REPORT OF THE
CHIEF LEGISLATIVE ANALYST

Date: May 13, 2014

To: Honorable Members of the Budget and Finance Committee

From: Gerry F. Miller, Chief Legislative Analyst

Subject: **FISCAL YEAR 2014-15 BUDGET**

On April 14, 2014, the Mayor submitted to the City Council his Proposed Budget for fiscal year 2014-15. The Proposed Budget reflects the moderate economic recovery we are experiencing and recognizes improvement in the City's on-going revenue generation. However, the Proposed Budget also reflects continued significant deficits over the next several years.

Attached you will find recommended changes to the Proposed Budget. These changes are in response to specific directions from your Committee as well as instructions to this office to evaluate some areas of concern and provide recommendations on how to address those issues. The recommendations to follow are designed to ensure our financial strength during fiscal year 2014-15 and make material progress in dealing with continued significant budget gaps in 2015-16 and beyond.

Calculation of the Deficit:

In his Proposed Budget, the Mayor recognizes a 2014-15 deficit of $242 million. This amount is $26.5 million more than the $215.5 million General Fund deficit the City faced in the 2013-14 Budget, and $83 million more than the projected 2014-15 deficit from one year ago. The City has made substantial progress in its efforts to achieve structural balance in the General Fund. However, the City continues to face budgetary pressures in fiscal years 2015-16 and beyond. The City Administrative Officer (CAO) projects a General Fund budget deficit of $165 million in 2015-16, $187 million in 2016-17 and $74 million in 2017-18. Structural balance is not anticipated until 2018-19. It is essential that the City aggressively seek to reduce these deficits throughout 2014-15 and in future budgets to achieve structural balance as quickly as possible.

Policy Compliance and the Budget Stabilization Fund:

The Proposed Budget as well as the actions before your Committee comply with Council policy relative to: 1) a Reserve Fund at a minimum of 5% of General Fund revenues (the actions contained in the recommendations to this report would result in a Reserve Fund of 5.52%); 2) the 1% infrastructure investment requirement (the CIEP Policy); and, 3) the Budget Stabilization Fund (BSF). However, we note an interplay between the CIEP Policy and the BSF provisions recently enacted that should be reexamined.

The BSF policy provides that, should growth in the City's seven primary sources of ongoing revenue exceed 3.4%, the amount over 3.4% would be deposited into the fund. For the Proposed Budget, that would result in the BSF deposit of $25 million. The policy allows for that deposit not to me made if the excess amounts are used to meet the CIEP Policy. In the case of the Proposed Budget that is what occurred. However, the goals of the two policies are quite different. The goal of the CIEP Policy, which was enacted on April 19, 2005 (CF#04-1822) well before the BSF provisions were developed, is to ensure that we annually make at least a modest General Fund cash investment in our infrastructure. The goal of the BSF is to establish a substantial source of funding for future economic downturns. Since revenue reductions can occur much more quickly than the City can reduce its on-going expenditures, the BSF would provide a bridge to gradually reduce expenditures until they are realigned with revenues to avoid the extreme cuts the City had to make during the Great Recession. If it becomes common practice to avoid BSF deposits by using those funds to meet the CIEP Policy it will make growing the BSF to sufficient levels much more difficult. The Council may want to either eliminate the CIEP provisions from the BSF Policy, or amend those provisions to state that funds that would otherwise be deposited in the BSF can be deposited into the CIEP if the one percent CIEP Policy has already been met from other General Fund sources.

Summary of Budget Balancing Actions:

Among the actions proposed to reduce the General Fund deficit are new and expanded on-going revenue ($166 million), one-time revenue ($181 million), specified efficiencies and expense reductions ($15 million), and other changes and adjustments ($5 million). With regard to these actions, of particular note are the following:

- A Special Parking Revenue Fund (SPRF) transfer of $10 million is proposed. It has been the practice over the last number of years to transfer SPRF surpluses into the General Fund to help balance the budget. While it is appropriate to consider these funds on-going revenue, transferring balances each year limits the ability to invest those funds in capital improvements to meet parking needs.

- A Reserve Fund transfer of $129 million is included.

- $12.8 million in one-time lawsuit settlement funds are recognized.

- A planned $65 million cash overtime payment to bring down the LAPD overtime bank has been eliminated.

- As reported by the CAO, one-time actions to solve for the 2014-15 budget gap comprise 46% of the total solutions.

The use of one-time solutions in the Proposed Budget results in the increase in budget gaps in future years. As we discussed last year, during the Great Recession it had been the practice of the City to target an on-going/one-time budget balancing ratio of 70%/30%. That is a reasonable technique when revenues are falling. However, when revenues are growing, that practice should not be used. The result would be perpetual structural imbalance and magnified difficulties in dealing with future economic downturns. The City's Financial Policies, adopted by the Council on April 19, 2005, state as follows:

> *"To the extent possible, current operations will be funded by current revenues. The use of unencumbered prior year balances in all funds shall be scrutinized and carefully limited to be used primarily for one-time expenditures. <u>One-time revenues will only be used for one-time expenditures</u> <u>**(emphasis added)**</u>. The City will avoid using temporary revenues to fund ongoing programs or services."*

It should be noted that, if the City funded only obligatory increases ($124 million) and increases necessary for continuation of current services ($65 million), new ongoing revenues, pension savings and efficiencies and other changes would nearly eliminate the projected 2014-15 deficit and the City would be in structural balance. The Proposed Budget adds $91 million in increased and new services. We recognize that due to significant service level reductions during the Great Recession some service restorations have become urgent and are appropriate to avoid future costs. For example, Fire Department recruit training is important to mitigate rising overtime costs due to attrition and constant staffing requirements. Additionally, information technology investments are essential to improve service levels and economic development opportunities and to ensure that vital City systems continue to perform. However, it is imperative that the City continue to exercise restraint in restoring services to ensure that the projected deficits do not worsen and that the City is in structural balance with a substantial BSF when the next inevitable recession occurs.

<u>Revenue Issues:</u>

For the most part, the revenue projections in the proposed budget appear reasonable and reflect the continued economic recovery. We have no basis for recommending reductions in those assumptions. However, we note that some revenue sources can be very volatile and, with significant projected deficits in future years, we urge careful monitoring of a few revenue sources that may pose greater risk to the City.

The General Fund revenue contained in the Proposed Budget is projected to be $5.118 billion, which is 5.2% above the 2013-14 budgeted amount of $4.867 billion. The CAO's revised current year General Fund revenue estimate is $4.900 billion, or $33 million above plan.

Accordingly, 2014-15 revenue is projected to be 4.4% above the projected current year actual receipts.

Property related taxes show strong performance. The Proposed Budget projects 2014-15 Property Tax receipts at $1.630 billion which is 5.6% above current year projections. Based on higher assessment estimates since the Proposed Budget was prepared we have included an additional $14.5 million in Property Tax receipts. 2014-15 Documentary Transfer Tax (DTT) receipts are projected to total $197 million, or 10% above current year projections. Current year DTT receipts are more than 12% above plan and projected 2014-15 DTT receipts are still more than 9% under the DTT peak in 2005-06, so these projections appear reasonable. However, the DTT is very volatile and it is difficult to accurately project receipts beyond the near term.

The Transient Occupancy Tax (TOT) has continued its strong performance. The 2014-15 Proposed Budget estimates that this revenue source will grow by 5% over revised current year estimates. Given that current year receipts are projected to be 6.3% above plan, the incremental increase appears reasonable.

Sales Tax is also performing well. The Proposed Budget assumes a 4.5% growth in these revenues from revised current year estimates. Current year performance is projected to be 5.5% above plan. The 2014-15 projected increase is in the middle of the range of projections from a variety of other recent sales tax forecasts as detailed on Page 50 of the Revenue Outlook Supplemental Schedule and is consistent with the County's sales tax growth projections.

The proposed budget recognizes a Communication Users' Tax (CUT) reduction of $12 million, or 5.3% from current year projected receipts. This is a particularly large year-to-year drop due to an infusion of revenue for the current year as a result of the amnesty program. In addition, during your Committee's hearings it was determined that a lawsuit settlement payment of $5.75 was not included in the Proposed Budget. The attached recommendations address that issue. Those payments will continue for four years which will impact future deficit projections. The CUT is expected to continue to erode as it has over the last number of years due to changing communication technology.

Risk Factors:

Cost-of-Living Increases (COLA) - Consistent with the assumptions contained in the 2013-14 Budget, the proposed 2014-15 Budget and the projected budget gaps in subsequent fiscal years assume no COLAs for any civilian and sworn employees. Since the vast majority of the General Fund budget is salary related, in order to meet or improve upon the projected future deficits discussed above, the City will have to control salary costs over the next several years.

Police Overtime - As discussed above, one proposed budget balancing action is the elimination of a planned cash payment of $65 million in LAPD overtime. The current LAPD overtime bank liability is approximately $115 million and additional overtime is accrued annually. LAPD management has worked diligently to try and control increases in the bank through schedule management, but that has resulted in a reduction of officers on duty. As was discussed repeatedly by your Committee in its hearings, over the next few years the City must begin to materially invest in paying down the existing LAPD overtime bank and paying future overtime in cash to avoid a significant liability in the future.

Economic Downturn - Most economists predict a continued economic recovery for the coming year as well as a strengthening European economy. However, given the fact that we expect structural deficits until the end of the decade, the City must strive to reach structural balance as quickly as possible and prepare for the inevitable economic downturn.

Since the Great Depression which ended in 1933, the nation has experienced 13 economic recessions (defined as a reduction in Gross Domestic Project (GDP)). Clearly, the causes, duration and severity of the recessions have varied widely, with the Great Recession from 2007 through 2009 being the most severe. The average time between recessions has been five years, and the longest interval between recessions has been 10 years. The Great Recession officially ended in June of 2009, so we are now at the average interval at which another recession has occurred over the last 81 years. By the end of the decade we will be at an interval nearly equal to the longest interval between recessions during that time.

It must be kept in mind that the City faces financial pressure as a result of an economic slowdown that is not technically a recession. Even with GDP expansion, if City revenue growth is less than projected it is very difficult to slow expenditure growth to bring revenues and expenditures in line. There are factors over the relative short-term which could impact the rate of growth. For example, many economists are closely monitoring the situation in Ukraine. If tensions escalate and additional sanctions are placed on Russia, particularly in the energy sector, many believe that retaliation by Russia could cause another recession in Europe which is heavily dependant on Russian oil and gas. That, in and of itself, would probably not cause the US economy to fall into another recession but there is a high likelihood that such an event would slow the US economy. Debate has also begun on whether we are experiencing another "tech bubble" similar to what occurred in the early 2000s which, when it burst, began a stock market slide that lasted through most of the decade.

Of course, the timing and severity of any economic downturn cannot be predicted. However, given the length of the current economic recovery and our history over nearly the last century, it is important for the City to aggressively prepare for another recession by redoubling our efforts to control ongoing expenditures, seeking additional sources of ongoing revenue, and making every effort to grow the BSF so that there is a source of funding to offset the inevitable revenue downturn that will occur at some point.

Recommended Changes to the Proposed Budget:

In assisting your Committee in developing the Council's 2014-15 Budget, we have sought to identify as many structural revenue initiatives and expenditure reductions as feasible. You will find in the attached some use of one-time budget balancing solutions which we believe are unavoidable at the current time. We strongly recommend that the City continue its multi-year budget planning to implement long-term, on-going budget reductions and use great caution in restoring or adding new services until the growth in our ongoing revenues can fund such services.

There are a variety of changes to the Proposed Budget. Of particular note are the following:

- A net revenue increase of $22 million is recognized. This is primarily comprised of $14.5 million in additional Property Tax receipts, an additional $7.1 million in the Electric Users Tax based on revised power sales, $4 million in additional reversions and loan repayments and a $5.75 million decrease in CUT receipts as discussed above.

- An expenditure reduction of $4.2 million is recognized in the Human Resources Benefits Fund based on revised premium projections.

- A $1.3 million reduction in Fire and Police pension payments is included based on budgeted sworn salaries.

- Adjustments have been made in General City Purposes to reflect the Mayor's proposed reallocation of funds.

- Funding is added for outside counsel to support the Los Angeles Community Broadband Network.

- Funding is restored for Citywide median maintenance.

- A variety of add/deletes are included with no net impact on the budget to reflect funding priorities identified by the Committee and to make technical corrections to the Proposed Budget.

Attachment