

REPORT FROM

OFFICE OF THE CITY ADMINISTRATIVE OFFICER

Date: September 27, 2024

CAO File No. 0590-00098-5291

Council File No. 24-0600

Council District: All

To: The City Council

From: Matthew W. Szabo, City Administrative Officer



Reference: 2024-25 Budget

Subject: **2024-25 BUDGETARY CONCERNS AND INITIAL RECOMMENDATIONS TO RESTORE THE RESERVE FUND**

RECOMMENDATION

That the City Council, subject to the approval of the Mayor:

1. Retain the prioritized critical hiring process, pending review and recommendations from the City Administrative Officer in future financial status reports.
2. Defer all requests for interim budget appropriations, including new requests for reappropriations, insofar as they require the use of the General Fund.
3. Instruct departments to absorb overspending within their budgeted resources and adjust operations, where necessary, to do so.
4. Instruct the City Administrative Officer to provide recommendations in its Financial Status Reports to protect and restore the Reserve Fund to the five percent Financial Policy minimum.
5. Instruct the City Administrative Officer and request the City Attorney to report on potential strategies to limit future liability payouts.

SUMMARY

As a result of the continuing economic conditions which have resulted in lagging revenues, as well as an extraordinary number of liability claims resolving after years of court delays that are likely to cost hundreds of millions of dollars, the Office of the City Administrative Officer (CAO) projects that the Reserve Fund may reach the Emergency Reserve Account level and recommends steps to address spending within the City's control without delay.

The adopted 2024-25 Budget assumed that the Reserve Fund would likely begin the fiscal year very close to five percent of the General Fund budget, which is the minimum amount required by the City's financial policies. The CAO's review of early data from this fiscal year has, unfortunately, confirmed concerns about the state of reserves, particularly due to high expenditure levels in certain areas and unexpected costs.

Therefore, in this report, this Office proposes actions for the City to take to curtail any departmental overspending, restrict new spending, and begin to take steps to restore the Reserve Fund.

Known Financial Challenges

Based on the actual current balance of the Reserve Fund and approved and likely upcoming transfers, we believe that the amount of funding available in the Reserve Fund will soon be just over 2.75 percent of the General Fund budget. As further explained below, 2.75 percent of the Reserve Fund resides in the Emergency Reserve Account. This leaves the City with extremely limited options to address additional overspending in 2024-25, let alone unforeseen challenges or initiatives.

Based on the data available at the time, the Adopted Budget projected that the Reserve Fund would begin 2024-25 at 5.07 percent of the General Fund Budget, just above the five percent policy minimum. On September 26, 2024, the Controller reported the actual Reserve Fund balance on July 1, 2024 was 4.12 percent of the General Fund Budget. This Office compared the assumptions that the Adopted Budget made to project the July 1 Reserve Fund balance to the Controller's year-end closing data in order to understand this discrepancy. We have concluded that actual General Fund revenues fell short of the projections in the Adopted Budget by over \$50 million. Further, based on recommendations in the 2023-24 Year-End Financial Status Report, the City transferred over \$7 million more from the Reserve Fund for year-end overspending than the Adopted Budget projected.

On September 13, 2024, the City Council approved a request from the City Attorney to transfer funds to the Liability Claims Account in an amount sufficient to address all judgments and settlements that were pending before the Council at that time. Specifically, Council approved a transfer of the entire \$59 million balance in the Unappropriated Balance, Reserve for Mid-Year Adjustments, a \$23 million transfer for the Reserve Fund, and a transfer of the remaining \$2 million balance of the Unappropriated Balance – Reserve for Extraordinary Liabilities. In its report, the City Attorney identified an additional \$76 million in settlements and judgments it has finalized but not yet transmitted to Council for approval. This Office expects the Council to consider those in the coming months. If approved, the only source of funds available to pay these settlements and judgments will be the Reserve Fund. Upon payment, the Reserve Fund will likely stand just above 2.75 percent of the General Fund budget, at the Emergency Reserve Account level.

We also foresee using the Reserve Fund in the event that costs of the agreements with the sworn Fire unions exceed the amount set aside in the Unappropriated Balance – Department Payroll Reconciliation Account for those purposes. The Fire Department, with support from this Account, will likely be able to front-fund any such costs for a portion of the fiscal year, but will likely need a transfer from the Reserve Fund to pay any excess amount toward the end of the fiscal year.

Condition of the Budgeted Reserves

As a result of these known and likely actions, only three months into the fiscal year, the reserves that the City set aside in the 2024-25 Reserve Fund and Unappropriated Balance (UB) are all fully used or severely strained:

Reserve Account	Adopted Budget Amount	Current Balance	Comments
Reserve Fund – July 1, 2024	\$407 million 5.07%	\$330 million 4.12%	Accounting for known settlement and judgment payments, likely to fall to the 2.75 percent Emergency Reserve level.
UB, Reserve for Mid-Year Adjustments	\$59 million	\$0	All \$59 million expended on the payouts of settlements and judgments.
UB, Reserve for Extraordinary Liabilities	\$20 million	\$0	All \$20 million expended on the payouts of settlements and judgments.
UB, Department Payroll Reconciliation	\$105 million	\$105 million	The \$105 million in this Account may not be sufficient to cover the likely cost of the pending sworn Fire agreements. It also includes funds for civilian agreement costs not included in departmental budgets.

Pursuant to the City Charter (Section 302(b)), the first 2.75 percent of the Reserve Fund resides in the Emergency Reserve Account. A transfer from this Account requires a two-thirds vote of the Council and the Mayor’s approval or a three-quarters vote to override the Mayor’s veto. Concurrent with the transfer, the Council must make a “finding of urgent economic necessity.” The basis for such a finding includes, but is not limited to, a significant economic downturn after the adoption of the budget, a natural disaster, or another significant unanticipated event requiring the use of the General Fund.

This is a higher standard than the simple majority required to transfer funding from the Contingency Reserve Account, which is the portion of the Reserve Fund above the 2.75 percent level. The higher standard reflects the critical importance to retain the full Emergency Reserve Account in case the City faces a significant, unanticipated event that it has to address.

Potential Financial Challenges Ahead

This Office is beginning its work on the First Financial Status Report of 2024-25, which will project overspending and report on revenues through the end of August 2024. While we have not completed our analysis of specific spending and revenue data, we are concerned that data could reveal additional financial challenges.

The 2024-25 Budget assumed that 2023-24 General Fund revenues would fall approximately \$170

million below the Adopted Budget amount. Actual 2023-24 General Fund revenue, however, fell short of these revised projections by more than an additional \$50 million. Consequently, since 2024-25 Budget General Fund revenue growth was based on these revised projections, there is downside risk to several categories of receipts. The City must offset any shortfall in total adopted revenue by either reducing appropriations or finding a new source of funds. As an example, the City transferred over \$220 million from the Reserve Fund to address the 2023-24 General Fund revenue shortfall. Based on the current condition of the Reserve Fund, we do not expect it will be available to this degree in 2024-25 should revenues fall short again.

In addition to these revenue concerns, departments are likely to face challenges operating within their approved budget appropriations. In recent years, several departments have relied on high salary savings to fund shortfalls in other accounts. Following the elimination of over 1,700 vacant positions Citywide in the 2024-25 Adopted Budget, we expect those salary savings to be significantly lower. Further, the Adopted Budget also includes significant reductions to many expense accounts. It is, therefore, reasonable to expect that in our financial status reports, this Office will project overspending across more departments than we have in recent fiscal years.

Initial Recommendations to Restore Financial Strength

1. Retain the prioritized critical hiring process, pending review and recommendations from the City Administrative Officer in future financial status reports. On September 18, 2024, the Council instructed this Office to report with options to sunset the prioritized critical hiring process in our financial status reports (24-0275-S1). As part of these reports, we will compare the City's financial conditions to those that led the City to implement prioritized critical hiring in February 2024. Those conditions included risks to revenue, overspending, and likely impending reductions to the City's reserves. As described in this report, at this time those same financial conditions are, or may soon be, in place. Therefore, we recommend that prioritized critical hiring remain in place and until these conditions change. Pursuant to Council's instruction, we will revisit these conditions and this recommendation in our financial status reports.

2. Defer all requests for interim budget appropriations, including new requests for reappropriations, insofar as they require the use of the General Fund. Unless offset by an equal appropriation reduction, and in the absence of any other funding options, all requests for interim General Fund appropriations and new reappropriations will require the use of the Reserve Fund. It is likely that any such appropriation would cause the Reserve Fund to drop below the 2.75 percent Emergency Reserve Account level and require a finding of urgent economic necessity. Restricting these new appropriations is both necessary due to our current financial condition and consistent with the City's Financial Policies. Pursuant to the Financial Policies, requests for new or expanded programs should only be considered outside of the annual budget process in extreme circumstances (Fiscal Policy #16). The Financial Policies further state that reappropriations not approved during the budget or year-end reporting process are discouraged (General Fund Reserves Policy, Section I.D.)

3. Instruct departments to absorb overspending within their budgeted resources and adjust operations, where necessary, to do so. While the CAO generally recommends that departments first attempt to absorb overspending, in recent years we have included significant transfers from

General Fund reserves to address departmental overspending. The City will not have the capacity to approve these transfers this year to the same degree. As stated above, there are essentially no reserves available to cover these costs. It is possible that in order to absorb overspending, departments will have to make difficult choices that could have a negative impact on operations.

4. Instruct the CAO to provide recommendations in its Financial Status Reports to protect and restore the Reserve Fund to the five percent Financial Policy minimum. As potential examples, we will consider recommending denial of certain Reserve Fund loans, which departments often request to cash flow programs that are funded by lagging receipts, such as grant programs. We will revisit and consider recommending reversal of already approved reappropriations. We will seek to identify special fund balances that are no longer necessary and permitted to be swept to the Reserve Fund. We will work with departments to accelerate the repayment of outstanding Reserve Fund loans, where possible. Finally, we will consider proposing that the City issue judgment obligation bonds. These bonds could be used to pay for settlements and judgments directly or on a reimbursement basis to repay the Reserve Fund or other internal borrowing source. The CAO is taking the initial steps that are required to preserve this option, even if the actual issuance will not occur in the immediate future or at all.

5. Instruct the City Administrative Officer and request the City Attorney to report on potential strategies to limit future liability payouts. The approved and likely transfers to the Liability Claims Account this fiscal year mark the second year in a row when spending on settlements and judgments will significantly exceed the amount budgeted for that purpose. Therefore, this Office recommends that the CAO and City Attorney work together to develop and propose strategies that could reduce these payments in future years.

FISCAL IMPACT STATEMENT

The recommendations in this report have no fiscal impact. If adopted, they will support the City's efforts to restore the Reserve Fund to the five percent Financial Policy minimum.

FINANCIAL POLICIES STATEMENT

The recommendation in this report complies with the City's Financial Policies as they will:

1. Help the City take steps to return the Reserve Fund to the five percent policy level.
2. Reinforce the Fiscal Policy that interim budget appropriations should only be approved in extreme circumstances.
3. Reinforce the General Fund Reserves policy discouraging reappropriations, unless the adopted budget or year-end reporting included them.