Performance Audit
Kansas City's Financial Future Forum

April 2006

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City Auditor's Office

City of Kansas City, Missouri

7-2006

April 19, 2006

Honorable Mayor and Members of the City Council:

This report focuses on the potential impact the nation's fiscal challenges could have on Kansas City and steps that Kansas City could take to address the impact of those challenges.

In December 2004, I attended a forum in Washington, D.C., hosted by the Comptroller General of the United States. The forum was to foster dialogue on how to communicate the nation's fiscal challenges to the public. Participants were budget and policy experts, as well as other individuals from Washington and beyond. The forum was a wake-up call for me and I thought Kansas City would benefit from a similar discussion.

On November 7, 2005, we convened a group of 28 leaders from business, government, academia, and other areas to listen to two presentations. One presentation on the nation's fiscal condition was given by the Director, Federal Budget Analysis, Strategic Issues, U.S. Government Accountability Office. The other addressed Kansas City's five-year financial outlook and was presented by the city's Budget Officer. Following these presentations, participants discussed the impact the nation's fiscal challenges could have on Kansas City's future and actions the city could take to mitigate those risks. The participants' comments were recorded in written form, but none are attributed in this report.

Based on the ideas and thoughts expressed by the forum participants and our prior audit work, we drew conclusions and make recommendations. We recommend that the City Manager develop financial policies for City Council deliberation on revenues, debt level and capacity, contingency planning, balancing the budget, and development incentives; encourage staff to develop simulations and financial forecasts to analyze the future consequences of any proposed actions; and, in consultation with the City Council, consider establishing a citizen working group to pursue regional strategies and work with other jurisdictions on regional priorities.

We would like to thank the participants for their suggestions and ideas. We sent a draft report to the participants and to the City Manager for their review. Management's response is appended. The audit team for this project was Michael Eglinski and Sharon Kingsbury.

Mark Funkhouser
City Auditor

Kansas City's Financial Future Forum

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List of Exhibits

Introduction

Objectives

We convened this forum on Kansas City's financial future to consider how it may be impacted by the nation's financial condition, as a performance audit under the authority of Article II, Section 13 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the City Auditor's primary duties.

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

This report is designed to answer the following questions:

- What impact might national fiscal challenges have on Kansas City?

- What steps should Kansas City take to address the impact of these challenges?

Scope and Methodology

In December 2004, the City Auditor participated in a Washington, D.C. forum, hosted by the Comptroller General of the United States. The forum was intended to foster dialogue on how to better communicate the nation's long-term fiscal challenge to the public. Participants at the Washington, D.C. forum were drawn not only from budget and policy experts, but also from other key groups both in Washington and from "beyond the Beltway." The Comptroller General opened the forum saying that the discussion was about saving the nation's future. The General Accountability Office (GAO) published its report to Congress in February 2005.

The City Auditor decided to hold a similar discussion in Kansas City to identify possible outcomes, approaches, and strategies for dealing with

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

the city's future. The forum was convened on November 7, 2005. Forum participants included leaders from business, government, academia, and others. Forum participants were invited to review GAO reports, audits, and other documents prior to attending the forum. (See Appendix A for a listing of participants.)

The 28 forum participants listened to two presentations. The first, on the nation's fiscal condition was presented by the Director, Federal Budget Analysis, U.S. Government Accountability Office. The other addressed the city's five-year financial outlook, and was presented by the Budget Officer of Kansas City's Office of Management and Budget. (See Appendix B and C for Power Point outlines of both presentations.)

Following these presentations, participants were asked to discuss the impact the nation's fiscal challenges could have on Kansas City's future and actions that the city might take to mitigate those risks. The participants' comments were recorded in written form, but none are attributed in this report.

We conducted this audit in accordance with generally accepted government auditing standards. No information was omitted from this report because it was deemed privileged or confidential.

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Findings and Recommendations

Forum Summary

Forum participants listened to two presentations prior to discussing Kansas City's financial future. The first was a presentation on the nation's long-term fiscal policy. The second presentation addressed Kansas City's five-year financial forecast. Based on these presentations, forum participants agreed that the nation's long-term fiscal policy is unsustainable, and that Kansas City has little margin for error in managing its fiscal condition going forward.

National challenges could adversely affect Kansas City. The most likely response to the nation's fiscal challenges will be the elimination of programs at the federal and state levels of government, which will put pressure on local governments to fill the gap. Urban areas will be hit hardest. There may be changes to the federal tax structure which could impact local government. Economic disruptions, though less likely, cannot be discounted. The choice will be higher taxes or fewer services.

To address the future, Kansas City should articulate a vision and strengthen financial management, which will require leadership and engagement of the public. The public and their leaders need to identify services that the city will provide and assess how best to provide those services. Kansas City should develop regional partnerships to consolidate functions and services and to develop regional priorities to lobby Washington and state governments.

With a rapidly changing fiscal landscape, Kansas City needs to follow basic management principles and responsible budgeting practices. There should be both long-term and short-term planning, debt policy, economic development policy, and a review of the city's revenue streams. The city should simplify the regulatory environment. Management should analyze current finances and revenues, measure long-term costs, develop forecasts and simulations to identify risks, and communicate clearly with the public.

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Nation's Long-Term Fiscal Policy Is Unsustainable

The GAO is seeking to call public attention to the fact that our nation's fiscal policy is on an unsustainable course. As long-term budget simulations by GAO and others show, over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs.

Federal budget flexibility decreased. In the past several decades, federal budgetary flexibility has decreased. Spending for mandatory programs, such as Social Security, Medicare, and Medicaid has grown much faster than spending for discretionary programs, such as defense. In 1965, about 66 percent of total federal spending was discretionary; in fiscal year 2005, this share had shrunk to about 39 percent.

The intersection of an aging population and rising health care costs drives the fiscal challenge. Contrary to public perceptions, health care is the biggest driver of the long-term fiscal challenge while Social Security is a relatively small part. Social Security in its current form will grow from 4.3 percent of gross domestic product today to 6.4 percent in 2080. In contrast, Medicare's portion of the budget will quintuple in that period—from 2.7 percent to 13.8 percent of the economy.[2] Not only does Social Security grow more slowly, it also comes close to leveling off; Medicare, in contrast, grows rapidly and no leveling off is visible. (See Exhibit 1.)

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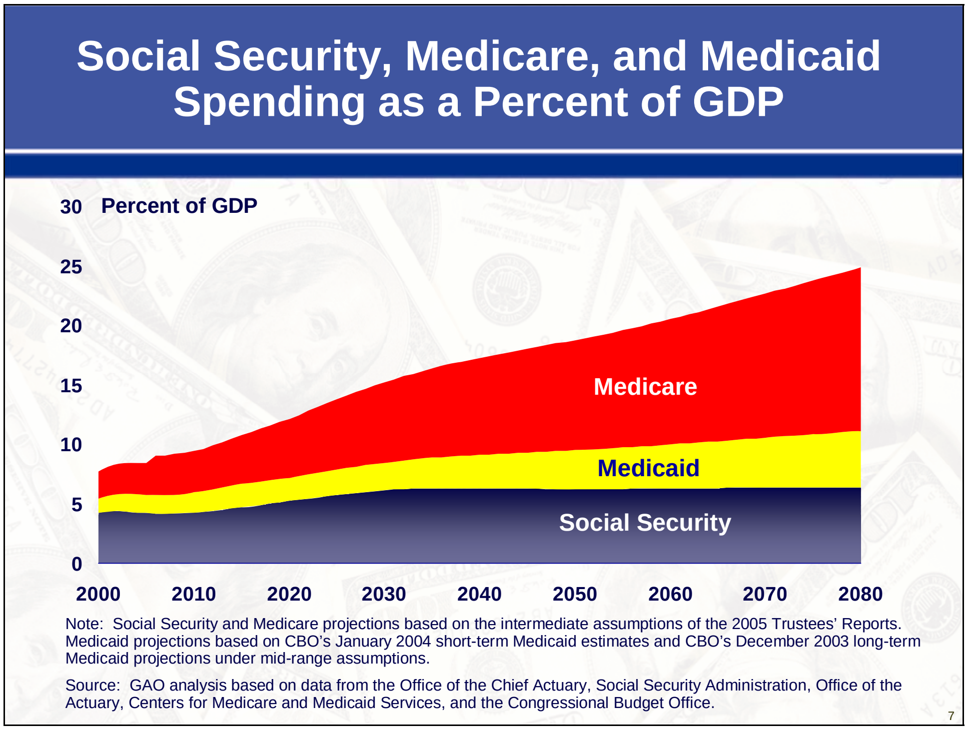
[2] Based upon the Social Security and Medicare Trustees' 2005 intermediate estimates.

Exhibit 1. Social Security and Healthcare Spending as Percentages of Gross Domestic Product



Changes must be made. GAO and the Congressional Budget Office agree that addressing the long-term fiscal challenge will require fundamental changes. Such changes could include changes in policies, processes, transparency, and enforcement mechanisms.

In GAO's view, nothing less than a fundamental re-examination of all major existing spending and tax policies and of priorities is needed. This re-examination should also involve a national discussion about what Americans want from their government and how much they are willing to pay for those things. This discussion will not be easy, but it must take place.

A key question is: how much time remains before action must be taken? One participant commented that, "Things that can't go on forever do stop—but how they stop matters." Acting sooner rather than later permits the miracle of compounding to stop working against us and instead work for us. GAO has observed that within the community of those concerned with the long-term fiscal challenge, a broad and bipartisan recognition exists that it should be addressed sooner rather than later.

In its publications and public forums, GAO is saying that:

- We cannot grow our way out of this;
- Across-the-board cuts and or eliminating fraud, waste, and abuse is not enough;
- Letting the tax cuts sunset is not enough;
- Cutting discretionary spending is not enough; and
- Waiting is not painless.

It is important that the public understand the magnitude of the choices that must be made—and that policymakers and the public begin to discuss those choices.

GAO has dedicated a special portion of its website to this issue: http://www.gao.gov/special.pubs/longterm/

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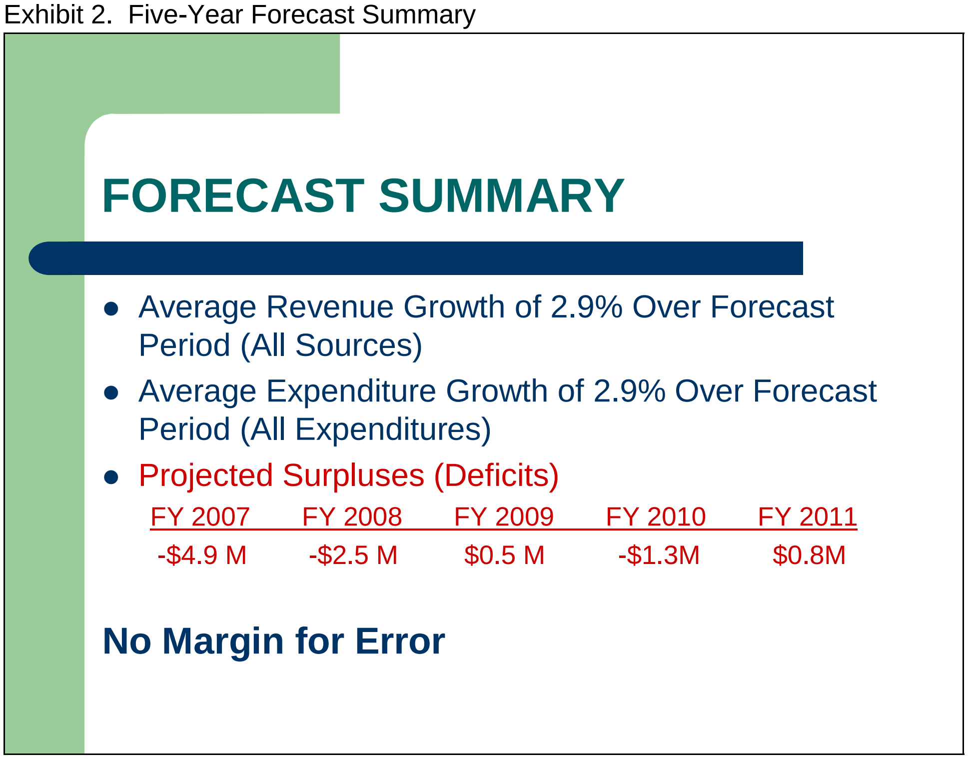
Little Margin for Error in Managing Kansas City's Fiscal Condition

The city's Office of Management and Budget's (OMB) forecast shows improvement in the budget's structural balance, but there is little margin for error. The forecast anticipates average revenue growth of 2.9 percent over the forecast period with a matching average expenditure growth of 2.9 percent. (See Exhibit 2.)

Exhibit 2. Five-Year Forecast Summary



Source: Kansas City, Missouri, Office of Management and Budget.

The forecast assumed a stable local economy with no significant changes in current city programs. However, the forecast did not consider the following:

- An unfunded city commitment of $47 million for the performing arts center;
- Diminished capital maintenance spending and the use of maintenance funds to service general obligation debt;
- Public safety radio replacement, estimated at $15 million;
- Additional equipment replacement for police, public works, and parks;
- The KC Live! Entertainment District with $20 million in annual debt service; and
- Underperforming economic development debt.

Another risk – identified by OMB but not included in the forecast – was the continued devolution of federal and state funding for social and health services, which results in pressure for the city to provide those services.

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National Challenges Could Adversely Affect Kansas City

National fiscal challenges and Congressional actions in response to those challenges will impact all states and municipalities. It is not a matter of if, but when and how. The magnitude and timing of those impacts are uncertain. The most likely responses to these challenges are federal revisions to the tax structure and continuing pressures on local governments to fill the gaps resulting from reductions in and the elimination of programs at the federal and state levels of government. Urban areas such as Kansas City will be hit hard due to high concentrations of poor and working poor families. The choice will be higher taxes or fewer services.

Less likely, but not to be discounted, are major economic shocks brought on by changes in the international monetary markets, natural catastrophes, or terrorist attacks. Such risks call for all cities and regions to develop strong reserve funds and contingency plans.

Federal and state governments could eliminate programs, pressuring local government to fill the gap. As programs that the public values are eliminated at the federal and state level, there will be pressure at the local level to fill the gap. The city recently increased its levy for health care initiatives while the state cut spending for Medicaid recipients. One participant noted that there is increasing pressure on Truman Medical

Center to provide indigent care to the entire region because the federal and state governments have already bailed out on health care for these families.

Another participant thought that reductions in Medicaid and economic disruptions, such as job losses, could lead to rural-county migration to the cities where more resources exist. Someone else said state changes in health care requirements, a graduated fee, and new income qualifications are making it harder for workers to qualify for state health care coverage. These are families making between $8 and $10 per hour, and if the trend continues, those making between $15 and $18 per hour may be forced out of the health care market.

As federal and state support devolves the urban core will be hit hardest. Participants agreed that the Kansas City urban core will be hit hard in the coming years because of its disproportionate numbers of poor and working-poor families. Census data shows the median household income in Kansas City is about $38,000, with about 13 percent of the households living on less that $10,000. By comparison, median household income for the metropolitan statistical area is nearly $47,000, with 8 percent of the households living on less than $10,000.[3]

Changes to the federal tax structure could impact local government. During her presentation, the GAO Director of Federal Budget Analysis presented information showing that the federal government, at some point, will be forced to examine entitlements, discretionary spending, and tax policy. The federal government could institute a consumption tax. One participant said this could have huge implications for state and local governments, as a consumption tax could drive out local sales taxes, or the federal government could collect and share with state and local governments.

Though unlikely, economic disruption is possible. While some participants thought that an economic disruption was not the most likely scenario—it cannot be discounted. Several participants mentioned the substantial foreign investment in the nation's debt, and if foreign investors decided that they no longer wish to hold American debt, changes could take place quickly, rippling throughout the economy. One participant pointed out that the nation's economy is a good place to invest.

Kansas City's economy is more vulnerable to national shocks. As a participant noted, the city was once somewhat immune from the booms

[3] U.S. Census Bureau, Kansas City, Missouri 2004 American Community Survey Data Profile Highlights; Johnson County, Kansas, 2004 American Community Survey Data Profile Highlights, http://factfinder.census.gov

and busts of the national economy, but “We are more vulnerable now.” As the national economy moves, so does Kansas City. There has been a loss of jobs in manufacturing and the meat packing industry, and there has been no public policy to address the issue of job loss.

Cities may have to increase taxes or cut services. One participant said that as the federal government cuts spending, cities will have to decide whether to cut services and benefits or raise taxes. Some forum participants noted that there is already a lot of uncovered health care need at this time. The health care delivery system should be reformed, as the American system is costly and inefficient. Regardless of what actions are taken, there needs to be more honesty about costs and what drives the rise in costs.

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City Should Articulate a Vision and Strengthen Financial Management

To prepare for the future, Kansas City needs to articulate what it wants to be as a city, which will require leadership and engagement of the public. There should be public dialogue about what people want their city government to provide and how much that will cost. Decision making will be critical as new projects and programs will impact others already underway. There should be public conversations about what we will pay for now and what our children and grandchildren will have to pay.

Kansas City should strengthen its financial management by following basic good governance practices and management principles and practicing responsible budgeting. The city needs to have both long-term and short-term planning, develop debt policies, build its reserve fund, develop contingency plans, rethink the revenue base, and work to simplify the regulatory environment.

The city should work to develop regional partnerships. Kansas City may want to consolidate functions, both within its own departments, and across jurisdictions. The city also needs to develop regional, nonpartisan priorities and send a clear message to lobby Washington and state government.

Articulate a Vision

Kansas City needs to articulate where it wants to go as a city. One participant said that communities need to decide how to use their resources to be competitive and successful in the global economy. That participant emphasized the importance of partnerships, good schools, good universities, and great parks and police.

Identify needs and how best to meet those needs. The city needs to redefine what types of services it will provide and assess how to best provide those services. One participant talked about assessing needs by comparing Kansas City's services to what other cities offer and considering functions that other cities deliver through private management. Efficient delivery of services may require consolidation and regional cooperation. One participant said, "We need to plan for less, which increases the need for regional institutions and the need to cut costs. We need to provide services in a more efficient and productive manner."

De-concentrate poverty from the urban core. One participant said Kansas City should understand the needs of the urban core, but also become more proactive in developing regional partnerships to do what no single jurisdiction can do alone. It is a matter of sharing, not shedding functions and services.

The city needs a clear strategy to de-concentrate poverty from the urban core—this concentration undermines all service delivery systems. One participant said the city needs to address disenfranchisement and blight, which discourages economic development and encourages flight.

Develop regional, non-partisan priorities to lobby Washington and state governments. One participant said that state and local governments should develop and send a stronger message to Washington. Another participant thought it would be appropriate for the city to take this opportunity to work with other cities in a bi-partisan way and to work with other organizations. Another suggested that Kansas City and the region develop regional priorities that could be presented to state governments—this would require regional consensus on priorities, however.

Strengthen Financial Management, Communicate Clearly

Forum participants talked about the need to follow basic management principles and responsible budgeting practices. There should be both long-term and short-term planning, a debt policy, and a review of the city's revenue base. One participant said the city should simplify the regulatory environment. Management should analyze current finances and revenues, long-term costs, develop forecasts and simulations to identify risks, and communicate clearly with the public.

Adopt and follow contingency and debt policies. One participant said there are few guidelines or limitations on the city's use of debt. Ten years ago the city didn't have much debt, now we have debt with few limitations and little discussion of financing vehicles. Another said there is too much ambiguity in the debt structure and a need for debt planning. You need strict debt policies until you know what is going to come in to offset debt requirements.

There is a need for automatic debt mechanisms and the need for reserve funds. The city's reserve fund is too low, currently at about 4.5 percent of the general fund—it should be at least 8 percent. Another participant said there is also a need for more contingency planning, and another said contingency funding was needed to deal with the unexpected.

The city should simplify the regulatory environment. One participant said the city should simplify how business with the city is conducted. Another suggested a clinic in how building and business can be effectively supported.

Analyze current finances and revenues. It seemed to forum participants that management makes decisions in a vacuum without considering current finances and revenues. The consequences of new projects and programs and how they will impact deferred projects or those already underway is not addressed. Inter-relationships should be considered; there should be conversations and sorting out. Automatic caps on spending can force elected officials to come up with revenues if they propose a new program or project.

There was also concern about the city's revenue base. With declining revenues, it is time to rethink the revenue base. For example, analyze the effect of an economy that increasingly relies on services rather than manufacturing. A manufacturing economy generates tax revenue from products and commodities. To offset the decline in manufacturing, leaders must consider taxing services, such as accounting and legal services.

One participant noted that the city's business license system is out of date. There has been a loss of earnings taxes with businesses moving to the suburbs; there is also a problem with revenue enforcement on profits and withholding taxes as residents take jobs outside of the city. One participant was concerned about the city's dependence on consumer spending. Another expressed concern about the city's use of tax incentives and thought the city should identify and measure tax abatements. Currently, the city foregoes about 5 percent of total revenues through tax abatements.

Measure costs, especially long-term costs. Several participants noted that deferred maintenance is an unrecognized fiscal exposure. In Kansas City there should be more honesty about the costs of deferred maintenance because private sector productivity depends upon government infrastructure. One participant said that capital planning should be organized differently and deferred maintenance should be posted as a liability.

Another long-term cost involves government retirement benefits, which need to be planned for and discussed. Non-pension retiree benefits (such as health care) were formerly carried on the books as pay as you go but soon the liability will have to be recorded.[4] One participant said there should be a discussion about changing from a defined benefits plan to a defined contribution plan and what that could mean for employees, especially those nearing retirement age.

Identify risks and report on risks. To be honest with the public, the city needs to identify and report on risks, as was done in the latest financial forecast. Management should make both forecasts and simulations to help the public and decision-makers understand costs and risks. A participant warned of using overly optimistic forecasts when budgeting. Once risks are identified, the public should be asked whether they are willing to live with a certain level of risk.

Communicate clearly with the public. Several participants talked about the lack of information to the public about the fiscal condition of their governments. One participant said there is no public discussion on the city's debt exposure—there should be public dialogue about this issue. Another participant noted that leaders get elected on platforms promising people will not have to make choices.

One participant said that the conversation should be about choices and futures—about where to go as a nation, as a region, and as a community. Another said this would be less polarizing than looking only at tough choices. Another participant said that we need to think and explain the fiscal situation in simple terms.

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[4] *Reporting Requirements for Non-Pension Retiree Benefits*, Office of the City Auditor, Kansas City, Missouri, July, 2005.

Recommendations

The forum resulted in suggested methods and strategies to address issues Kansas City will face in the future. In addition, the forum will influence the work of this office and the issues we study going forward. Based on the ideas and thoughts expressed by forum participants, and our prior audit work, we include the recommendations below. The recommendations are those of the City Auditor, not the forum participants. Also included in Appendix E is a list of prior audit work that helped form these recommendations.

1. The City Manager should develop financial policies for City Council deliberation on revenues, debt level and capacity, contingency planning, balancing the budget, and development incentives.

2. The City Manager should encourage staff to develop ways to analyze the future consequences of proposed actions, including simulations and financial forecasts.

3. The City Manager, consulting with the City Council, should consider establishment of a citizen working group to pursue regional strategies and to work with other jurisdictions to develop regional priorities.

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Appendix A

Forum Participants

Forum Participants

The Financial Futures Challenge	**Monday, November 7, 2005**
Moderator	**Mark Funkhouser** City Auditor, City of Kansas City, Missouri
Participants	**Robert Bixby** Executive Director, The Concord Coalition
	Dan Carpenter Chairman, Gemaco, Inc.
	Jack Craft Attorney-At-Law, Lathrop & Gage LC
	Glenn Deck Executive Director, Kansas Employees Retirement System
	Craig S. Hakkio Sr. Vice President and Director of Research Federal Reserve Bank
	Debra Hinsvark Director of Finance, Kansas City, Missouri
	Helen Hsing Managing Director for Strategic Planning and External Liaison, U.S. Government Accountability Office
	Susan Irving Director, Federal Budget Analysis, Strategic Issues U.S. Government Accountability Office

Forum Participants

Robert Kipp
Vice President, Hallmark Cards, Inc.

Bob Litan
Vice President, Research & Policy
Kauffman Foundation

Chris Lester
Assistant Managing Editor/Business
The Kansas City Star

Justin Marlowe
Assistant Professor, Department of Public Administration,
University of Kansas

Ed Mazur
Member, Governmental Accounting Standards Board

James R. Moody
James R. Moody & Associates

Richard Moore
President, Commerce Mortgage Corporation

Daniel J. Moyer
Managing Director, Capital Markets
GE Insurance Solutions

John Nachbar
City Manager, City of Overland Park, Kansas

Joseph O'Keefe
Senior Director of Public Finance
Fitch Ratings

Forum Participants

William Pound
Executive Director
National Conference of State Legislatures

Ralph Reid
Executive Director, Sprint Foundation

Landon H. Rowland
President, Ever Glades Financial

Troy Schulte
Budget Officer, Office of Management & Budget
City of Kansas City, Missouri

Jewel Scott
Executive Director
Civic Council of Greater Kansas City

Professor Max J. Skidmore
Professor of Political Science/Curators' Professor
UMKC – Department of Political Science

Michele M. Stromp
Partner, KPMG, LLP

David Warm
President, Mid-America Regional Council

Steve Winn
Deputy Editorial Page Editor, *The Kansas City Star*

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Appendix B

GAO Power Point Presentation – The Nation’s Long-Term Fiscal Challenge

The Nation's Long-Term Fiscal Challenge

Susan J. Irving
Director, Federal Budget Analysis
U.S. Government Accountability Office

Kansas City Auditor's Financial Futures Forum
November 7, 2005

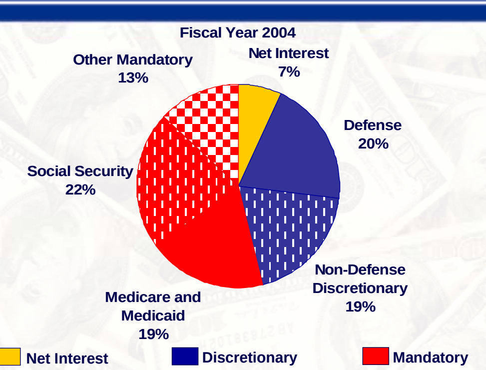
Fiscal Year 2005 Deficit Numbers

	$ Billion	% of GDP
On-Budget Deficit	(494)	(4.0)
Off-Budget Surplus	175*	1.4
Unified Deficit	(319)	(2.6)

*Includes $173 billion Social Security surplus and $2 billion surplus for the Postal Service

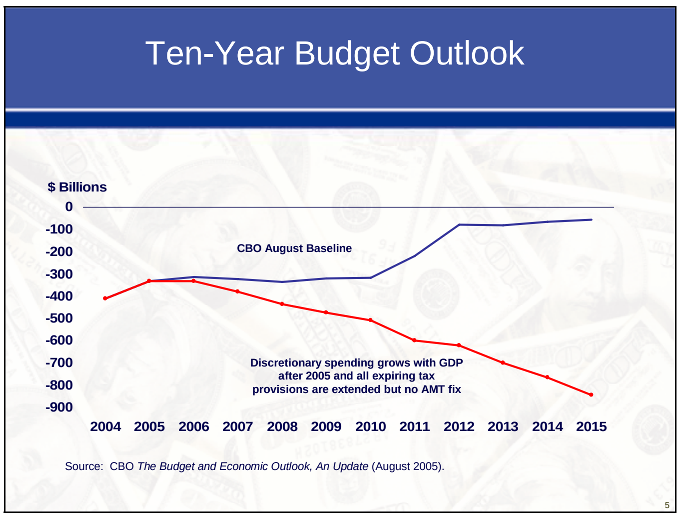
2

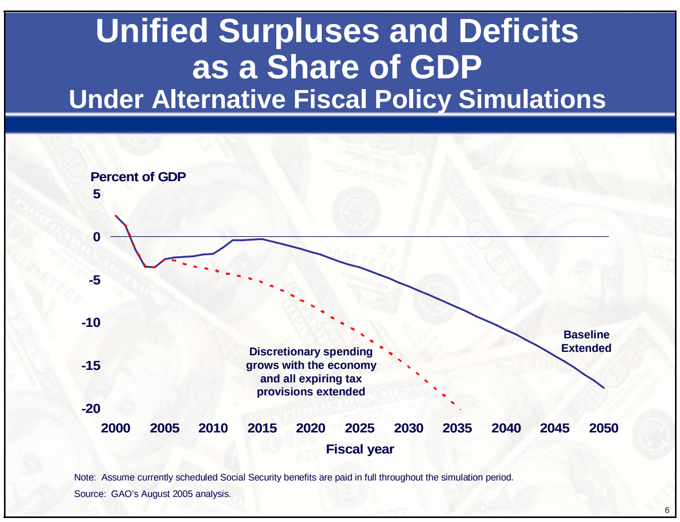
Composition of Federal Spending by Type and Function

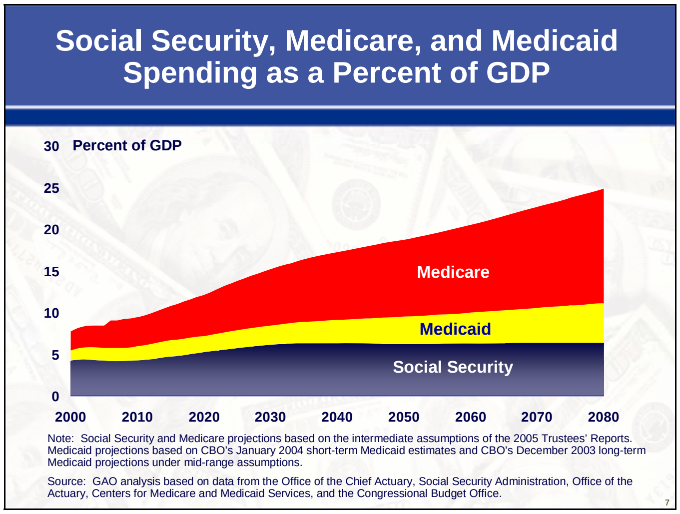


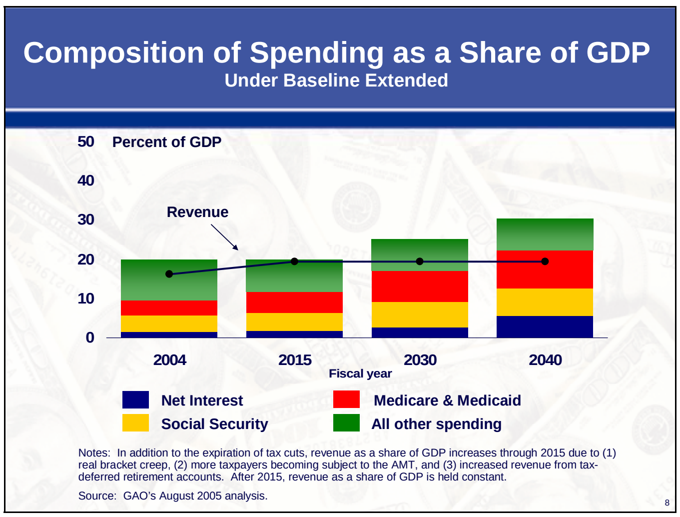
3

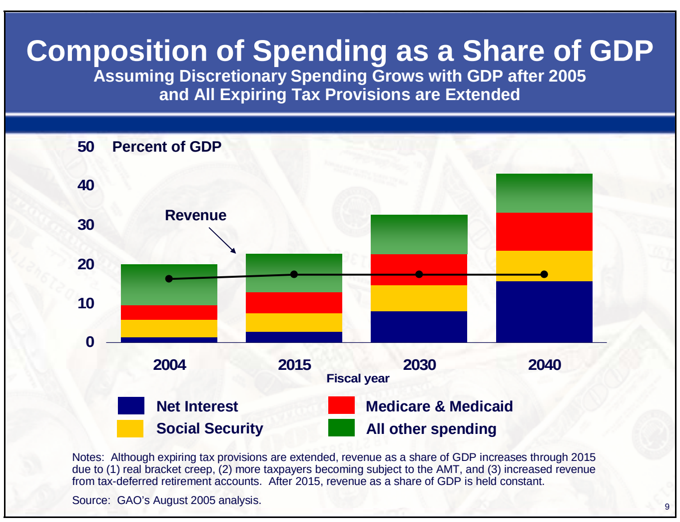

OFFICIALS IN WASHINGTON CONTINUE TO IGNORE WARNINGS ABOUT THIS STORM, WHICH IS PROJECTED TO BE A CATEGORY 500 BILLION....
FEDERAL DEFICIT
D.C.
Used with permission from the *Milwaukee Journal Sentinel*
4


Ten-Year Budget Outlook
$ Billions
0
-100
-200
-300
-400
-500
-600
-700
-800
-900
CBO August Baseline
Discretionary spending grows with GDP after 2005 and all expiring tax provisions are extended but no AMT fix
2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Source: CBO *The Budget and Economic Outlook, An Update* (August 2005).
5

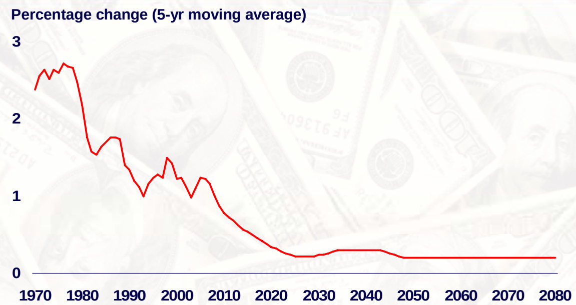

Unified Surpluses and Deficits as a Share of GDP
Under Alternative Fiscal Policy Simulations
Percent of GDP
5
0
-5
-10
-15
-20
Baseline Extended
Discretionary spending grows with the economy and all expiring tax provisions extended
2000 2005 2010 2015 2020 2025 2030 2035 2040 2045 2050
Fiscal year
Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.
Source: GAO's August 2005 analysis.
6


Social Security, Medicare, and Medicaid Spending as a Percent of GDP
30 Percent of GDP
25
20
15
10
5
0
Medicare
Medicaid
Social Security
2000 2010 2020 2030 2040 2050 2060 2070 2080
Note: Social Security and Medicare projections based on the intermediate assumptions of the 2005 Trustees' Reports. Medicaid projections based on CBO's January 2004 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.
Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.
7


Composition of Spending as a Share of GDP
Under Baseline Extended
50 Percent of GDP
40
30
20
10
0
Revenue
2004 2015 2030 2040
Fiscal year
Net Interest
Social Security
Medicare & Medicaid
All other spending
Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.
Source: GAO's August 2005 analysis.
8


Composition of Spending as a Share of GDP
Assuming Discretionary Spending Grows with GDP after 2005
and All Expiring Tax Provisions are Extended
50 Percent of GDP
40
30
20
10
0
Revenue
2004 2015 2030 2040
Fiscal year
Net Interest
Social Security
Medicare & Medicaid
All other spending
Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.
Source: GAO's August 2005 analysis.
9

Labor Force Growth is Expected to be Negligible by 2050

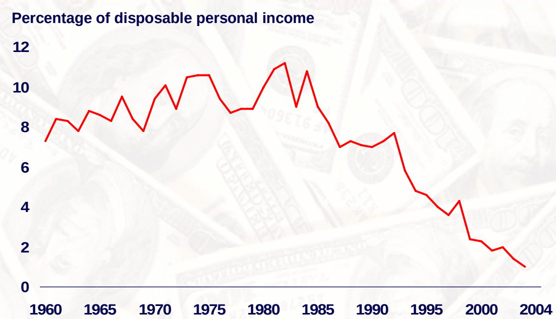


Note: Percentage change is calculated as a centered 5-yr moving average of projections based on the intermediate assumptions of the 2005 Trustees Reports.

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

10

Personal Saving Rate



Source: Bureau of Economic Analysis.

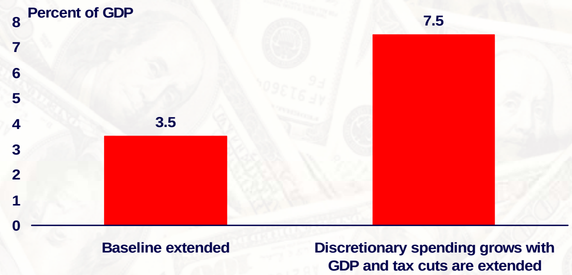
11

Moving Forward: Debunking Myths

- **Myth #1: We can grow our way out of this.**
- **Myth #2: Across-the-board cuts and/or eliminating Fraud, Waste & Abuse is enough.**
- **Myth #3: Letting the tax cuts sunset is enough [or the parallel—cutting discretionary spending is enough].**
- **Myth #4: Waiting is painless.**

12

Size of Action Needed in 2005 to Close the Fiscal Gap



Source: GAO's March 2005 analysis.
Note: The fiscal gap is the size of the one-time permanent policy action—measured in terms of GDP—needed to keep debt held by the public (as a percent of GDP) from rising above the level in the base year (FY2004).

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Current Fiscal Policy Is Unsustainable

- **Waiting is not free—and we can't do it all on one side of the ledger**
  - GAO's simulations show that balancing the budget in 2040 could require actions as large as
    - Cutting total federal spending by 60 percent or
    - Raising federal taxes to 2.5 times today's level
- **Faster economic growth can help, but it cannot solve the problem**
  - Closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
  - During the 1990s, the economy grew at an average 3.2 percent per year.

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Moving Forward: The Task

Improve Process, Measures and Metrics:

- Process:
  - Budget controls [caps, PAYGO]
  - Moving beyond "holding the line": triggers etc.
- Metrics:
  - More transparency
  - More information about long-term costs of major tax & spending proposals [including programs run through the tax code

Re-examine Policies and Programs:

- Entitlements
- Discretionary: reexamine the base
- Tax policy--including tax preferences and enforcement programs

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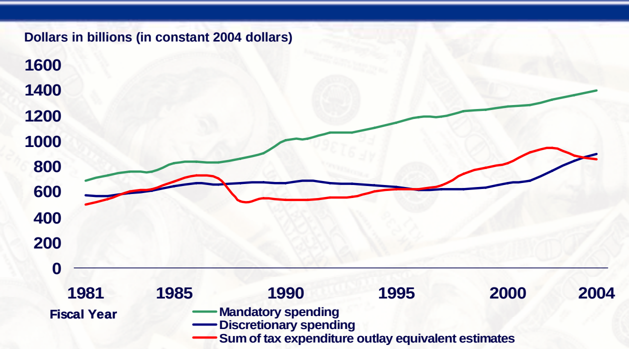
Moving Forward: A Closer Look at Some Items

Measured on an Outlay Equivalent Basis, Tax Expenditures Exceeded Discretionary Spending for Most Years in the Last Decade



Note: Outlay-equivalent estimates represent the amount of budget outlays that would be required if the government were to provide taxpayers with the same after-tax income they receive through the tax expenditure. Outlay-equivalent estimates are useful to compare tax expenditures and other parts of the federal budget. Summing tax expenditure estimates does not take into account interactions between individual provisions.

Source: GAO Analysis of OMB's Budget Reports on Tax Expenditures, Fiscal Years 1976-2006.

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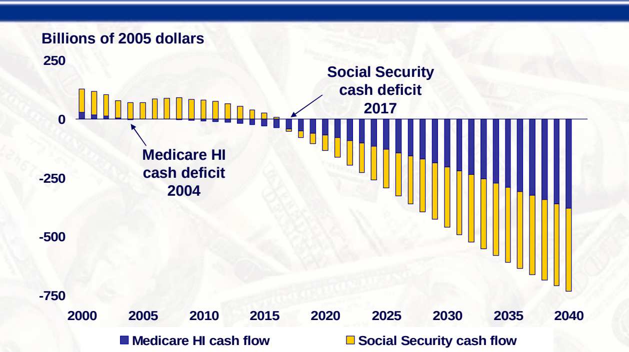
Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits



Note: Projections based on the intermediate assumptions of the 2005 Trustees' Reports.

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

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The Importance of Looking Beyond the 1st Year

- **Terrorism Risk Insurance expansion to aircraft and aircraft engine manufacturers enacted in 2003**
  - Estimate for FY 2004: $3 million income
  - Estimate for 10 years (2004-2013): $47 million cost
- **Health Care Benefit extension to older uniformed services retirees enacted in 2000**
  - Estimate for FY 2001: $223 million cost
  - Estimate for 10 years (2001-2010): $40.4 billion cost
  - Financial statement liability: $293 billion
- **Medicare Drug Benefit enacted 2003**
  - Estimate for CY 2006: $64.4 billion
  - Estimate for 2006-14: $851 billion
  - Estimate from program inception through 2079: $8.7 trillion in present value terms

Sources: Medicare estimates for net federal spending are drawn from the 2005 Medicare Trustees' intermediate estimates. All others are CBO cost estimates in year of enactment and 2001 Consolidated Financial Statement.

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Estimated Fiscal Exposures
(in $ trillions)

	2000	2002	2004
• Explicit liabilities	**$6.9**	**$7.8**	**$9.1**
• Publicly held debt • Military & civilian pensions & retiree health • Other			
• Commitments & Contingencies	**0.5**	**0.8**	**0.9**
• E.g., PBGC, undelivered orders			
• Implicit exposures	**13.0**	**17.8**	**33.3**
• Future Social Security benefits	3.8	4.6	5.2
• Future Medicare Part A benefits	2.7	5.1	8.5
• Medicare Part B benefits	6.5	8.1	11.4
• Medicare Part D benefits	--	--	8.1
Total	**$20.4**	**$26.4**	**$43.3**

Sources: Consolidated Financial Statements.

Note: Estimates for Social Security and Medicare are PV as of January 1 of each year as reported in the Consolidated Financial Statements and all other data are as of September 30. The 2005 Trustees Reports issued in March of this year show that the Social Security and Medicare exposures have increased as follows: Social Security increased to $5.7 trillion, Medicare Part A increased to $8.8 trillion, Medicare Part B increased to $12.4 trillion and Part D increased to $8.7 trillion. Totals may not add due to rounding.

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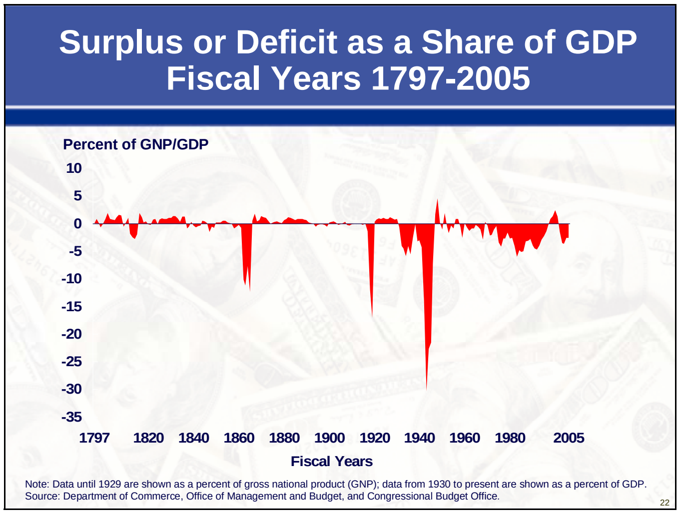
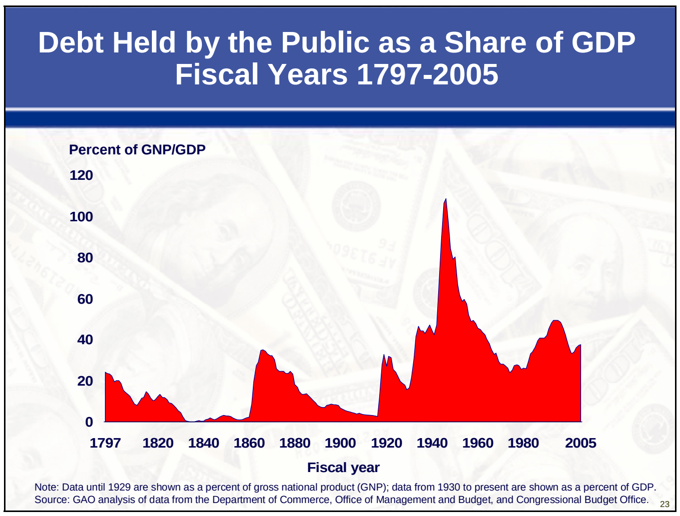
Putting Today in Historical Context





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Appendix C

Kansas City Office of Management & Budget Power Point – Five-Year Financial Condition and Forecast FY 2006-07 to FY 2010-11

City of Kansas City, Missouri
FIVE YEAR FINANCIAL CONDITION AND FORECAST
FY 2006-07 to FY 2010-11

Budget and Audit Committee

November 8, 2005

Forecast Assumptions

- A stable local economy
  - Moderate levels of economic growth through Forecast Period
  - Stable to Declining Levels of Unemployment
  - Rate of Inflation of approximately 2.5% per year
  - Developed separately but consistent with MARC area forecast
- No significant changes in current City programs

Structurally Balanced Budget

- Four criteria for a budget to be structurally balanced
  - Current Revenues Equal Current Expenses
  - Projected Revenues Equal or Exceed Projected Expenses
  - Adequate Reserves
  - Adequate Capital Maintenance Funding

Focus of the Financial Forecast

- Nine General Fund Supported Funds
  - General Fund
  - Parks Maintenance Funds (East and West Park)
  - Motor Fuel Tax Funds
  - Gaming Funds
  - Hazardous Materials
  - Health Levy
  - Convention and Tourism
  - Community Centers
- Represents approximately 45% of total budget
  - Nearly all city services impacted.

Financial Condition of Current Revenues

- Positive Projected Growth
  - Revenue Growth Exceeds Rate of Inflation
- Stable or Neutral Projected Growth
  - Positive Revenue Growth, but not exceeding rate of inflation
- Negative Projected Growth
  - No growth or declining collections during Forecast Period.

Positive Projected Revenues

Greater than 2.5% Growth Per Year

- Earnings Tax – Projected Growth of 3% to 4%
  - By comparison, late 1990's saw collections of 5% to 5.5%
- Real Property Tax – Projected Growth of 3% to 3.5%
  - Potential Risk – Continued loss from abatement ($4.0 million)
- Gaming – Projected Growth of 2.5% to 3%
  - Potential Risk – Increased Gambling in Region (Kansas)
- Business Licenses – Projected Growth of 2.5%
  - Need for simplification and modernization of code
- Interest Earnings – Projected Growth of 3.5%
  - Contingent on City's ability to rebuild reserve funds

Stable Revenue Sources
Growth of 1% to 2.5% Per Year

- Motor Fuel Taxes
- Convention and Tourism Taxes
- Park Maintenance Taxes
- Most Service Charges
- Most Utility Taxes (Except Telephone)
- Court Fines
- Rental Income

Negative Revenues
No Growth or Negative Growth

- Local Use Tax
  - Projection assumes loss of $5.5 million in resources from expiration of KCATA sales tax in March of 2009.
- Personal Property Tax
  - Continued loss of taxable commercial property
- Park Taxes (Boulevard and Vehicle Licenses)
- Telephone Franchise Tax
  - Recent change in State Law makes this revenue stream less uncertain. Potentially no growth from previous 8-10% annual declines

Revenue Summary

Aggregate Revenue Growth consistently around 3% for forecast period

- A return to more “normal” tax collections
- Vulnerable to external shocks
  - Local economy now more reflective of national economy
- Need for revenue reform to increase rate of growth of certain revenues (Parks)
- Increased need for revenue enforcement and collection

EXPENDITURE PROJECTIONS

- Personnel Costs
  - Salary and Benefit Cost Projections
    - Annual Salary Increases of 3% for City civilian staff
    - Annual Salary Increases of 3.5% to 3.75% for City uniformed staff
    - Health Insurance Costs Increases of 10% Per Year ($3.5 million in FY 2006-07)
    - 20 Police Officers through FY 2009-10
    - Continued Investment to Maintain Four Defined Benefit Pension Programs
  - Need to Reduce Salary Savings to Traditional Levels
  - Average Annual Growth Rates of 4% through Forecast

Expenditure Projections FY 2006-07

- Gasoline Price Increases
  - Solid Waste Collection (5% to 6% increases)
  - City Fleet Operations (55% projected increase)
  - Park Mowing Costs (10% to 20% increases)
  - Street Resurfacing
- Rat Control Program (Est. $150,000 program)
- Worker's Compensation (Additional $1.5 million in needs)
- Technology Initiatives (Approx. $3 million)
  - 311 / Revenue System
  - Additional Staff to Support PeopleSoft
- Equipment Replacement
  - Solid Waste and Parks and Recreation
- Debt Service to Support General Obligation Bonds
  - Funded by Reduced Capital Maintenance Spending

Expenditure Summary

Aggregate Expenditure Growth averages 2.9% for forecast period including net transfers.

- Assumes implementation of variable pay plan for city employees
- Price pressures from health insurance costs and pension obligations.
- Vulnerability to external price shocks.
- Reduced capital maintenance spending to support general obligation debt service

FORECAST SUMMARY

- Average Revenue Growth of 2.9% Over Forecast Period (All Sources)
- Average Expenditure Growth of 2.9% Over Forecast Period (All Expenditures)
- Projected Surpluses (Deficits)

FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
-$4.9 M	-$2.5 M	$0.5 M	-$1.3M	$0.8M

No Margin for Error

Expenditure Projections Out Years
Not Included in the Forecast

- Additional Equipment Replacement
  - Police, Public Works, Parks
- Public Safety Radio Replacement
  - Estimated Need of $15 million
- Unfunded City Commitments
  - $Ex. 47 million for Performing Arts Center
- Additional Capital Maintenance needs
  - Scarce funds used to support debt
- Additional funds for staff training and development
  - Recommended 2% of payroll or $1.6 million

Other Expenditure Risks
Not Included in the Forecast

- Diminished Capital Maintenance Spending
  - Maintenance Funds used to service G.O. Debt.
  - Projected Capital Spending of $15 million in FY 2007-08.
- KC Live Entertainment District/Other Development Projects
  - $270 Million project backed solely by incremental tax revenues/State support
    - Est. $20 Million annual debt service requirement
  - Need for higher fund reserves to support
    - Consider reserve requirement of at least 10% or $34 million
    - Currently at 4.5% or $15.3 million

Other Expenditure Risks
Not Included in the Forecast

- Devolution of Federal and State Funding
  - Diminished support for social and health services
  - Increased pressure for City to provide those functions
- Underperforming economic development debt
  - Requiring additional General Fund support
- Supply Shocks
  - Potential of further price increases (fuel, etc).

CONCLUSIONS

- Significant Improvement in Overall Financial Condition
  - Previous forecasts showed $100 million out year deficits
  - FY 2003-04 budget cut over $60 million in deficits
  - Projected deficits less than 1% of total budget
  - Revenue growth of 3% returning to historical levels.
  - Expenditure growth contained at 3%
    - Cost pressure from employee salary and benefits
- Limited ability of City to respond to new services or challenges within current resources.
- Vulnerable to external price shocks or underperforming development projects.
- Need for higher reserves and additional funding for capital maintenance
- **No Margin for Error**

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Appendix D

Prior Audit Work Related to Kansas City's Fiscal Condition

Prior Audit Work Related to Kansas City's Fiscal Condition

Review of the Submitted Budget for FY 2007, 03/01/2006

Summary of Issues Reported by KPMG and JMA Chartered for FY 04, 12/19/2005

City Services Performance Report for FY 2005, 11/21/2005

Flowchart for Report on Managing Risks of Increased Debt, 08/23/2005

Managing the Risks of Increased Debt, 08/23/2005

Reporting Requirements for Non-Pension Retiree Benefits, 07/19/2005

Review of the Submitted Budget for FY 2006, 03/01/2005

Review of the Submitted Budget for FY 2005, 03/02/2004

Review of the Submitted Budget for FY 2004, 03/05/2003

Financial Condition Forum, 09/04/2002

Potential Budget Changes for 2004, 09/04/2002

Review of Submitted Budget for FY 2003, 03/05/2002

Analysis of the City's Budget Structure, 10/17/2001

Budget Process Practices, 08/01/2001

Review of Submitted Budget for FY 2002, 02/28/2001

To review these or other reports, go to www.kcmo.org/auditor.

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Appendix E

City Manager’s Response

CITY OF FOUNTAINS
HEART OF THE NATION

KANSAS CITY
MISSOURI

Office of the City Manager

29th Floor, City Hall
414 East 12th Street
Kansas City, Missouri 64106

(816) 513-1408
Fax: (816) 513-1363

RECEIVED
APR 1 4 2006
CITY AUDITOR'S OFFICE

DATE: April 14, 2006

TO: Mark Funkhouser, City Auditor

FROM: Wayne A. Cauthen, City Manager W.A.C

RE: Kansas City's Financial Future Forum

I am in receipt of the report you have assembled as a result of the forum you hosted on November 7, 2005. The report yielded three recommendations to the City Manager. Before my response to the recommendations resulting from this report, I address some general issues and concerns with the format and presentation of this information.

This report is a departure from your usual methodology of conducting an audit, and is the result of a forum, and not of any investigation or analysis of efforts undertaken by staff at city hall to address Kansas City's financial future. Therefore I approach this report from a different perspective than usual.

While I find the outcomes of your forum valuable, Mayor Barnes and I met with you previous to your holding this discussion, and expressed an interest in participating. However, you indicated that the forum attendees would not be as forthcoming with their genuine feelings about the city's financial position if we were present. I believe this was a mistake, as my and Mayor Barnes' presence would have allowed a free and open exchange, and it would have been valuable for they Mayor and I to hear first hand, in context, the concerns of the panel of participants you convened. Should you choose to hold this type of forum in the future, I would like to recommend that you include the Mayor and City Manager.

It is my belief that the Mayor and City Council have made a policy decision to correct the deteriorating infrastructure in the central business district, and to address it in an accelerated manner. The outcome of such activities will have a direct positive affect on business growth and stabilization, revitalizing downtown, and will create spin-off to generate additional sales tax revenue that the citizens of Kansas City will not bear the majority of the expense through tax increases. Providing an environment for citizens and tourists alike to live work and play will transform downtown from a 'work only' environment as it has been for the past thirty-five years to being home after work hours to the more than 18,000 residents that live downtown fulltime. This wise decision is a departure from the status quo; had it not been made, the status quo would remain, and Kansas City would see no return as it would not have made an investment. The completion of the Entertainment District and Sprint Arena will attract even more residents, and a multitude of tourists.

The broad brush with which you stroke Kansas City's resources and service delivery does not accurately portray the efforts our City Council has made to balance unfunded mandates with an existing body of services to deliver with dwindling, or fluctuating funds. The efforts this administration has made to consolidate basic services, anticipate the cuts made at the state level regarding healthcare, and increase revenues is not referenced throughout the document, and therefore do not offer a fair depiction of efforts that have actually been made by city staff in these past three years.

Recommendation #1: *The City Manager should develop financial policies for City Council deliberation on revenues, debt level and capacity, contingency planning, balancing the budget, and development incentives.*

Response: Agree in part. It is the role of the City Council to develop policies, and the City Manager to implement those policies. As always, city staff is available to assist and provide counsel to the City Council and inform them of the feasibility of the practical application of policies as they deliberate and develop them.

That said the Finance Department is in the process of addressing such issues. The focus of activities has been to address operational functions so that we are able to report regular, accurate information to our governing bodies, and enhancing internal controls. The Finance Department is also in the final stages of engaging a consultant to assist in reviewing our investments and addressing our debt policies. As a good deal of the city's debt is in economic development, it makes sense that the consultant is engaged in these activities. The bulk of the existing debt policies are in draft form, and mirror our current practices. As we are updating our practices, we are refining our policies as well.

Recommendation #2: The City Manager should encourage staff to develop ways to analyze the future consequences of proposed actions, including simulations and financial forecasts.

Response: Agree. I currently engage in these activities, as does my executive staff who liaison with all city departments. As you well know, the local level of government is always hardest impacted by national economic downturns. When the federal government catches a cold, local government catches pneumonia. Our jobs first and foremost are to ensure we continue basic service delivery, and to remain in compliance with all mandates. Whenever possible, we anticipate shortfalls, and compensate accordingly.

A recent example of not only analyzing, but taking action to mitigate the negative affects of proposed actions is the Health Levy increase passed on April 5, 2005. As City Manager, I recognized that the health levy had not been increased in nearly twenty years. Recognizing the disposition of our city's budget, I recommended the City place a ballot measure for a health levy increase in the 2003-2004 budget submittal letter. While the cuts made at the State of Missouri counteracted the gains we made locally, the actions taken to increase the levy allowed the citizens of Kansas City to win in multiple ways: the city has a dedicated revenue stream with which to address the healthcare; the general fund dollars that were going to healthcare are now re-dedicated to basic services and core city functions; indigent healthcare nets zero growth versus netting a negative funding stream.

The City has also consolidated multiple basic service and administrative functions, allowing us to deliver services with less oversight, and dedicate more money to service delivery versus administration. In addition, the city developed an internship program with UMKC to provide additional manpower without significant capital outlay.

Recommendation #3: The City Manager, consulting with the City Council, should consider establishment of a citizen working group to pursue regional strategies and to work with other jurisdictions to develop regional priorities.

Response: Disagree. In addition to citizen representation via the City Council, The City of Kansas City currently interacts with multiple citizen taskforces, advisory boards, and other governing boards. The City also actively participates with and partially funds some organizations like Mid-America Regional Council, The Greater Kansas City Chamber of Commerce, Convention and Visitor's Association, Kansas City Area Development Council, and Missouri Municipal League, American Society for Public Administrators, and the City Manager's Roundtable, whose express missions it is to identify regional trends and address solutions to areas of challenge. As a region, we certainly have a responsibility to learn from progress made in regional cooperation from other metropolitan areas with hurdles similar to ours.

As the largest municipality in the region, Kansas City plays a pivotal role in the execution of those strategies. Over the last three years, this administration has focused on assuming responsibilities that have been decentralized and abdicated to private or other entities. The City of Kansas City will continue to be a central player in regional strategies, and an active participant in the solutions to our collective challenges.

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