May 16, 2016

The City's Long-Term Financial Direction

This Backgrounder provides highlights of the report, The City's Long-Term Financial Direction, from the City Manager, Deputy City Managers and Chief Financial Officer, being considered by Executive Committee at its meeting of May 24, 2016.

Overview

- The City has been able to achieve balanced budgets on an annual basis, despite underlying concerns regarding sustainability**.** Analysis strongly suggests that the circumstances of the recent past have been uniquely favourable and do not form a realistic basis for responsible future fiscal planning.
- The staff report on the City's Long-Term Financial Direction explores the underlying conditions of City finances by reviewing the expense and revenue patterns of recent budgets.
- It also provides a basic forecast of future expense pressures and revenue performance and outlines a series of principles and directions to guide the development of new strategies to manage expense and revenue over multiple years.
- The report's recommendations and additional actions are intended to improve the long-term financial stability of the City.
- Full implementation of the directions described through the recommendations will require a shift in how the City approaches its annual budget and medium-to-long-term program planning.
- Changes in both expense and revenue management will be required for the City to balance the annual budget.

Current budget process

- The City's current budget process focuses on the fiscal year under consideration. Forecasts are limited to a two-year timespan.
- Decision-making is centred on "net" or tax-supported budget items, which tends to heighten focus on property tax impact and lessen focus on user fees and utility rates and the overall impact on residents and businesses.
- Net budget accounting also records reserve draws as revenue, suggesting programs are more funded than is actually the case.
- City divisions are subject to detailed review. Agency budgets, which account for many of the City's most significant expense drivers (TTC, Toronto Community Housing Corporation and Toronto Police, for example), while reviewed by City staff and Budget Committee, are subject to agency board direction and approval.
- Annual budgets have adopted temporary measures to offset expense pressures, including temporary reserve draws and deferral of known operating and capital needs.

- Short-term measures used to balance the budgets in earlier years place incremental pressures on the 2017 budget and beyond.

Recent performance

Expense

- Overall City expenses have been constrained over the past six years, rising much more slowly than earlier periods.
- Council has also annually approved new and enhanced service levels.
- Spending per resident is slightly lower over the past six years, when adjusted for inflation, even with the addition of new services.
- Expenses related to three broad service areas – transit, emergency services and rate-supported programs – account for almost three-quarters of the gross expenditure increase incurred by the City.
- These increases have been offset by other areas of direct savings or lower growth:
    - Efficiencies achieved through line-by-line savings, program reviews, new technology and changes to collective agreements.
    - Moderate savings from social programs which are cost-shared with the province. The savings from social programs may not be available in the future, reflecting Ontario's assumption of increased responsibility for these programs.
    - Deferrals of operating and capital expense – unfunded capital projects are now estimated at up to $29 billion over 15 years. The strategy of deferral is reaching practical limits as investment becomes necessary.

Revenue

- On the revenue side, reliance on property tax – the City’s most important and stable revenue source – has decreased over the past six years.
- Council has made long-standing decisions to hold overall property tax increases at or below inflation.
- Adjusted for price inflation, property tax revenues have actually decreased since 2010.
- Overall revenue growth has instead been supported by:
    - Increases in utility rates for water and solid waste, Toronto Transit Commission (TTC) fares and other user fees and
    - Rapid growth in Municipal Land Transfer Tax (MLTT) revenue.

Future projections

Expense

- The overall gap between expense and revenue is growing.
- Projections confirm expense challenges in the future, in addition to typical labour and material cost pressures, including:
    - Funding requirements for TTC and Toronto Community Housing Corporation (TCHC)
    - Annualized costs related to earlier capital and operating commitments

  - Addressing prior year deferrals of employee benefit liabilities and
  - Adjustment in response to the loss of the Toronto Pooling Compensation grant.
- Other factors may drive expenses higher, notably pressures from Toronto Police Service, currently factored at zero, and any new investments identified by Council, including the Poverty Reduction Strategy or transit priorities.

Revenue

- On the revenue side, it is anticipated that growth will slow in the absence of policy changes.
- Projected revenues will be influenced by:
  - Continued low growth in property tax revenues
  - Leveling off of increases related to water and solid waste charges, TTC fares and other user fees
  - Anticipated levelling off of MLTT revenues.
- Looking toward future years, there are unlikely to be quick solutions or shortcuts to achieve balanced budgets:
  - Annual surpluses are falling
  - Reserve funds are already at relatively low levels
  - Funding from the governments of Ontario and Canada for housing and transit investments are essential to city building, but cannot replace long-term gaps in operating funding or fully offset unmet capital needs.

2017 budget

- The report focuses on the longer term. It does, however, present a summary of 2017 budget pressures.
- As the City undertakes the 2017 budget process over the coming months, it will be important to ensure consistency between decisions taken in the short-term and the City's emerging long-term priorities.
- The pressures expected for the 2017 budget process will pose challenges.
- For 2017, the anticipated net opening pressure on the property tax base is estimated at $588 million, after all offsetting expense and revenue are factored in.
- Subtracting forecasted revenues from an inflationary property rate tax increase, assessment growth and potential City Building Fund revenue reconciles to a potential gap of $483 million.
- This does not account for new expenses or savings that may be approved by Council for either operating programs or new capital projects.
- Any incremental operating investments or new capital projects will increase expense. Any savings initiatives will offset expense.
- Key sources of pressure for 2017 are:
  - Long-term inflation and core cost drivers
  - TTC pressures and annualization including contractual payments for Presto use
  - TCHC operating gap, as reserve and debt financing offsets are less tenable

- Catch up with short-term expense and revenue measures implemented in prior years, which must now be reversed.

Initial advice

- The advice from staff suggests the following actions:
    - Manage immediate pressures and avoid compounding financial challenges, such as deferral tactics that push off rather than address core cost drivers
    - Prioritize future operating investments and capital expense, on a multi-year basis
    - Implement longer term expense constraint
    - Explore revenues through existing and potentially new tax and non-tax sources.
- Of note, the City has set out annual savings targets in recent budget processes with varying degrees of compliance and impact
- Council should approve targets and require that City divisions and agencies provide options to meet these targets and avoid deferring expenses to future cycles
- As Council gives consideration to a long-term approach to financial planning, it should be focused on the following considerations:
    - A "whole of government" approach to expense management that accounts for all aspects of City operations, including agencies
    - Linking program and financial planning to desired outcomes
    - Reviewing and developing a funding plan for priority capital projects
    - Maximizing savings through efficiencies and responsible service level changes
    - Focus on long-term labour cost drivers
    - Contracting out and alternative service delivery.
- Back office savings (achieved through shared services or modernization of administrative functions).
- Council may also wish to look at new sustainable revenue sources, user fees and asset optimization to improve the City's fiscal position or support priority investments.

Next steps

- The report currently before Executive Committee recommends staff report back with a series of reports aimed at strengthening financial processes, strategic planning, decision-making and oversight.
- Staff are scheduled to report back to Executive Committee on revenue tools in June 2016.

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