Metro Transit (primarily Public Services OT): non-Public Safety overtime totals \$212 thousand for the first quarter of 2010, a 30% reduction versus the 1<sup>st</sup> Quarter of 2009. **If the last three quarters see the same percentage reduction as the 1<sup>st</sup> quarter, the projected overtime for 2010 would total roughly \$452 thousand less than the budgeted amount for 2010. If non-Public Safety departments spend the same dollars in overtime as they did for the last three quarters of 2009, the projected overtime for 2010 would total roughly \$300 thousand less than the budgeted amount. These savings accrue to funds other than the General Fund. Within the General Fund, however, the total amount of non-Public Safety overtime is minimal, and the change is not significant.**

# Travel/conferences

Education and Training expenses in the General Fund (not including amounts to be reimbursed by the State of Michigan) totaled \$13 thousand in the 1<sup>st</sup> Quarter of 2010, compared to \$38 thousand during the same

period in 2009. **The projected amount for 2009 is roughly \$83 thousand, compared to the budgeted amount of \$219 thousand. This projects to a budgetary savings of \$136 thousand for 2010.**

## Telephone/Cell phones

Through the 1<sup>st</sup> Quarter of 2010, telephone costs for the General Fund are recorded at \$47 thousand, inclusive of roughly \$7 thousand of one-time charges that AT&T has agreed to credit back in the 2<sup>nd</sup> Quarter. The net expense of \$40 thousand represents a decrease of \$14 thousand or 26% over the same period in 2009.

**If the same percentage increase is realized for the rest of the year, the total amount of projected expense would be roughly \$82 thousand less than budgeted for 2010. If however the same amount of dollars are spent for the rest of the year as was spent for the same period in 2009, savings would total \$113 thousand versus the budgeted amount for 2010.**

# **Management Controls**

## **Phase I (immediate)**

### **Travel and Conferences: Limitations and Creative Solutions**

Out-of-state travel has been limited to those events that are required to retain professional certification and other demonstrated needs. Employees are being encouraged to adopt creative ways to achieve professional development, including webinars and other on-line learning opportunities.

### **Telephone Cell Phone Usage Review**

The Information Technology Department is working with staff from Budget and Accounting to develop a comprehensive review of telephony. Telephone units will be matched up to physical phone lines, and cell phones will be reviewed for business necessity.

### **Take-Home Vehicles and Car Allowance Review**

The need for take-home vehicles is being reviewed at this time.

### **Selective Hiring Freeze**

The Deputy City Manager, Human Resources Director and CFO have collaborated already on reviewing a number of requests to post job openings. Already several studies have been launched to see about re-designing tasks to achieve greater efficiency without simply replacing existing staff. In several cases, this review resulted in hiring a lower level staff person.

### **Overtime: Monitor and Control**

The Public Safety Chief and Public Services Director have instituted a review of overtime, and are monitoring data and practices in order to limit the more than \$2 million of overtime spent in these departments. Other departments are being asked to do the same.

## Phase II (if needed)

### **Furloughs: Voluntary and Involuntary**

A Preliminary analysis indicates that if all employees who are paid directly by the General Fund were given an unpaid day off, the savings to the City would save roughly \$100,000. General Fund staff other than sworn Public Safety officers total about \$30,000 - \$35,000 a day. Minimum staffing levels in Public Safety would have to be examined carefully in order to determine furlough parameters within the sworn officer ranks and to avoid creating overtime replacements.

The City is not interested in furloughs at this time.

### **Early retirement**

Given the renewed state of the Pension Trust Fund, enhanced retirement initiatives may be beneficial to the City. These will be re-examined periodically.

### **Outsourcing and Operational Reductions, Program elimination**

These opportunities are being looked at in many areas, particularly as it relates to the reduction plans that are being reviewed between department heads and the City Manager.

### **Future Wage/Benefit Constraints**

In light of the current state of the pension system, as well as issues with revenue sharing and property taxes, a heightened sense of the City's ability to pay to maintain staffing and service levels has been shared between the City management and collective bargaining leadership. In 2009, the City successfully negotiated economically rational agreements with ATU, AFSCME and KMEA, as well as the KPSOA.

**Short term:** If the outlook for revenue sharing and/or property taxes worsens significantly in the near term, the City would likely approach the bargaining units in an effort to restructure existing agreements as a way to preserve jobs and service levels. The City already approached several bargaining units in 2009 to discuss alternatives to layoffs.

Furthermore, there is a wage opener in the KMEA and AFSCME contracts for 2011, which provides flexibility should the economic situation worsen (or improve) significantly.

**Long-term:** The pension trust fund has experienced a dramatic turnaround. It may be beneficial to seek to close the defined benefit system to new hires, while retaining the defined benefit Pension benefit to existing retirees and employees. At this time, it does not appear to represent a benefit to the City.

Although converting new hires to defined contribution pension (similar to the change that was negotiated with KMEA to convert new hires to defined contribution health care) would involve a guaranteed annual expense to fund their retirement investment account, nevertheless such a change would gradually lessen the risk of unpredictable payments into the Pension Trust Fund. On the other hand, adding a guaranteed annual expense at a time when projected contributions to the Pension Trust Fund is over 15 years away, during a period of fiscal stress, does not seem advisable.

## Capital deferment

The City plans to bond for over \$2.8 million in capital projects in 2010. While deferring capital improvements is by no means a preferred option, cutting out about \$1 million of projects from that list would save about \$500 thousand in interest payments every 5-7 years.

Due to previously budgeted capital projects that have been released, staff has identified roughly \$2 million of available capital reserves that has been reallocated in the FY 2010 – 11 Adopted Budget to priority capital projects such as critical road improvements.

## Cost Containment

The goal as set forth in the FY 2010 – 11 Adopted Budget and Fiscal Plan is to avoid the need for cuts in FY 2011 in the General Fund. The slippage of \$752 thousand as of the end of FY 2009 versus the projected net revenue is of concern. Accordingly, the City Manager has asked departments to engage in cost containment efforts by first identifying alternative methods to reduce cost while preserving services such as collaboration with other departments or organizations, as well as any new concepts that would alter how we do business and substantially reduce cost within an individual department or the entire organization.

It must be stressed that any further cuts that are needed that are enacted will be sensitized to maintain service levels to the community, so that across-the-board cuts are out of the question. Management will strive to achieve greater efficiencies and change the way we do business in order to keep the focus on delivering high-quality services to the public.

**I wish to thank the dedicated staff in Management Services for their assistance and support in this process, particularly Patsy Moore, Jennifer Clark, Phil Miller, Wade Carlson, Connie Darling and Wayne Nelson.**

**Thomas C. Skrobola**  
**Director of Management Services/CFO**