CAO File No. 0590-00098-4204
Council File No. 11-0600

CITY OF LOS ANGELES

Four-Year Budget Outlook and Update to the Three-Year Plan to Fiscal Sustainability

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April 6, 2012

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A CAUTIONARY TALE: THE CITY OF STOCKTON CALIFORNIA

In 2008, the City of Vallejo declared bankruptcy. In response, the California legislature adopted AB 506 in 2011[1] to prohibit a local government agency from filing for bankruptcy unless the agency has participated in a "neutral evaluation process" with interested parties (e.g., creditors, parties to labor contracts), or the agency has declared a fiscal emergency which includes findings that the emergency jeopardizes the health, safety, or well-being of residents. On February 28, 2012, the Stockton City Council adopted a resolution to pursue the AB506 process in an attempt to prevent insolvency and bankruptcy.

Stockton opted to pursue the evaluation after an assessment of its financial condition determined that the city was unable to fund current service levels, much less fund its deferred maintenance costs, liabilities, and adequate reserves. With insufficient revenue, the city has been relying on one-time revenue and contingency monies in order to fully fund services. The balances in several unrestricted funds and contingency appropriations are expected to be exhausted.

According to Stockton, its budget deficits resulted from reduced revenues, pension system losses, and unsustainable compensation packages for its employees. Additionally, debt payments for issuances from the prior decade and questionable fiscal management practices were cited as contributing factors to its insolvency.[2]

Stockton's story provides a cautionary tale for the City of Los Angeles and other cities struggling to remain solvent. Getting to the doorstep of bankruptcy did not happen overnight. Some of the factors were external - such as the Great Recession and the anemic recovery. However, too many factors were self-inflicted - such as unsustainable labor contracts, reliance on one-time solutions, failure to prioritize services or create new revenues. Perhaps most detrimental to Stockton's position was a failure by the city to plan and establish a roadmap to fiscal sustainability: a plan to restore city government finances for the long term while continuing to provide services city residents depend on.

This report presents issues and recommendations on how the City of Los Angeles can achieve fiscal sustainability over the next few years. The intent of these recommendations, developed by the Office of the City Administrative Officer, is to restore the City's long-term financial health and sustainability while continuing to address the most critical needs of the City's residents.

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[1] AB 506 (Wieckowski) Local government: bankruptcy: neutral evaluation. Chaptered by the Secretary of State, Chapter Number 675, Statutes of 2011.

[2] February 28, 2012 City Manager memorandum to the Mayor and City Council: *Fiscal Condition Update for Fiscal Years 2010-11, 2011-12 and 2012-13*.

SUMMARY: FROM CRISIS MANAGEMENT TO STRATEGIC PLANNING

In our continuing effort to restore the City's long-term financial health and sustainability, this Office has prepared an update to its Three-Year Plan for Fiscal Sustainability (Three-Year Plan), originally adopted in 2010 for the purpose of re-establishing a sustainable path for the City's future. The Three-Year Plan continues to be centered on the following four guiding principles:

I. Adhere to responsible management and fiscal practices by maintaining a healthy Reserve Fund, pursuing ongoing solutions to our deficit instead of one-time fixes, and preparing for unpredictable liabilities.

II. Focus on core services by prioritizing, implementing efficiencies, and eliminating redundancies.

III. Pursue alternative service delivery models that reduce the costs of providing quality services while maintaining or even enhancing services.

IV. Maintain a sustainable workforce through a fair and equitable compensation system, managed healthcare costs, and controlled pension obligations.

Additionally, in light of the size of the City's fiscal challenges, a fifth guiding principle has been developed that promotes a balanced approach to addressing these challenges:

V. Raise new revenues through the support of constituents and through efforts that grow the economy and stimulate job creation, while protecting and maximizing existing revenue sources through a responsive collection system and full-cost recovery of services rendered.

As was the case with the original plan, the updated Three-Year Plan involves significant policy decisions, difficult budget choices, and decisive actions required of the City's decision makers. Additionally, this plan requires the cooperation and commitment of the City's management, its employees, and its residents. <u>There are no easy fixes</u>. The fact of the matter is that the City has priced itself out of its ability to deliver services at the level its residents expect. In order for the City to address this imbalance, it must adhere to responsible management and fiscal practices, re-examine its core functions, explore alternative service models, and address the ever increasing cost of its workforce. Furthermore, so long as the service level needs and expectations remain consistent, the pursuit of new revenue sources or increases to existing sources can no longer be delayed.

For each of the last ten fiscal years, the City has been challenged by a structural deficit where expenditures exceed revenues. In dealing with this challenge the City has sought to address the structural deficit through ongoing structural solutions. However, success has been limited. Despite eliminating close to 4,900 positions since its employment peak in 2007-08 (a 13% reduction) and increasing the amount that employees contribute to their own pensions, the City has relied heavily on one-time solutions to close the budget gaps. These one-time solutions have included the receipt of revenues earmarked for specific purposes and over a short period of time (i.e. grants), expenditure deferrals for capital improvements, the use of one-time revenues for ongoing programs, hiring freezes, and furloughs. Furthermore, even structural solutions such as the elimination of positions have not always been based on a strategic plan that takes into consideration the needs of departments and whether the impacted services are core services of the City. Rather, vacant positions were targeted for elimination to achieve the highest savings possible with the least layoff impact. The end result has been short-term budgets with long-term price tags.

While this form of crisis management offers immediate budgetary relief, it also creates an environment with little to no planning for the City's future, limited investment in capital improvements, and an avoidance of answering the central question of what services the City should no longer provide. When some one-time solutions are exhausted, others are found. In some cases one-time solutions become ongoing in the sense that the City relies on these same solutions every year with decreasing value. At times, the one-time solutions never materialize, resulting in the City's budget falling out of balance which in turn necessitates extraordinary mid-year budget reductions. Consequently, the structural deficit is only partially addressed and the City's crisis management mode of operation continues.

The recommendations presented herein are strategies based on the best practices in municipal finance, budgeting, and strategic planning. Several of these strategies have proven to be successful in various cities, counties, and states. However, no one strategy alone will be enough to address our challenges; not one is a panacea. Failure to adopt and implement the strategies collectively, without viable alternatives in their place, will at best result in the status quo method of budgeting: relying on one-time budget transfers, deferring maintenance, and over-estimating revenues. At worst, straying from the path set forth here is likely to result in fiscal insolvency. Either outcome will undoubtedly continue the crisis management mode in which the City has been operating for the last decade - a mode that hampers innovation and productivity; demoralizes employees; fractures service delivery; limits economic recovery; and lowers the standard of living in the City.

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FOUR-YEAR BUDGET OUTLOOK: CONTINUED STRUCTURAL DEFICIT

Budget Outlook

As part of its budget planning, this Office prepares a multi-year Budget Outlook based on the existing budget, known major future obligatory expenditures, and projections of other revenues and expenditures. The purpose of the Budget Outlook is to identify future budget challenges, including whether a budget gap is likely to occur. This planning tool helps the City identify potential budgetary pressures and allows for earlier implementation of budget adjustments, either through the annual budget process or through interim action. The Budget Outlook is updated in connection with the City's periodic financial status reports and the budget process.

The Budget Outlook is constantly changing, and does not include all potential revenues that may be received or expenditures that may occur in future years. As actual data relative to revenues and expenditures becomes available, the Budget Outlook is adjusted. For example, should the actual revenues received for the current fiscal year be closer to what the City Controller estimated in her *March 1, 2012 Report* ($31.5 million below the adopted revenue of $4.485 billion), the revenue assumed as part of the Budget Outlook will be considerably lower in 2012-13 and thereafter. Consequently, the projected deficits identified in the Budget Outlook will be larger. In addition, as policy decisions are made that have budgetary impacts - such as with labor agreements or expenditures on capital projects - the Budget Outlook is revised to account for any one-time or ongoing impact.

A summary of the Budget Outlook is provided below. The full Budget Outlook and a more detailed explanation of assumptions used in the development of the Budget Outlook are attached.

Table 1

Budget Outlook Summary for Fiscal Years 2012-13 to 2015-16 (Dollars in Millions)

	2011-12 Adopted	2012-13	2013-14	2014-15	2015-16
ESTIMATED GENERAL FUND REVENUE					
General Fund Base (1)	$ 4,372	$ 4,386	$ 4,459	$ 4,590	$ 4,727
Revenue Growth (2)	$ 14	$ 73	$ 132	$ 136	$ 163
Total Revenue	**$ 4,386**	**$ 4,459**	**$ 4,590**	**$ 4,727**	**$ 4,890**
General Fund Revenue Percent Increase	***0.2%***	***1.7%***	***3.0%***	***3.0%***	***3.5%***
ESTIMATED GENERAL FUND EXPENDITURES					
General Fund Base (3)	$ 4,375	$ 4,386	$ 4,681	$ 4,933	$ 5,154
Incremental Changes to Base: (4)	$ 11	$ 295	$ 252	$ 221	$ 109
Subtotal Expenditures	**$ 4,386**	**$ 4,681**	**$ 4,933**	**$ 5,154**	**$ 5,263**
Expenditure Growth Percent Increase	***0.2%***	***6.7%***	***5.4%***	***4.5%***	***2.1%***
TOTAL BUDGET GAP	**-**	**(222)**	**(342)**	**(427)**	**(373)**

(1) General Fund (GF) Base: The revenue base for each year represents the prior year's estimated revenues.

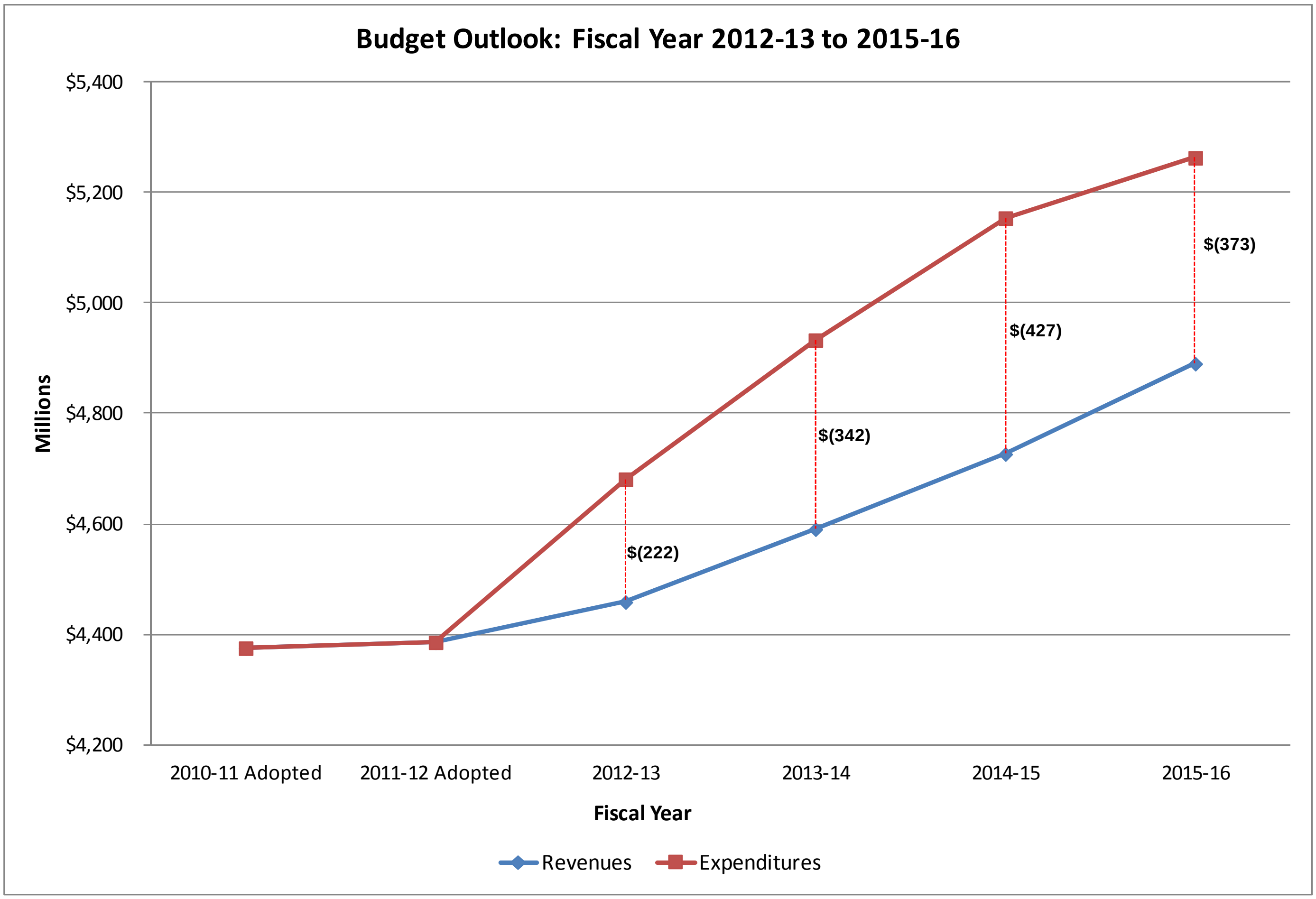
(2) Revenue Growth: Amounts represent projected incremental change to the base. Any one-time receipts are deducted from the estimated revenue growth for the following fiscal year.

(3) Estimated Expenditure General Fund Base: Using the 2010-11 General Fund budget as the baseline year, the General Fund base is the "Total Obligatory and Potential Expenditures" carried over to the following fiscal year.

(4) The 2011-12 incremental changes reflect funding adjustments to the 2010-11 General Fund budget. The Four-Year Outlook expenditures included for subsequent years are limited to those obligatory and major expenses known at this time and are subject to change.

Based on the most recent data available regarding revenue projections and expenditure increases tied primarily to the Fire Department, this Office is anticipating the deficit for Fiscal Year 2012-13 to be approximately $222 million, which remains subject to further revision. From December 2010 to today, the projected budget deficit for Fiscal Year 2012-13 has dropped steadily from a high of $446 million to the current projection of $222 million.[3] This improvement is attributable to employee contributions for retiree healthcare, the elimination of positions, and the continuation of the City's hiring freeze. Additionally, decisions by the boards of both retirement systems to extend the impact of investment gains and losses permitted the City to defer some pension contributions to future years. Furthermore, the stabilization of the economy allowed the City to maintain the revenue assumptions made in December 2010 which also contributed to the closing of the budget gap.

Chart 1



Despite the progress made in cutting the projected deficit for 2012-13 by half, the Budget Outlook still provides a harsh dose of reality. Over the next four years, the projected average growth in General Fund *expenditures* is approximately 3.8%. For workforce related *expenses* (salaries, pensions, healthcare, and workers' compensation) the projected average growth for this same period is even

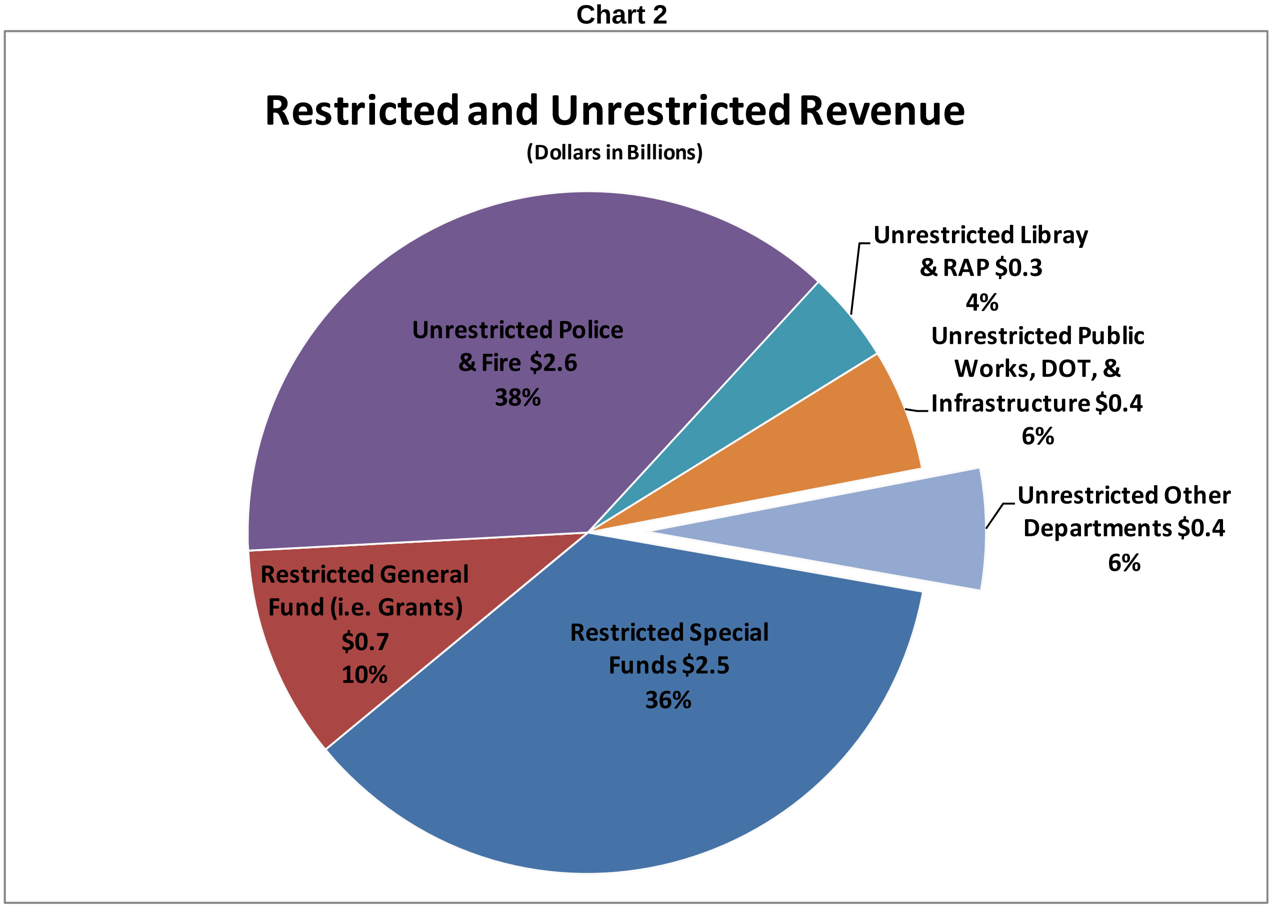
[3] CAO Second Financial Status Report FY2010-11, released December 10, 2010.

greater; 4.7%. At the same time, the projected average growth in General Fund base *revenue* is only 2.3%. This scenario speaks to a structural problem rather than a cyclical problem that can be addressed solely through economic recovery.

The magnitude of the projected deficits warrants permanent changes in both spending and revenue. Addressing only spending through reductions in positions, services, deferring maintenance, or avoiding critical investments will lower expenditures, but will also result in a degradation of services that constituents will not support or which will result in future liabilities. Furthermore, while the City does have funds that are deemed unrestricted, about 70% of these funds are dedicated to maintaining police and fire services at existing levels. Charter-mandated funding level requirements for the Public Library and Recreation and Parks Department, and funds that are reimbursed by proprietary departments or special funds, further reduce the unrestricted funds that may be considered discretionary.

Ultimately, out of the City's total budget of $6.88 billion (General Fund and Special Funds), the City's discretionary funds are less than $400 million after accounting for the funds required to operate the Police Department, Fire Department, Public Library and Recreation and Parks Department, and those departments such as Building and Safety, Planning, and the Public Works Bureaus which receive significant reimbursements for their services.

Chart 2



Although the size of the remaining discretionary funds may still appear significant, these funds represent the entire General Fund costs (direct and indirect) of all remaining departments including Animal Services, City Administrative Officer, City Attorney, Controller, Council, Office of Finance, Mayor, and Zoo. Thus, given a deficit of about $220 million projected for next year, it is impractical to assume that the entire deficit can be addressed through reductions in discretionary spending. Revenues must be increased to eliminate the structural deficit. Without new revenues, maintaining public safety as the City's first priority is in severe jeopardy.

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ACHIEVING FISCAL SUSTAINABILITY: REVENUE CHALLENGES AND OPPORTUNITIES

As the primary indicator of whether the City has achieved fiscal sustainability, the Budget Outlook clearly demonstrates that the City is far from achieving fiscal sustainability. This goal is further complicated by the numerous challenges the City will need to overcome; challenges that may limit revenue growth or increase costs. However, just as challenges exist that could widen the budget deficit; there are opportunities for the City to address the structural deficit. This Office has identified the following revenue challenges and opportunities that the City must consider to achieve fiscal sustainability.

Imposed Loss of Ongoing Revenue

It is not outside the realm of possibility for the City to lose an entire ongoing source of revenue as a result of legal actions, state actions, federal actions, or the City's own policy changes. Such has been the case for several revenue sources since 2005-06 including the Water Revenue Transfer from the Department of Water and Power and the State's Vehicle License Fee.

Beginning in 2006-07, following a California State Supreme Court decision on *Bighorn-Desert View Water Agency v. Verjil*,[4] the annual transfer of approximately $30 million from the Department of Water and Power for surplus water revenue to the City was halted. This revenue source was never replaced. The cumulative loss of City revenue since 2006-07 has been approximately $200 million.

In 2011-12 revenues from the Vehicle License Fee (VLF) that cities and counties across California historically received were diverted to State programs as part of the State's budget action for 2011-12. The City's annual share of VLF funds was about $15 million. While the possibility remains that some grant funds may be received by the City as a partial offset to this revenue diversion or that the courts may overturn this decision as a result of a lawsuit filed by the League of California Cities,[5] the City must now begin to account for an ongoing loss of $15 million from the VLF on an annual basis.

Elimination or Reduction of City Revenue Sources

While not entirely eliminated, the City's Business Tax has experienced ongoing losses as a result of policy decisions by the City. Since 2005-06 portions of the Business Tax have been eliminated as a result of Business Tax reform efforts including exemptions for new or small businesses and relief for internet-based, entertainment, multi-media-based businesses and mutual funds. While the intent of these reform efforts has been to promote business and job growth in the City, the direct benefits of these efforts have not been clearly tracked. Nonetheless, the budget impact as a result of the business taxes lost from these exemptions or relief efforts have resulted in less revenue. Should additional policy decisions be made relative to further business tax reforms, including the possible elimination of the tax, the immediate budget impact will result in significant increases to the budget deficit.

[4] SCOCAL, *Bighorn Desert etc. v. Verjil* , S127535 available at: (http://scocal.stanford.edu/opinion/bighorn-desert-etc-v-verjil-33651)
[5] On Sept. 28, 2011 the League filed a lawsuit challenging the constitutionality of the State's diversion of vehicle license fee (VLF) revenues through SB 89 and AB 118. The case will be heard by the Sacramento County Superior Court on May 4.

A recent study released by the City's Office of Economic Analysis, prepared by the Blue Sky Consulting Group, concluded that while eliminating the business tax would result in an increase in other General Fund revenues of up to $30 million, these increases in revenues would not be sufficient to offset the cost of eliminating the business tax. Rather, the net fiscal impact of eliminating the business tax would be an annual net revenue loss of nearly $400 million.[6]

Revenue Diversion

In addition to revenue sources that the General Fund has lost, there are other revenue sources that due to policy decisions have been diverted from the General Fund for the purpose of funding discretionary programs and projects. Three examples of such revenue diversion have been identified in audits by the City Controller: Real Property Trust Fund, AB1290, and Street Furniture Funds.

Real Property Trust Fund

In February 2010, the City Controller conducted an audit of the Real Property Trust Fund in the City and found that, over the last 12 years, nearly $25 million had gone into City Councilmembers' discretionary accounts that could have been deposited into the General Fund. These funds originated from the oil pipeline franchise fee revenues and from sales of surplus property. According to the Controller's audit, if these monies had been deposited into the General Fund, the monies would have been available to use on expenditures which were deemed to be a high priority for the City and that would benefit the City as a whole, instead of being restricted to certain discretionary uses. Given the sizable City deficit, the Controller recommended that all revenues generated from surplus property sales and from oil pipeline franchise fees be deposited into the General Fund on a permanent basis. This Office concurs with the Controller's recommendation.

Redevelopment Pass-through Funds (AB 1290)

In November 2010, the City Controller released another audit of funds would have also been available for the General Fund absent Council policy: AB 1290 redevelopment funds. AB 1290 funds are pass-through funds for entities eligible to receive a portion of a redevelopment agency's tax increment revenues generated by individual project areas. The City of Los Angeles is eligible to receive approximately 32% of these pass-through funds. Since 2003, a citywide policy directed that AB 1290 tax increment revenue due to the City should be retained by the Community Redevelopment Agency (CRA) for "planned uses" in the project area or Council District in which the revenue was generated based on and as designated by the Council Office(s) in which the redevelopment area is located.

With the imminent elimination of the CRA, AB1290 funds totaling about $23 million were transferred to Council-controlled accounts to continue funding the planned uses as designated by the Council

[6] Council File No. 09-1914-88 Consultant Study of Gross Receipts Tax by the Blue Sky Consulting Group on behalf of the Office of Economic Analysis, March 23, 2012.

Office(s) in which the redevelopment area is located. However, the Controller found that there was no formal process for establishing planned uses for the City's share of AB 1290 funds. Moreover, in many cases, planned uses were proposed projects that had been identified by an individual Council Office but not yet approved by the City Council. The dissolution of the CRA and the desire to create new economic development tools for the City present an opportunity to put AB1290 funds to use with a greater citywide benefit - such as the stabilization of the General Fund or for a citywide economic development strategy.

Street Furniture

The Controller recently issued an audit related to the City's Street Furniture Program. In addition to recommendations made to improve the permit approval process and amend the contract to generate as much revenue as possible for the City, the Controller recommended that 100% of street furniture revenues be placed in the General Fund as opposed to the current practice of distributing revenues to Council-controlled accounts. The Controller noted that since 2002, each Council district had received more than $1 million from the Street Furniture Program for discretionary community improvements.

Options to Maximize Existing Revenues

As the City continues to struggle to fill the revenue gaps within the General Fund to simply make its obligatory payments for such items as pensions and healthcare, the Mayor and Council must reconsider policies that restrict the flexibility of existing revenue sources such as the sources described and the Special Parking Revenue Fund. Other options that need to be considered are making investments to improve the collection of revenues that are due to the City and maximizing the additional tax increment resources that will become available as a result of the dissolution of the former CRA. However, in both of these cases, expectations on the amount of funds available must be realistic.

Special Parking Revenue Fund

The Special Parking Revenue Fund (SPRF) was established as a special fund to receive all revenue collected from parking meters and public off-street parking facilities in the City that are administered by the Department of Transportation (DOT). Over the past several years, the City has increased parking meter rates, expanded hours/days of parking meter operations and implemented electronic locks and technology upgrades. Together, these actions have dramatically increased meter revenue.

Revenues within the SPRF are used to fund the maintenance and operation of parking meters as well as for the maintenance, operations, construction, and capital improvement of public parking facilities. The SPRF is also used to make the annual debt service attributed to the Hollywood & Highland parking structure and the Civic Center Parking Project at Vignes and Temple. Over the last several years, the City has also relied on the transfer of surplus funds from the SPRF to help balance the budget. Changing the policy currently in place with regard to surplus transfers from the SPRF or paying off the outstanding debt tied to the parking structures can result in the dedication of additional revenue from parking meters and structures to the General Fund every year that would otherwise remain in the SPRF.

As it currently stands, any transfer of surplus funds to the General Fund from the SPRF must be repaid within two years unless this provision is explicitly amended by the Council. These amendments have been made on a case-by-case basis since the development of the 2010-11 budget. By making a permanent change to this policy, the City can budget for a transfer of funds from the SPRF on an annual basis that takes into account all obligatory payments from the funds as well as the maintenance of existing assets.

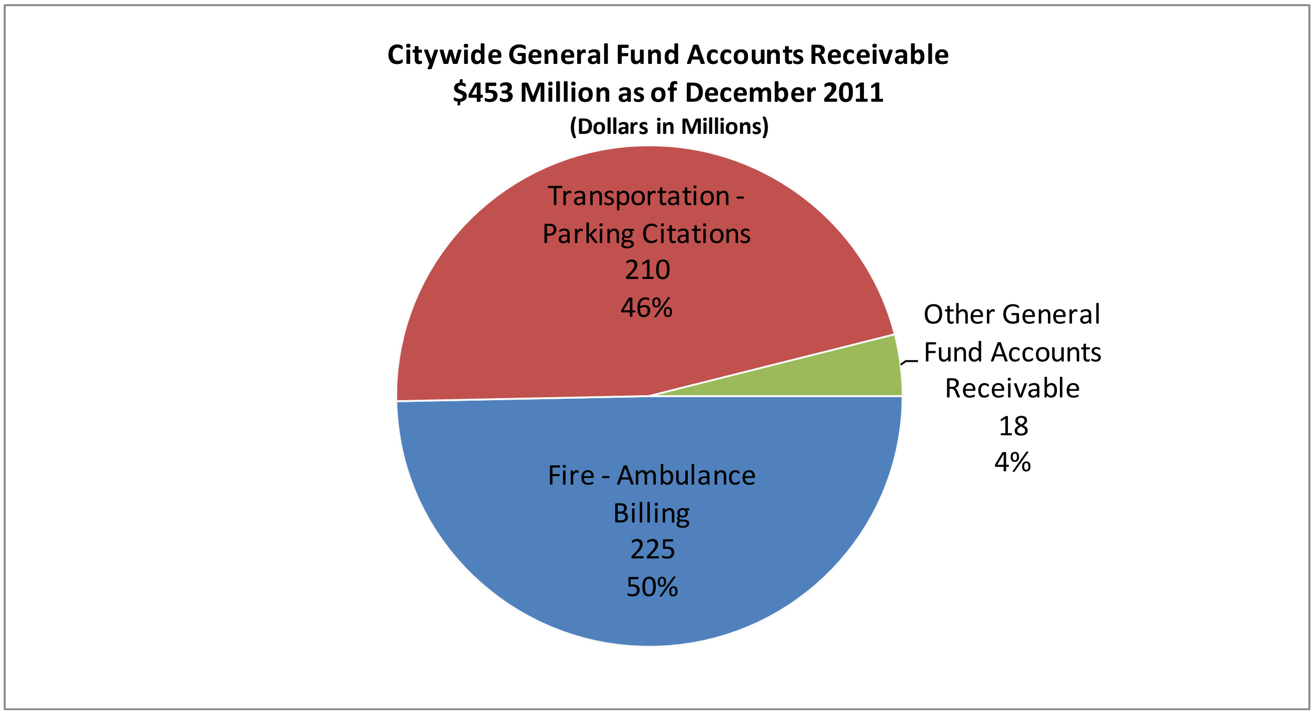
The City may also pursue a path to treat the parking revenues as unrestricted funds by paying off the outstanding debt of $89.5 million. Once this is done, the SPRF will not be subject to any bond provisions that limit the use of the SPRF revenues. The securitization of the parking meter revenue and the refunding of the existing debt are alternatives that may be considered to achieve this goal. However, each of these alternatives has their unique challenges and should be examined thoroughly before being pursued. As an interim step, this Office recommends that the policy limiting the transfer of surplus funds from the SPRF to the General Fund be amended to allow greater flexibility.

Collection of Uncollected Debt

Much negative attention and headlines have been generated over the years concerning the City's perceived lack of effective billing and collection operations. There is also a perception that there are large sums of money going uncollected that would make significant inroads to solving the City's budget issues. While there is certainly room for improvement in the City's billing and collections operations, the idea that the City's financial woes and structural deficit can be solved through improvements in collections is a myth.

The large outstanding balance of receivables being reported has amassed over many years and is no more collectible today than when it was issued. This uncollectible balance does not exist except on paper. Additionally, immediate improvements in collection of current receivables will not have a significant budgetary impact, particularly on the General Fund, to a level that would fundamentally reduce the City's structural deficit. Many receivables are enterprise or special fund and as such will have no impact on the General Fund. Furthermore, General Fund receivables will have a limited impact as 96% of the receivables, are principally attributed to ambulance billings and parking citations.

Chart 3



Of the General Fund receivables attributed to ambulance billing, 78% of the accounts are deemed to be current (less than 270 days old). However, of these current accounts, only 45% are anticipated to be collected on in a timely manner or at all. This under-collection is due to a number of factors, including but not limited to, statutory limitations on amounts payable, debtors that are indigent, deceased or which cannot be located, multiple debtors, debtors that enter into payment plans, or insurance payment disputes.

The receivables attributed to parking citations are more likely to be paid; 80% of tickets are paid within two years. However, significantly aged debt has accrued over the years resulting in a misleading receivable amount for parking citations. Due to penalties assessed on past due tickets, more than half the outstanding balance in parking citations receivables are penalties and late fees. Improvements in billing and collection processes may net millions, not hundreds or even tens of millions of dollars, and not without some amount of cost.

Nevertheless, the City must continue its efforts to improve billing and collections operations to maximize all existing funds. Recent efforts to improve the City's billing and collection operations have included the implementation of a field data capture system and a computerized emergency medical services billing and collection system to streamline the billing and accounts receivable process and provide for the tracking and reporting of each phase of the ambulance billing collection process for the Fire Department. Other efforts have focused on implementing a reporting system, allowing the Office of Finance to centrally track and analyze accounts receivable with an aim to increase the value of the City's collections. Combined with the upcoming hiring of an Inspector General of Citywide Collections, the City's billing and collections operations will continue to be enhanced.

Opportunities for a New Economic Development Model

The dissolution of the former CRA under AB1x26 will result in a distribution of net Tax Increment (TI) resources to the various taxing entities, after accounting for certain fees, pass-throughs and enforceable obligations. Starting June 1, 2012, this Office anticipates that the City will receive additional property tax payments (former TI funds). In a joint report by this Office and the Office of the Chief Legislative Analysts,[7] the City's share of the additional property tax payments were estimated by the former CRA to be, $57.4 million for 2011-12; $17.9 million for 2012-13; and $20.2 million for 2013-14. For 2011-12, the $57.4 million payment includes a one-time distribution of funds ($37.4 million) as well as ongoing funds ($20 million). The one-time distribution of funds includes portions of the former CRA's following funding sources: a) $85.7 million in unencumbered carryover resources for 2010-11; and b) $97.3 million which was originally set aside for the anticipated AB1x27 payment to the State which would have allowed redevelopment agencies to remain in operation. These figures are preliminary estimates and are subject to change based on many factors such as interpretation of the adopted legislation relative to enforceable obligations and decisions made by the independent Oversight Board and the California Department of Finance. It is important to note that the city has a minority vote on this board.

As a result of the elimination of the former CRA, the City no longer has access to the economic development and financing tools that have traditionally been used by the CRA to revitalize communities and generate new revenue to the City. This presents a unique opportunity for the City to create a new economic development model that will help the City meet its larger economic goals of creating new jobs, attracting new business and industries, maximizing the City's assets, and increasing the General Fund revenue. This Office anticipates that this new model would provide greater flexibility and opportunities for revenue growth and allow for an enhancement of citywide economic benefits.

This Office is preparing a joint report with the Chief Legislative Analyst that will review potential economic development models for Mayor and Council consideration. This report will outline various models for further evaluation, discuss available funding tools and revenue generating options (both new and existing), and make recommendations for implementation.

Options for New Revenue

Establishing new revenue sources for the General Fund has always been a challenging endeavor. Doing so after the passage of Proposition 218 has been even more difficult. Not only do all new taxes or tax increases require a vote, General Fund tax measures must be placed on a regular citywide election if a simple majority is being sought. The next general citywide election is scheduled for March 2013. Measures that are placed on special elections, primaries, and other non-city elections require a two-thirds majority. Consequently, in addition to policy and political considerations, the City has been limited in its pursuit of new revenue sources by the election cycle.

Nonetheless, with an upcoming citywide election in 2013, there are opportunities for increasing

[7] Council File No. 12-0049. Dissolution of the Community Redevelopment Agency of the City of Los Angeles and Discussion Relative to the Successor Agency, January 10, 2012.

revenue from existing revenue sources, such as the documentary transfer tax and the parking tax. As opposed to increases to the sales tax or business tax rates, which would place undue burden on the City's businesses and consumers, increasing the rates of the documentary transfer tax and/or the parking tax would burden a smaller subset of individuals and be based solely on voluntary transactions: the sale of property and parking in a lot within the City.

Preliminary estimates show that doubling the current documentary transfer tax rate would generate an additional $100 million in on-going revenues. At the new rate, the City of Los Angeles would be above the average rate for most neighboring cities. However, this rate would still be less than some of the northern California cities.

Table 2
Transfer Tax Rate per $1,000 of Property Sale Value

Cities in LA County	Rate per $1,000 of Property Sale Value	Other California Cities	Rate per $1,000 of Property Sale Value
Los Angeles (doubled)	**$9.00**	Oakland	$15.00
Los Angeles (current)	**$4.50**	Berkeley	$15.00
Culver City	$4.50	Piedmont	$13.00
Santa Monica	$3.00	Alameda	$12.00
Redondo Beach	$2.20	Richmond	$7.00
Pomona	$2.20	San Jose	$3.30
LA County Default Rate	$1.10	Sacramento	$3.75

Estimates of an increase to the parking tax show an additional $40 million on an annual basis if the tax rate was increased from 10% to 15%. If passed, the City would have one of the higher parking tax rates in Southern California. Other local tourist destination cities, such as Santa Monica and Burbank, would have taxes that are lower. Compared to other large U.S. cities, the new rate would still be lower than Miami, Philadelphia, New York, and San Francisco.

Table 3
Parking Taxes in Select Large U.S. Cities

City	Tax Rate
Pittsburgh	37.5%
Miami (parking and sales tax)	22% (15% + 7%)
Philadelphia	20%
New York (Manhattan)	18.38%
Chicago (Flat Tax – Variable)	$0 to $5.00
San Francisco	25%
Los Angeles (option)	**15%**
Ontario (monthly rate)	**12.5%**
Burbank	12%
Los Angeles (current)	**10%**
Santa Monica	10%

There are many who feel the taxes are high enough already and that expenditure cuts must come first. This is a sentiment that has resonated with City leaders as reflected in the approach taken to address the structural deficit which up to now has not relied on an increase to any of the General Fund taxes. Nonetheless, the pursuit of new revenue sources and/or increasing existing revenues is a strategy that can no longer be delayed. However, seeking to increase revenues that are subject to large fluctuations, such as the documentary transfer tax, should not be treated as a cure-all. As was the case with revenue received during the real estate boom, some increased revenue could be short-lived. Therefore, in conjunction with a new revenue strategy, this Office recommends directing a portion of any new revenue received into the City's Budget Stabilization Fund. Funding the Budget Stabilization Fund will ensure that revenue is available for those economic times when economically sensitive revenues have fallen. In addition to dealing with the economic cycles, funding the Budget Stabilization Fund will allow the City to better deal with uncertain legal liabilities.

It is important to note that the new revenue options described above would have little to no budgetary impact on the Fiscal Year 2012-13 budget as the collection of these enhanced revenues would not occur until very late in the fiscal year at the earliest. However, these solutions would have a positive impact on reducing the structural deficit beginning in 2013-14.

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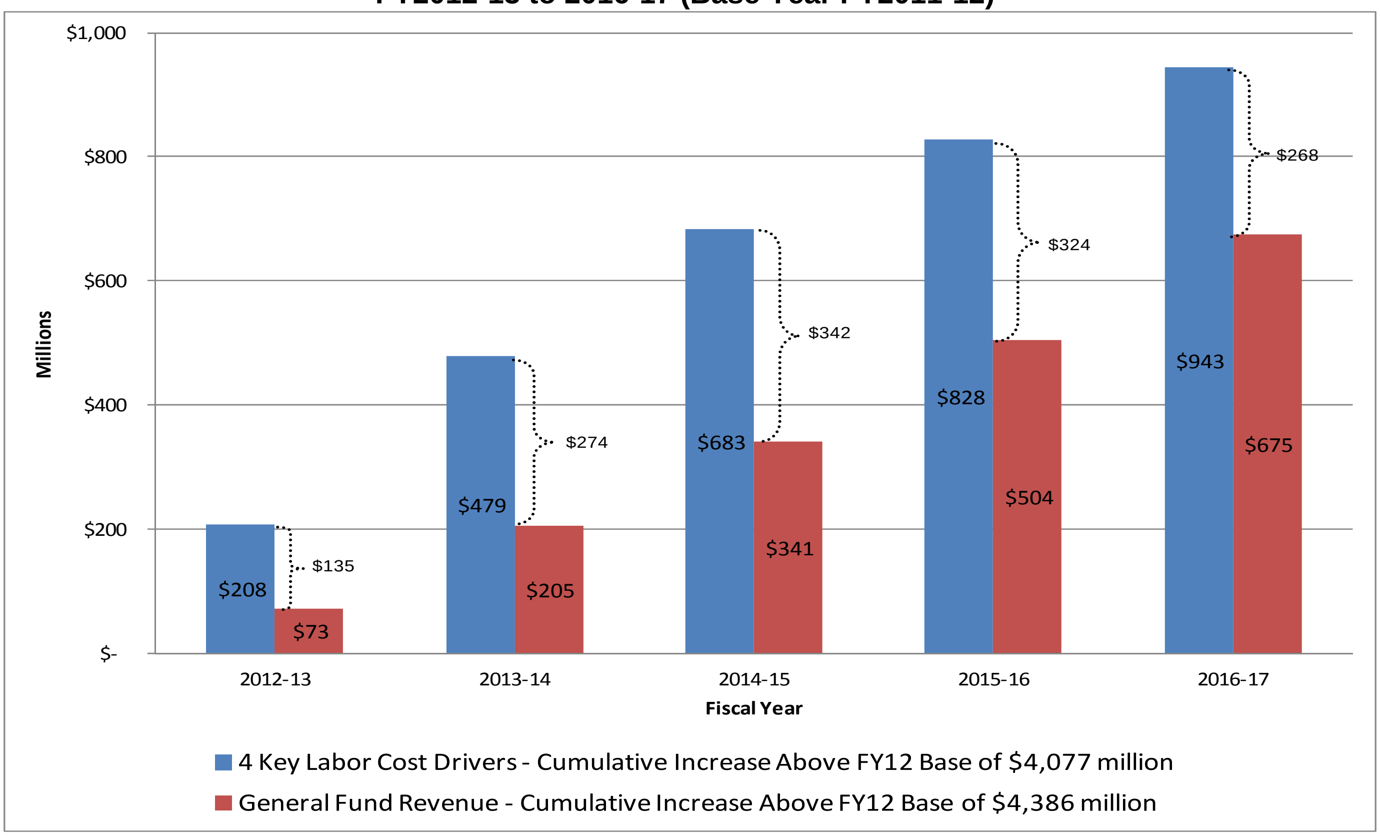
ACHIEVING FISCAL SUSTAINABILITY: EXPENDITURE CHALLENGES AND OPPORTUNITIES

Despite the revenue challenges and opportunities discussed, the large imbalance between the City's revenues and expenditures continues to widen as a result of significant increases to the City’s workforce expenditures including healthcare, workers’ compensation, employee compensation, and retirement benefits. Other expenditures, including those related to capital improvements are assumed to increase over the next four years as well thereby contributing to the structural deficit. Additionally, there are known and unknown liabilities that may undoubtedly impact the budget during the fiscal year and further exacerbate the structural deficit. This Office has identified the following expenditure challenges and opportunities that the City must address to achieve fiscal sustainability.

Labor Costs

The rise in the City’s labor costs in recent years has not been as a result of increased employment levels but rather increases to what the City spends on healthcare for employees, workers’ compensation, employee compensation, and retirement benefits.

Chart 4
Cumulative Labor Cost Projections Compared to Cumulative General Fund Revenue Increases FY2012-13 to 2016-17 (Base Year FY2011-12) [8]



8 Revenue Growth: 1.7% for FY13; 3% for FY14; 3% for FY15; 3.5% for FY16; 3.5% for FY17. Pension Returns: 0% Market Value of Assets for FY12; 7.75% per year thereafter. Authorized City Staffing in FY12: 32,274.

As illustrated, due to the four identified cost drivers, the City's workforce expenditures will increase by $943 million in 2016-17 above what it pays today. This represents an annual cost increase of about 4.3%.[9] This cost increase assumes the same level of City employees in 2016-17 as the number that currently exists today. With such a dramatic increase in the cost of the City's workforce, it should come as no surprise that the latest four-year outlook continues to show significant deficits in each of the next four fiscal years. Should the economy falter and/or recovery slow, these deficits will grow even larger.

Healthcare

Over the last decade, all employers – public and private – have been challenged to continue to provide quality, affordable healthcare to employees. While the national growth rate of healthcare costs has moderated from double digit increases to slightly more than 6% per year, this escalation is still twice the rate of inflation. For the City, this increase far exceeds the revenue growth rate it is projected to achieve. According to Mercer Consulting's 2011 National Survey of Employer Sponsored Health Plans, employees in Los Angeles companies with more than 500 employees pay 20% of the premium for an individual Health Maintenance Organization (HMO) plan, and 28% for a HMO family plan. In stark contrast, City employees pay less than 1% of the premium for either an individual or family HMO plan. Structural reform of the cost sharing methodology is essential to maintain this critical employee benefit without further reductions to the workforce and essential public services. Increasing the employee share of the cost of healthcare premiums by 10% would result in over $30 million in savings that could be utilized to maintain essential services.

Workers' Compensation

With regard to rising workers' compensation costs, the California Workers' Compensation Institute and the American Insurance Association report that the average medical costs per claim for all California self insured public entities has increased 27% over the past five fiscal years. The culprits for driving medical costs up include more use of outpatient services, increases in pharmaceutical costs, increases in inpatient surgery costs and increased use of pain medications.

Overall workers' compensation costs for the City show that the non-proprietary departments paid out $113 million in Fiscal Year 2009-10 and $131.6 million in Fiscal Year 2010-11 for workers' compensation claims (17% increase). Police and Fire sworn personnel account for 65% of these costs and civilian personnel account for the remaining 35%. In regard to citywide injured on duty (IOD) hours, sworn personnel account for 66% of all hours and 74% of all IOD costs compared to civilians in Fiscal Year 2010-11. Citywide IOD hours and costs increased approximately 15% from 2009-10 to 2010-11. In looking at preliminary data for the current fiscal year through February 2012, these upward cost trends continue.

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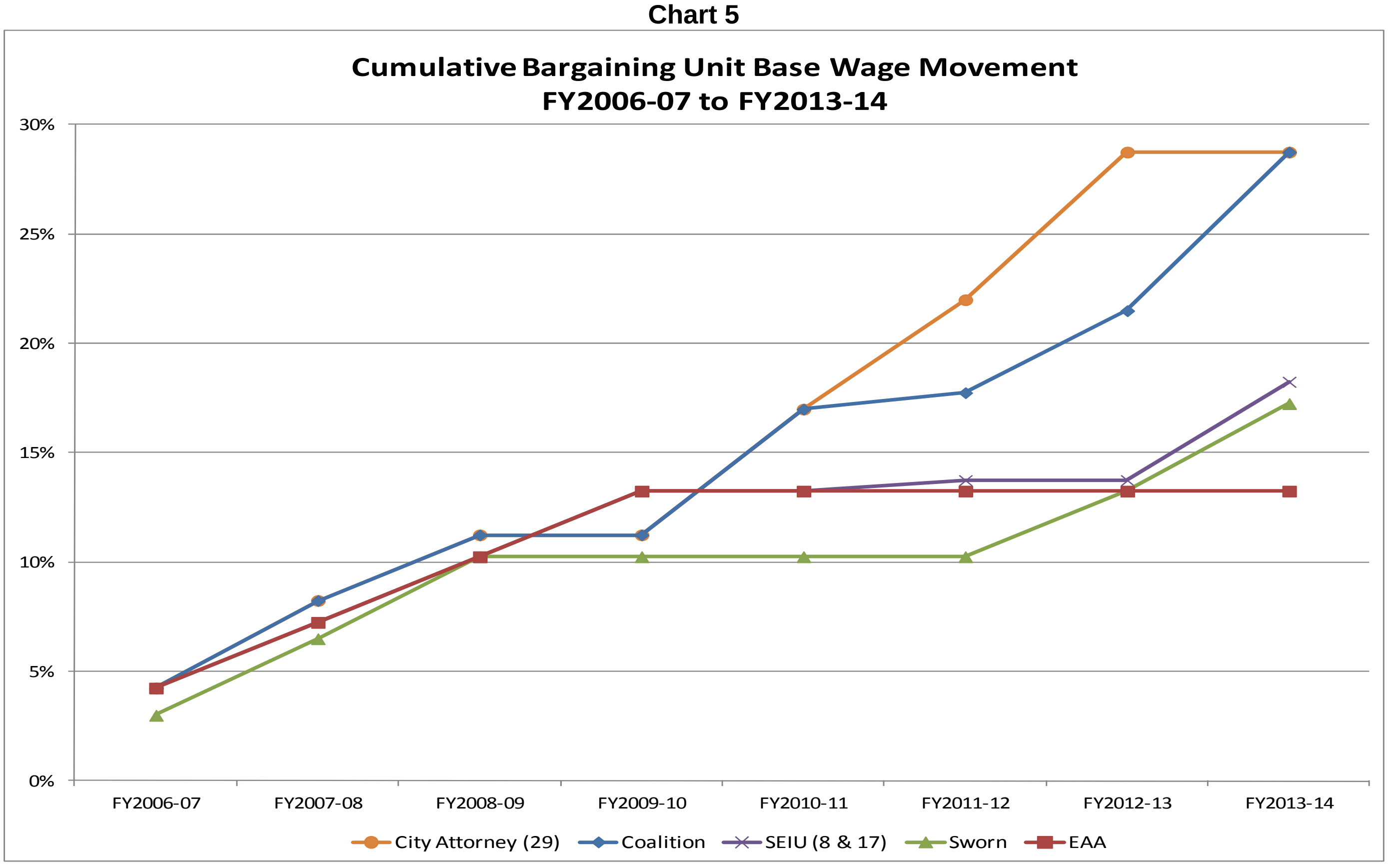
[9] Average annual increase of labor costs (employee compensation, healthcare, and retirement benefits) through FY15-16 is 4.7%. Average is 4.3% through FY16-17 due to limited compensation adjustments projected in FY16-17 as a result of expiring labor agreements.

The overwhelming majority of workers' compensation costs consist of medical costs, and as such are impacted by the national growth rate in the cost of providing healthcare. However, the costs are also determined in part by the State law that governs the administration of workers' compensation. The workers' compensation reform of 2004 appears to have ceased being effective in controlling the utilization of healthcare services by injured workers. Statewide reform will be necessary to bring these costs back under control in the absence of a significant reduction in the worker injury rate. At the local level, the City must initiate a process to reduce the City's workers' compensation rate to the State rate. Although the State has one of the most expensive rates nationwide, it is lower than the rate paid by the City.

Employee Compensation

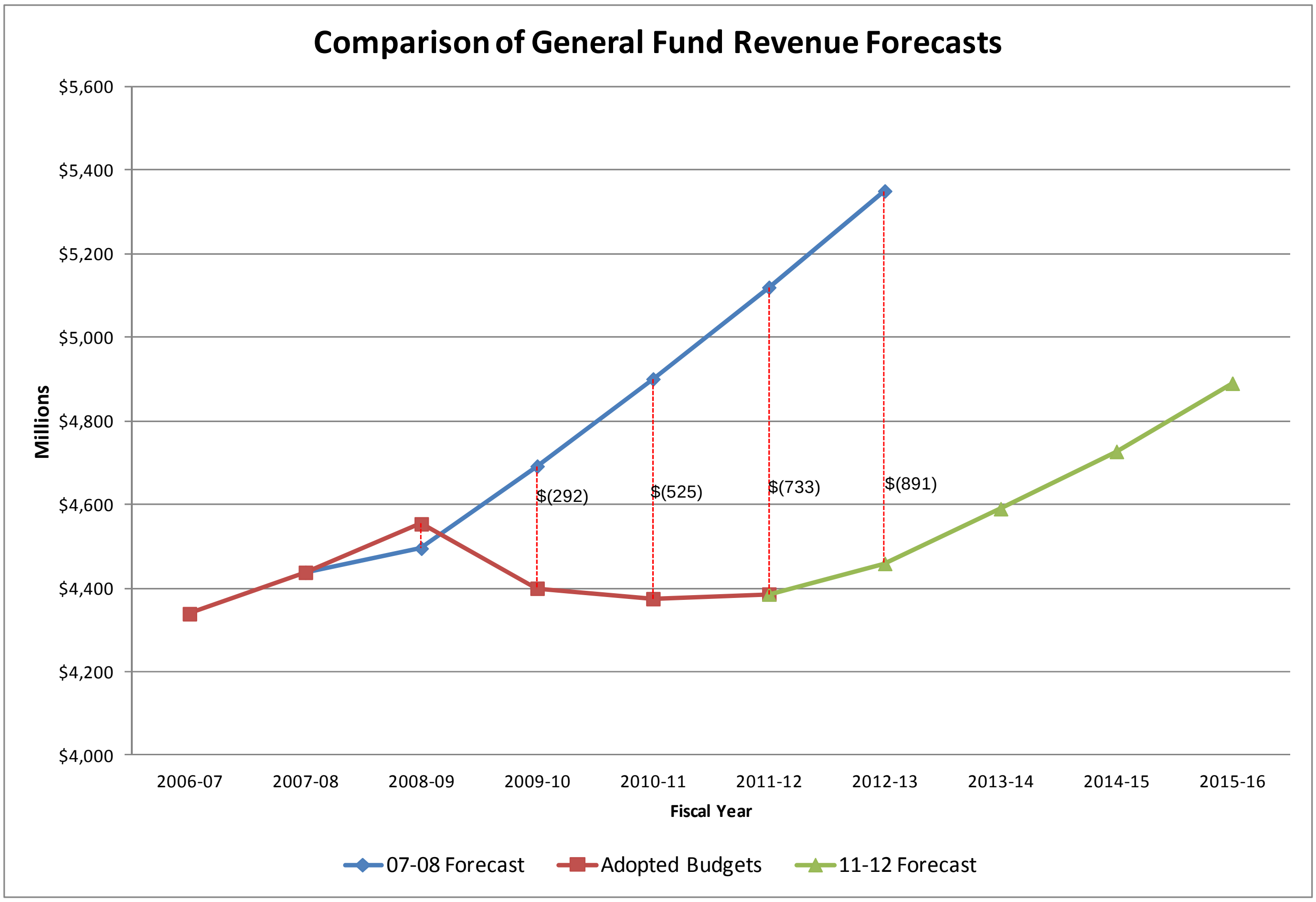
Given the economic reality that the City has faced over the last several fiscal years, it is hard to imagine a time when the economics of cost of living increases made fiscal sense. However, in 2007 revenue projections showed that the General Fund would continue its upward trend in large part due to revenues derived from the housing market. The projections were the basis for the significant base wage movement noted in the chart below for members of certain bargaining units belonging to the Coalition of Los Angeles City Unions (Coalition) and the Los Angeles City Attorneys Association (MOU 29). Coalition members represent approximately 60% of the civilian workforce.

Chart 5



As noted, the decisions resulting in the base wage movement for members of the Coalition and City Attorneys were made when economic times were better. Nonetheless, these decisions continue to impact the City as our expenditure projections have not been recalibrated to meet our new economic reality. As illustrated below, when the cost of living adjustments were negotiated with these labor organizations in December 2007, the Budget Outlook at the time showed that by Fiscal Year 2012-13, the City's General Fund revenue would be around $5.4 billion. As the current Budget Outlook now shows, the revised General Fund revenue projection only stands at $4.5 billion - a difference of about $900 million, or 17% less than originally projected.

Chart 6



While revenue is slowly recovering, structural employment cost increases are and will continue to far exceed revenue as demonstrated by the Budget Outlook. Over the next two fiscal years, compensation for most employees represented by the Coalition is scheduled to increase by 11%. Compensation for the majority of City Attorneys already increased by 5% in Fiscal Year 2011-12 and is scheduled to increase by another 6.75% in Fiscal Year 2012-13. This level of increase far exceeds projected revenue growth and is not sustainable without further reductions to the workforce and essential public services. In addition, these increases create substantial compensation inequity within the workforce. This will result in significant pressure from other unions to be provided with equivalent salary adjustments after Fiscal Year 2013-14. This pressure for compensation equity is exacerbated by the compensation levels for employees of the Department of Water and Power.

Historically, employees at the Department of Water and Power (DWP) have received higher levels of total compensation due in part to their unique industry, and negotiating apart from other City employee organizations. Over time, the disparity in compensation levels grew to as much as 20% for similar work. Attempting to solve this problem through upside compensation adjustments for other civilian City workers resulted in the contracts currently in place with the Coalition and City Attorneys Association. It is now clear that this contract is not sustainable within current or projected revenues. The compensation disparity remains and the City does not have the financial capacity to address it.

The City stands at a crossroad. In order to fund the negotiated salary increases in Fiscal Year 2012-13, the City may opt to reduce its workforce even further through layoffs of full-time General Fund employees, particularly since furloughs do not provide an ongoing solution. These eliminations would be on top of those the City has already made which resulted in the reduction of the City's workforce by 13% since 2007-08.

Alternatively, the City may choose to address the inequity of the upcoming compensation increases for the Coalition and the City Attorneys Association, by initiating the process to eliminate these increases. The elimination of salary increases for employees represented by these units for Fiscal Years 2012-13 and 2013-14 would result in savings to the General Fund of over $50 million based on the current size of the workforce. Moreover, while the cost of the workforce is reduced, the size could be maintained to allow for services at the current level to continue.

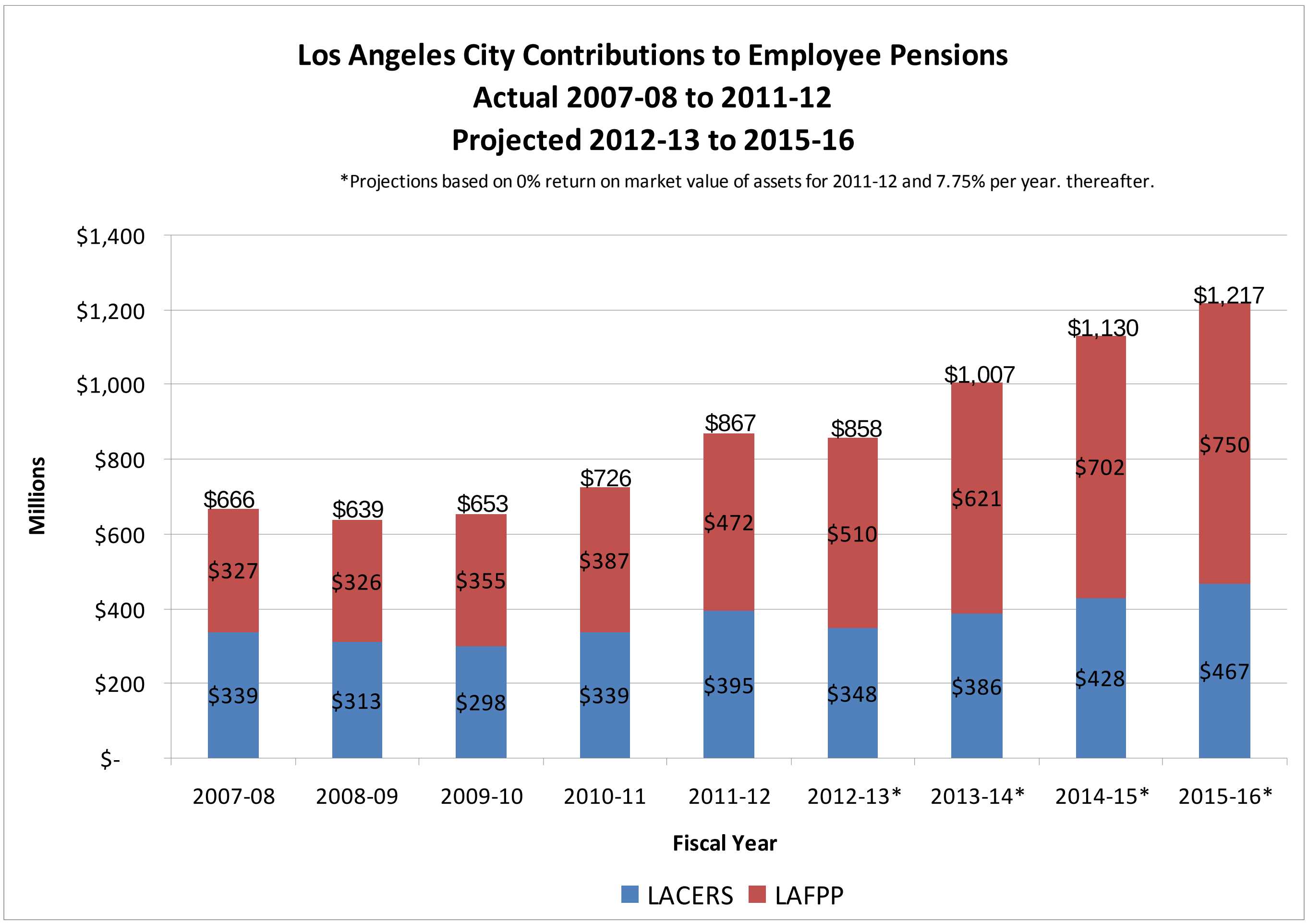
Another sensible approach to reduce workforce costs while mitigating negative impacts to services is adjusting salary levels downward yet keeping them competitive. Such an approach has proven successful with new police officers. The salary schedule negotiated for new police officers reduced the entry level compensation by 20%. This provision has not negatively impacted the City's ability to attract qualified applicants. This type of provision reduces the City's annual salary cost for up to eight years while the employee moves through the salary steps to the top step of the salary range, but does not reduce the employee's ultimate pensionable compensation. Implementing a similar salary step placement program in all City classifications would also decrease the City's yearly salary expenditures without impacting the employee's ultimate compensation. In those classifications where the City would be unable to recruit qualified personnel, advance step placement could be utilized to ensure the acquisition of qualified staff.

Finally, severing the employment relationship between the City and the DWP must also be considered. Severing the employment relationship in the long term would allow each organization to meet its public service commitments and employee compensation demands more effectively within the resource constraints of the respective organizations.

Retirement Costs

The City provides outstanding retirement and retiree healthcare benefits. Unfortunately, the costs for providing these benefits continue to strain the City's finances. By Fiscal Year 2014-15, the City may be contributing almost 30 cents for retirement benefits for every dollar it spends on salaries for civilian employees. For sworn employees, the City may be spending more than 50 cents for every salary dollar.[10] These ratios already take into account the reductions the City has been able to achieve by having the majority of active employees contribute toward retiree healthcare and freezing the retiree health subsidy at the current level for those employees that opted not to contribute.

Chart 7



Pension reform is an essential element of the City's long term fiscal sustainability and the City must continue to actively pursue efforts to contain and reduce retirement costs within both of the City's pension systems. However, the options for containing costs associated with active or retired employees are very limited as the majority of the benefits received by employees are vested.

[10] Ratio for civilian employees based on blended contribution rate of 28.47% for valuation year 2013. Ratio for sworn employees based on contribution rate of 52.35% for valuation year 2013. Both rates were estimated by The Segal Company using a scenario of 0% return on market value of assets for 2011-12 and 7.75% per year thereafter.

Nevertheless, one option that is clearly within the City's rights is the establishment of a new pension tier for civilian employees. Increasing the retirement age, lowering automatic cost of living adjustments, controlling future medical costs, averaging final compensation over five years, and sharing future funding risks are critical elements of a new civilian pension tier that will be sustainable within projected resources and still provide a quality retirement for future civilian employees.

In 2010, the voters of the City of Los Angeles commenced the process of pension reform by amending the Police and Fire Pension System to provide for a more sustainable benefit for the City's sworn employees. Pursuing a new pension tier for civilian employees is the next logical step. Moreover, unlike the pension reform efforts for the Police and Fire Pension System, establishing a new civilian tier with reduced benefits does not require a ballot measure and can be achieved before the end of Fiscal Year 2012-13.

Another effort that should be considered but which will require more time to complete is the consolation of the City's benefit delivery systems for retirement, retiree healthcare, and active healthcare benefits. Currently, the delivery of these benefits is best described as disjointed, duplicative, and inefficient. With three separate retirement systems using multiple duplicative investment advisors to manage fund assets, at a cost of over $91 million dollars (as pointed out in the Controller's audit of 2007), opportunities exist for unification and reduction in investment advisor costs. In addition, the City provides essentially the same types of healthcare products to active and retired civilian and sworn employees but does so through no less than five separate and distinct organizational entities. Duplication of management structures, electronic data systems and customer service staff is inefficient, not cost effective and provides an opportunity to reduce costs without reducing the benefits relied upon by active and retired employees.

Funding for Priority Services

The dedication of significant levels of funding for the Fire and Police Departments reflect the Mayor and Council's prioritization of public safety above all other services. As noted, about 70% of the City's unrestricted revenues are dedicated to maintaining police and fire services at existing levels. For the Police Department, the existing level of resources and services currently reflect the policy decision to continue police hiring to maintain an authorized deployment level at 9,963 officers. For the Fire Department, the current level of resources and services reflect deployment changes implemented to generate savings but which have now been called into question.

<u>It is a certainty that the City will need to provide additional funds to both the Police and Fire departments in 2012-13 just to maintain the current deployment models.</u> However, the City's ability to continue to protect these two core services at current levels is increasingly difficult with each passing year. Should the City move to restore the Fire Department's former deployment model, additional resources will be required making the choices more difficult.

The Council is currently debating increasing the Fire Department budget to 2007-08 funding levels. Some have argued that the re-prioritization of services and service levels in the Police Department may assist the City make these investments in the Fire Department. For example, suspending police hiring for one year and only hiring to attrition thereafter is estimated to save approximately $10 million in the first year and $27 million ongoing. While this would make a contribution, more funding will be needed to increase the Fire Department budget to its highest levels. The bottom line is that if City's top priority continues to be maintaining or enhancing the service levels for these two departments, outside of identifying and implementing some type of revenue increase, the City will continue to be faced with the prospect of eliminating funding and positions in its other departments.

Capital Improvement and Expenditure Program

In addition to the workforce reduction and related service impacts the City has endured to maintain a balanced budget, the City's financial outlook has made it difficult for the City to invest in its infrastructure as dictated by the Capital Improvement and Expenditure Program (CIEP) policy. The CIEP policy established an annual funding level for General Fund capital improvements at one percent of the total General Fund. Due to the City's fiscal crisis, the City has failed to meet this annual funding level requirement. The City last performed a citywide review of its capital and infrastructure needs in 2003 through a Blue Ribbon Task Force established by Mayor James Hahn. The Task Force found that the City had a 10-year capital and infrastructure need of $35 billion (proprietary and Council-controlled departments). Since that time, outside of the improvements made by the City's proprietary departments, the City has not been able to fully fund its capital improvement needs.

During the 2011-12 Budget process, it was proposed that the City's CIEP policy be suspended for three years to deal with on-going fiscal constraints. Though the suspension of the CIEP policy was not adopted, the City was only able to provide a fraction of the one percent policy requirement, or $6.5 million for critical infrastructure work. To comply with the one percent funding level in 2012-13, an additional $35 to $45 million will need to be provided on an ongoing basis. Due to continuing fiscal constraints, complying with the one percent CIEP policy may not be feasible in 2012-13 or for years thereafter. Nonetheless, until the CIEP policy is revisited, compliance with the current policy must be accounted as an obligatory expense in the Budget Outlook.

Adherence to the CIEP policy, while an important goal, results in a distortion to the projected deficit. Primarily, the one percent threshold does not account for alternative methods in which the City is currently investing in its infrastructure improvements including the use of monies from voter approved bond programs for libraries, police and fire stations, and animal care centers. Additionally, the City's use of short-term borrowing tools to make much needed improvements to City facilities including neighborhood city halls are also not accounted for in the one percent policy. This Office contends that the City's CIEP policy and in particular the one-percent threshold must be revised to better assist the City properly manage its infrastructure investments. A revised policy should focus on the useful life of infrastructure, the appropriate replacement cycle, criteria for investments, and the best financing methods for making these investments. Such revisions will lead towards an improved accounting of the City's infrastructure improvements as well as provide a more realistic illustration of the City's Budget Outlook.

Municipal Facilities

In more recent years, and largely due to the recession, the City has had to take steps to rein in municipal facilities projects that had already been authorized to avoid increased debt service and maintenance costs. For example, in 2008-09 and 2009-10, the City placed a number of authorized projects on hold. These projects total $94.18 million and include City yards, a neighborhood city hall, the relocation of the Urban Forestry Division, and three pool projects. For 2010-11 and 2011-12, the City was only able to set aside an average of $6 million to fund those critical infrastructure items that could not be deferred such as citywide asbestos removal, elevator and roofing repair, contaminated soil removal and State required fire, life, safety building systems support.

It should be noted that over the years, and to the extent possible, the City has continued to invest in new and renovated facilities and replaced old high-maintenance police, fire, library, animal care, and recreational facilities with new ones through the use of monies from voter-approved bond programs. Because of these investments and the relocation of employees to newer facilities, the City has been able to mitigate the lack of deferred maintenance expense and costly repairs at some of its outdated facilities by a small measure. However, the ratio of new versus older facilities is small and the City will need to continue to invest additional dollars in deferred maintenance as well as start a proactive preventative maintenance program for our new facilities to ensure an adequate life cycle for these new facilities.

Improved Asset Management

The City has a need to improve its asset management operations in various areas that include establishing appropriate performance metrics and best practices; optimizing the utilization of its properties; establishing short, medium and long term real estate goals based on industry standards; identifying efficiencies that might be gained through private-public partnerships; and, identifying improvements in technology to improve the City’s management of its assets. The 2011-12 Adopted Budget contains funding to support the elements discussed above. This Office will shortly be initiating a solicitation process to hire one or more firms to review and make recommendations to improve the City’s asset management function. The study is expected to be completed in 2012-13 in time for the Mayor and Council to consider the implementation of the study’s recommendations as part of the 2013-14 budget development.

Physical Plant

The worn-out roadways, sink-holes, and endless potholes are a constant reminder that the availability of funding to address physical plant infrastructure such as roadways, bridges, and alleys has been insufficient to meet the City’s needs. The City’s structural and cultural issues are of equal significance in creating challenges that limit the ability to address deferred maintenance. Even so, the City has begun to focus on infrastructure maintenance and improvement issues. For example, the City:

- Has approved increases in the Sewer Service Charge to allow for maintenance and improvement of the sewer system;
- Continues implementation of clean water projects through Proposition O to reduce the impact of contaminated runoff on our coast and public health;
- Finished the conversion of traffic signals to light emitting diodes to reduce energy usage and maintenance costs;
- Started the conversion of street lights to light emitting diodes to reduce energy usage and maintenance costs;
- Continues to fund the construction of ADA compliant access ramps, more durable bus pads within the roadway, the reinforcement of street lights to avoid wire theft and the filling of potholes and crack sealing of streets;
- Has begun exploring ways to improve the overall condition of the public roadway;
- Is completing the Automated Traffic Signal and Control System by June 2013; and,
- Focused City management on eliminating procedural issues within the City government to expedite street projects through to completion by establishing the Streets and Transportation Projects Oversight Committee.

Areas that still require improvement and a significant expenditure of funds, possibly in the billions, include improving the overall condition of:

- Public roadways, bridges and tunnels;
- Storm drain system;
- Public alleys, street furniture and median islands;
- Urban forestry; and,
- Strategic planning for infrastructure maintenance and improvement, such as
    - Strategic adjustments to the impact of climate change;
    - Strategic management of the intersection of infrastructure components;
    - Strategic funding of deferred maintenance needs to avoid peaks and troughs and minimize the potential for infrastructure failure; and,
    - Strategic selection and ranking of infrastructure projects to guide funding decisions.

Information Technology (IT)

Significant budget reductions over the last six years have greatly diminished IT staff, and the City does not have the resources to continue to meet the growing demand for IT infrastructure and services in an adequate manner. Consequently, the City has proposed to undertake an aggressive plan to review IT services and expenditures citywide and intends to procure the services of a Strategic Advisor for that purpose. The City has initiated a solicitation process to retain a Strategic Advisor to assist the City in reviewing its technology services and in assessing and recommending changes. Ultimately, the City is interested in providing the most cost-effective technology services throughout the City. The Strategic Advisor could assist the City in evaluating all areas of IT service delivery (infrastructure, enterprise applications, business applications, and support services), the current level of available services, and alternative options for providing or accessing those services.

Other Liabilities

The usefulness of the Budget Outlook as a tool is the ability to derive a projected budget deficit or surplus based on the expected revenue and expenditure trends. In the City's case, greater certainty in revenue or expenditure data will result in greater certainty of its deficit target. Thus, to the extent possible, the Budget Outlook incorporates what is known and quantifiable. However, there are known liabilities that are currently unquantifiable. Additionally, there are unknown liabilities that will undoubtedly surface. The Budget Outlook will undergo constant review and revision to incorporate new information. Some issues that may considerably alter future Budget Outlooks are the Ardon Case and the cases related to the Americans with Disabilities Act (ADA).

Ardon Case

The City is subjected to numerous lawsuits. One suit is of special significance due to the size of the potential liability. *Ardon v. City of Los Angeles* is a class action challenging the validity of the City's telephone users' tax based on a federal government interpretation of the federal excise tax in 2006, prior to its voter-approved amendment in 2008. On July 25, 2011, the State Supreme Court held that class actions against municipalities for refunds of local taxes are permitted under State law, and remanded the matter back to the trial court for consideration on the merits. While the class has not been certified and the ultimate resolution of this case may be several years away, it is possible that this matter could be resolved as soon as Fiscal Year 2012-13. If the plaintiffs prevail on the merits of the underlying complaint, the City's liability could be up to $750 million. The City annually budgets for liability payouts. However, it has not set aside reserves for a liability of this potential magnitude and would likely issue judgment obligation bonds if the plaintiffs prevail.

Americans with Disabilities Act Cases

The City of Los Angeles is a defendant in several cases where plaintiffs allege that the City is in violation of state and federal disability access laws due to the condition of the City's sidewalks. Additionally, the Civil Fraud Section of the U.S. Department of Justice is currently investigating whether the City violated the False Claims Act in connection with certifications to the U.S. Department of Housing and Urban Development regarding compliance with federal accessibility laws and regulations protecting individuals with handicaps. The City's participation in the investigation is in the preliminary stage. The possible financial exposure of these cases is currently unknown but the outcomes could materially affect the City's General Fund financial position.

Borrowing

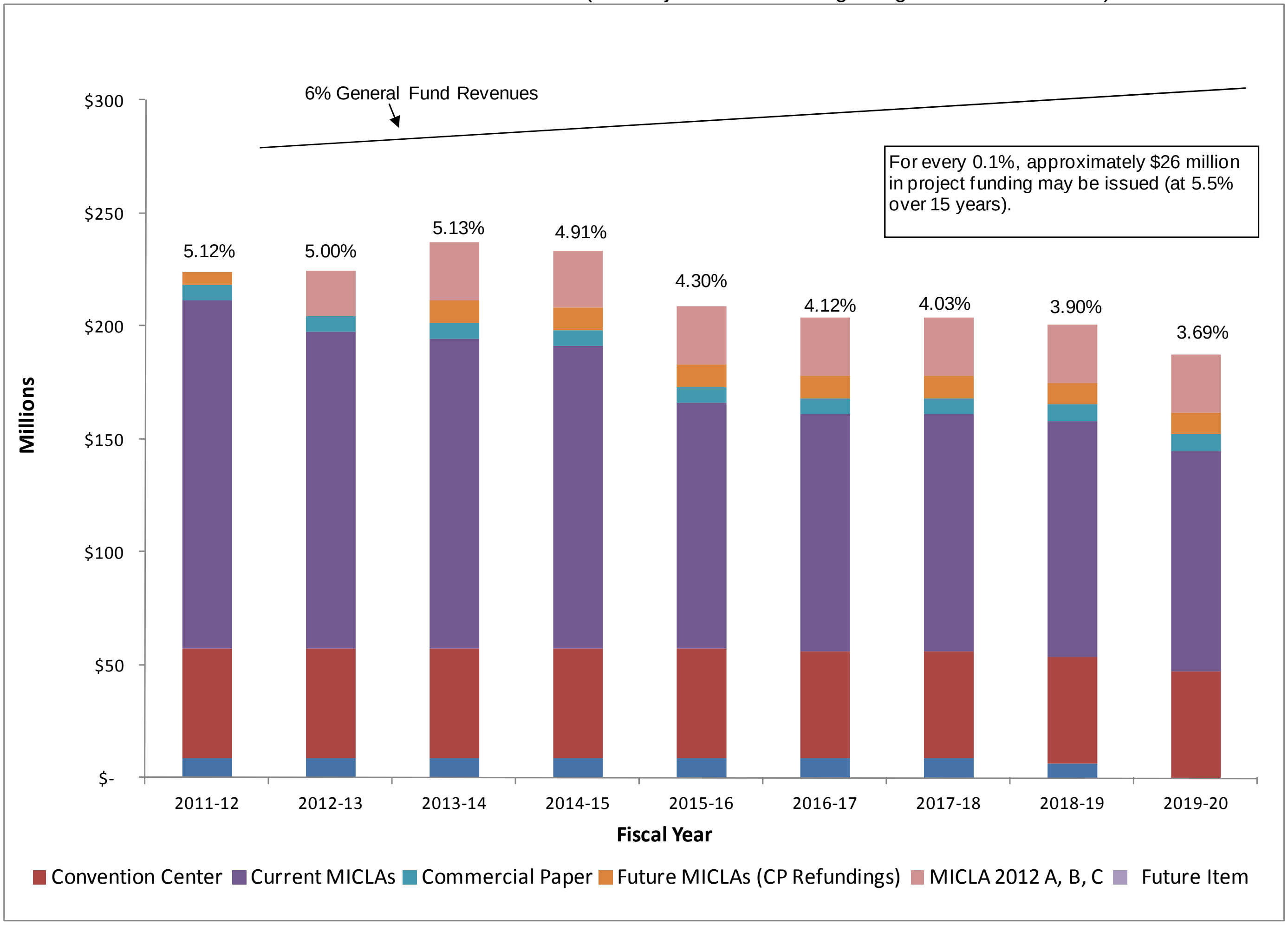
Issuing debt is an appropriate method of financing capital projects and major capital equipment acquisition, and for managing the short-term cash flow needs of the City. However, relying on borrowed funds to address long term structural deficits demonstrates credit weakness.

In 1998, the City adopted Debt Management Policies and revised them in 2005. One of those policies was to limit the amount of debt service on non-voter approved debt to a maximum of 6% of General Fund revenue. In 2011-12, the City expects the limit to be 5.12% and in 2012-13 at 5.00%. Depending on interest rates, this gives the City between $260 and $300 million of debt capacity on non-voter approved debt for financing strategies such as judgment obligation bonds, MICLA lease revenue bonds and Convention Center lease revenue bonds.

Chart 8

Non-Voter Approved Debt as of April 2012

Debt Service to General Fund Revenues (2% Projected Growth Beginning in Fiscal Year 2016)



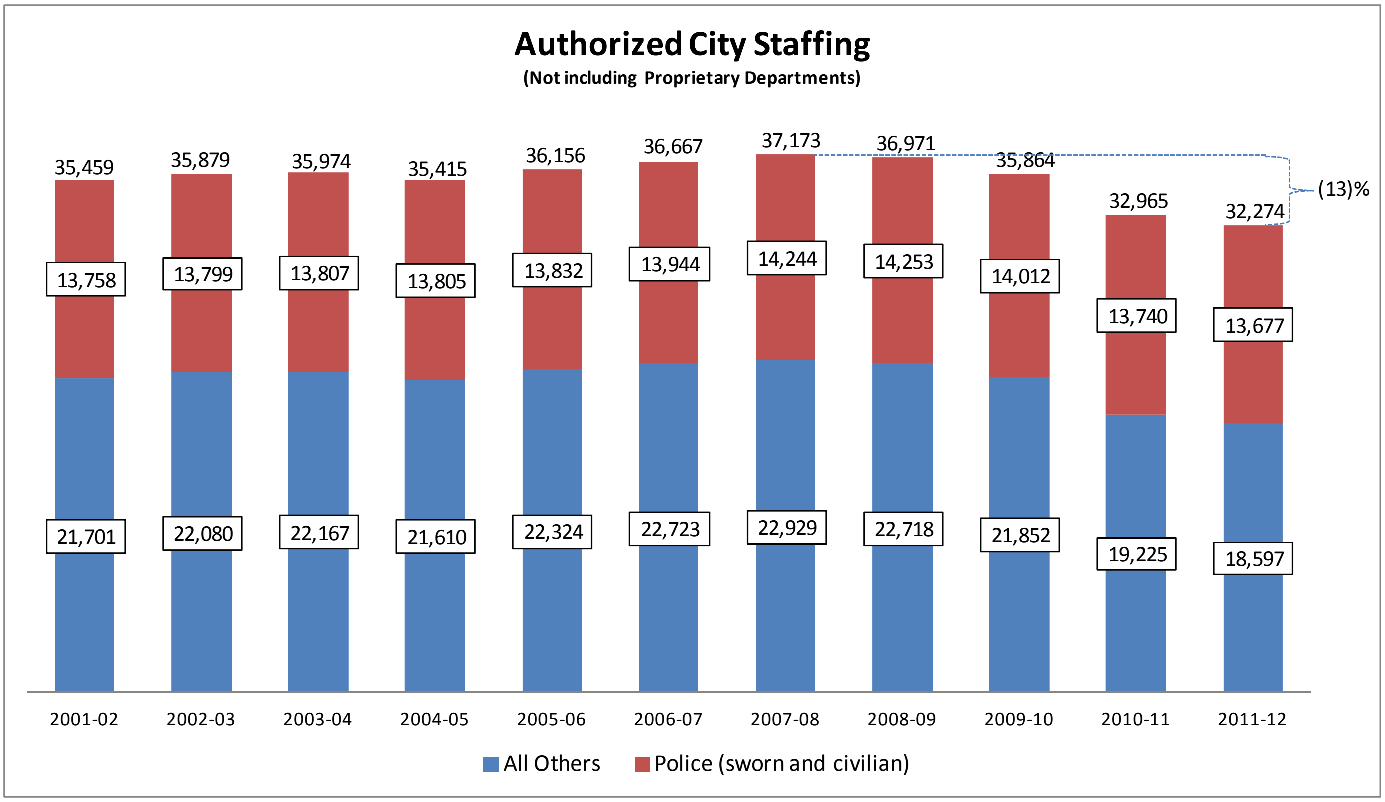
While borrowing to pay on any liabilities that could arise from lawsuits or other unforeseen events may be a necessity, due to the City's debt limit, the City's capacity to take on additional debt may be insufficient. A more practical approach to dealing with uncertain liabilities is to set aside reserves within the City's Reserve Fund or the Budget Stabilization Fund.

BUILDING ON SUCCESSES AND LESSONS LEARNED

Workforce Reductions

Since 2007-08, the City has eliminated close to 4,900 positions, a reduction of 13%, to bring the number of authorized staffing to its lowest point in decades. For civilian positions funded by the General Fund, the workforce reduction has been more severe. Since Fiscal Year 1990-91, the number of General Fund civilian positions has decreased citywide by 38%. Excluding the Fire and Police departments, the decrease in General Fund civilian positions has been 53%.

Chart 9



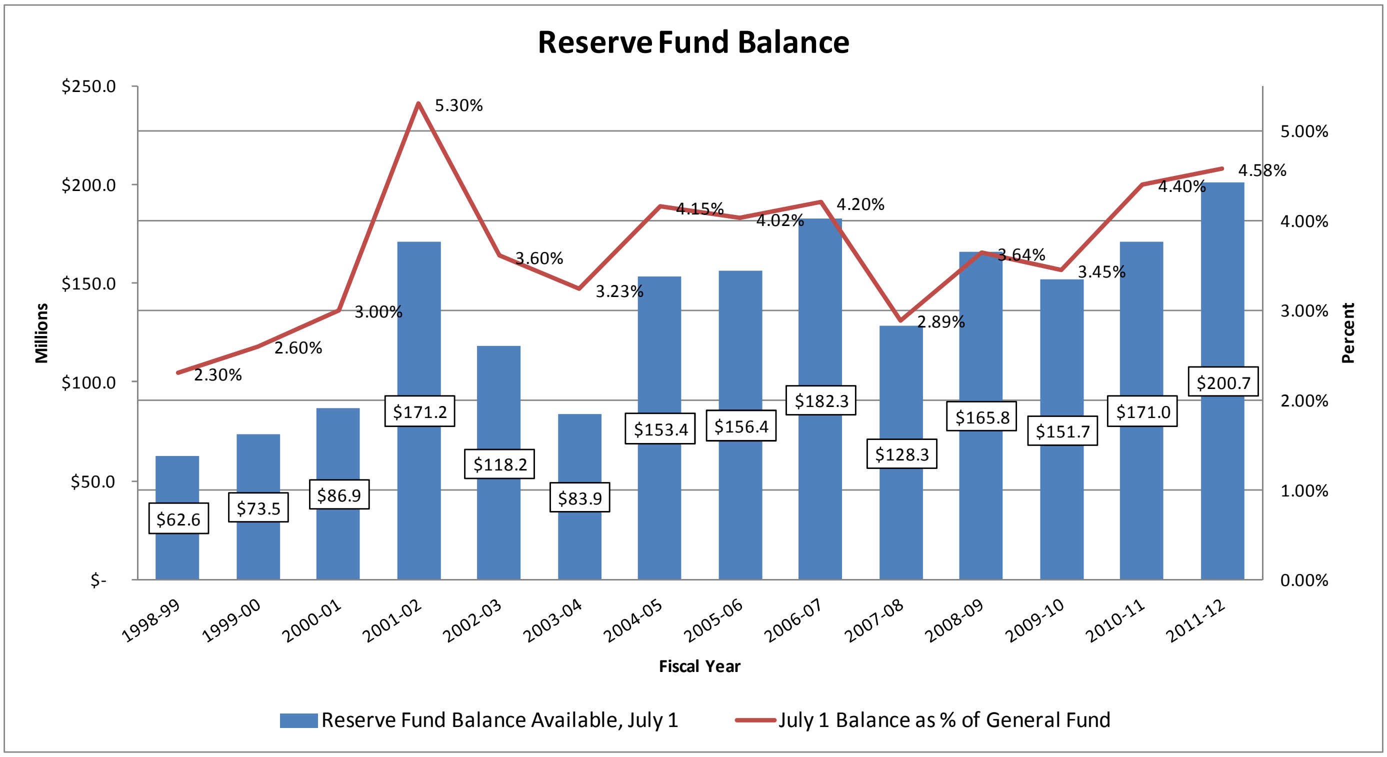
Such a large reduction in the City's workforce, while necessary to balance the budget, has not come without an impact to the services the City delivers. For this reason, the City must continue its efforts to negotiate for labor concessions that will reduce the cost of the workforce without further reducing the City's ability to provide services. However, should additional workforce reductions be required, the City should make these reductions in a manner that reflects its priorities and to the extent possible, look for alternative service delivery models to continue providing a service.

The City's transfer of the Northeast Valley Animal Care Center to the non-profit Best Friends Animal Society for operation as a pet adoption center is a prime example of implementing alternative service delivery models. Without this transfer of operation, the doors of the animal care center would have remained closed to the public and opportunities for pet adoption would have been diminished.

Reserve Fund

The commitment of the City to build its Reserve Fund over the last several years and forgo transfers out of the Reserve Fund to deal with the current year deficits has been a key factor in stabilizing the City's bond ratings following downgrades experienced in 2010-11. Since the adoption of the 2011-12 budget, the City has been able to increase funding within the Reserve Fund by about $20 million. More importantly, the City has been able to maintain this higher than budgeted level within the Reserve Fund even as it addressed a current year deficit projected to be $72 million in December 2011. As reported in the Mid-Year Financial Status Report adopted in February 2012, the City was able to address the projected current year deficit mostly by directing departments to develop operational plans to absorb any anticipated deficits and without a transfer from the Reserve Fund.

Chart 10



Reaching a Reserve Fund level of at least 5% of the General Fund is within the City's grasps. Not since July 1, 2001, when the City last surpassed the policy threshold, has the City been as close to this goal. To achieve this goal, the City will need to make a commitment, as it has done this year, to withhold from making transfers out of the Reserve Fund for service enhancements or other ongoing expenditures. The prolonged fiscal crisis can no longer be an excuse for failing to comply with this policy as other local entities have shown that complying with reserve fund policies even during tough economic times can be achieved.

Similar to the City, the Los Angeles Unified School District's (LAUSD) reserve fund policy requires that operating reserves are at least 5% of general fund revenues. Since fiscal year 2000-01, LAUSD has continually met its reserve fund policy goals and remains committed to meeting this policy. For fiscal year 2011-12, LAUSD projects to end the year with a 12% operating reserve.

Los Angeles County's policy, Reserve for Rainy Day Fund, has a cap of 10% for on-going locally generated revenue and states that transfers of 3% should be made each year into this reserve fund until the 10% cap is met. When the 10% cap is exceeded, the excess may be available for one-time purposes such as capital projects. The objective is to avoid on-going commitments with funding that may be unsustainable during economic downturns.

The importance of maintaining a strong Reserve Fund cannot be overstated. First and foremost, reserves are maintained for unanticipated expenditures or revenue shortfalls, and to preserve flexibility throughout the fiscal year to make adjustments in funding for programs approved in connection with the annual budget. The Reserve Fund also provides sufficient cash flow in instances where revenue receipts are delayed, such as in the case of deferred transfers from the State. Finally, sufficient reserves are necessary to maintain positive bond ratings, thereby securing favorable interest rates for the issuance of general obligation bonds and all of our other General Fund debt.

Table 4
Ratings of 10 Largest U.S. Cities (Updated March 27, 2012)

Rating Rank	City	Fitch	Moody's	S&P
1	San Antonio, TX	AAA	Aaa	AAA
2	San Jose, CA	AA+	Aa1	AAA
3	Phoenix, AZ	NA	Aa1	AAA
4	Dallas, TX	NA	Aa1	AA+
5	New York, NY	AA	Aa2	AA
5	Houston, TX	AA	Aa2	AA
7	**Los Angeles, CA**	**AA-**	**Aa3**	**AA-**
8	Chicago, Il	AA-	Aa3	A+
9	San Diego, CA	AA-	Aa3	A
10	Philadelphia, PA	A-	A2	BBB

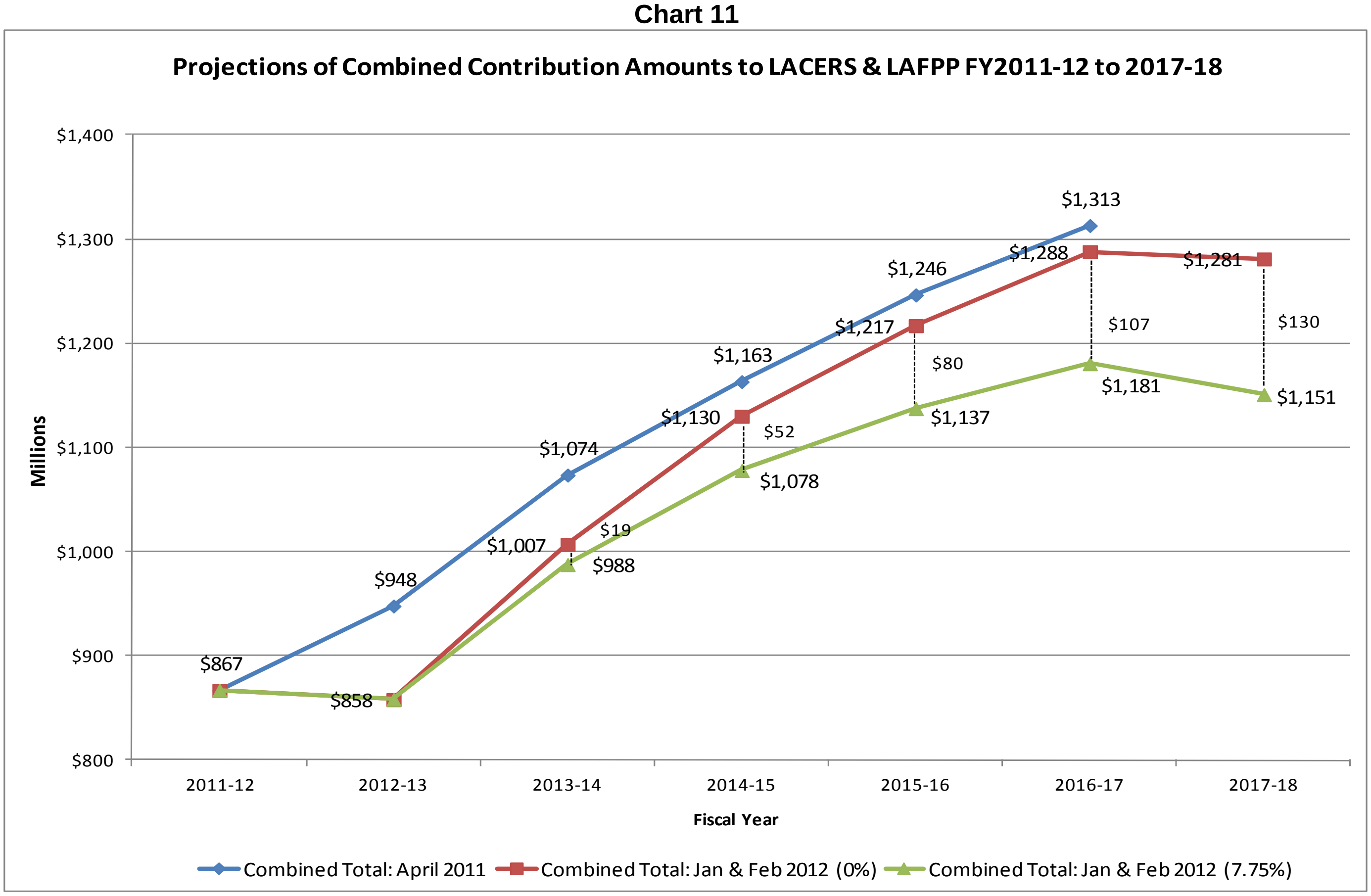
Retirement Cost Reductions

Finally, over the course of the past year, the City has been actively pursuing efforts to contain and reduce retirement costs within both of the City's pension systems. Most notably, the City negotiated agreements that have secured a 4% active employee contribution toward retiree healthcare for the majority of the civilian workforce; secured a 2% active employee contribution toward retiree healthcare for 64% of the sworn workforce; restructured cost-of-living adjustments; decreased salaries by 1.5% and/or frozen salaries for one-year for certain bargaining groups; reduced the starting salaries for police officers by 20%; and obtained voter-approval for a new tier of retirement benefits for sworn employees hired after July 1, 2011. For those civilian and sworn employees that opted not to make an additional contribution toward retiree healthcare, their retiree health subsidy has been frozen at the current level.

For their part, the Los Angeles City Employees' Retirement System (LACERS) and the Los Angeles Fire and Police Pensions System (LAFPP) have also taken actions to provide the City with some budgetary relief in the more immediate fiscal years. Such actions have included changing the asset smoothing method to reduce volatility of future contributions, amending the manner in which extraordinary losses or gains in the market value of assets are recognized, and approving a phased-in approach to the lowering of investment return assumptions.

The combined effect of the City's actions and the actions of the retirement systems has been a decrease to the projected contribution amounts the City was expected to make to LACERS and LAFPP for 2012-13 and beyond. The following chart illustrates the estimated combined contribution amounts by the City to LACERS and LAFPP over the next five years based on the two different scenarios and current payroll growth assumptions. The scenarios are: 1) 0% return on market value of assets for 2011-12 and 7.75% per year thereafter for both LACERS and LAFPP; and 2) 7.75% return on market value of assets for 2011-12 and 7.75% per year thereafter. These scenarios are compared to an earlier projection made in April 2011 which assumed an 8% return on market value of assets for 2010-11 and 8% per year thereafter for both systems.

Chart 11



According to fiscal year-to-date un-audited returns, Scenario 1, which assumes a 0% return on market value of assets at the close of 2011-12 and 7.75% thereafter, is currently the more likely scenario. The actuarial valuation for year end 2011-12 will be based on the investment returns as of June 30, 2012.

While these most recent projections demonstrate less expenditure growth than previously anticipated, the City will continue to experience cost increases of a significant magnitude to both LACERS and LAFPP between 2012-13 and 2016-17. A slight reprieve is expected to occur in 2017-18; however, increases to the City's future payroll beyond those assumed herein and actual investment returns may significantly alter these current projections.

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CONCLUSION

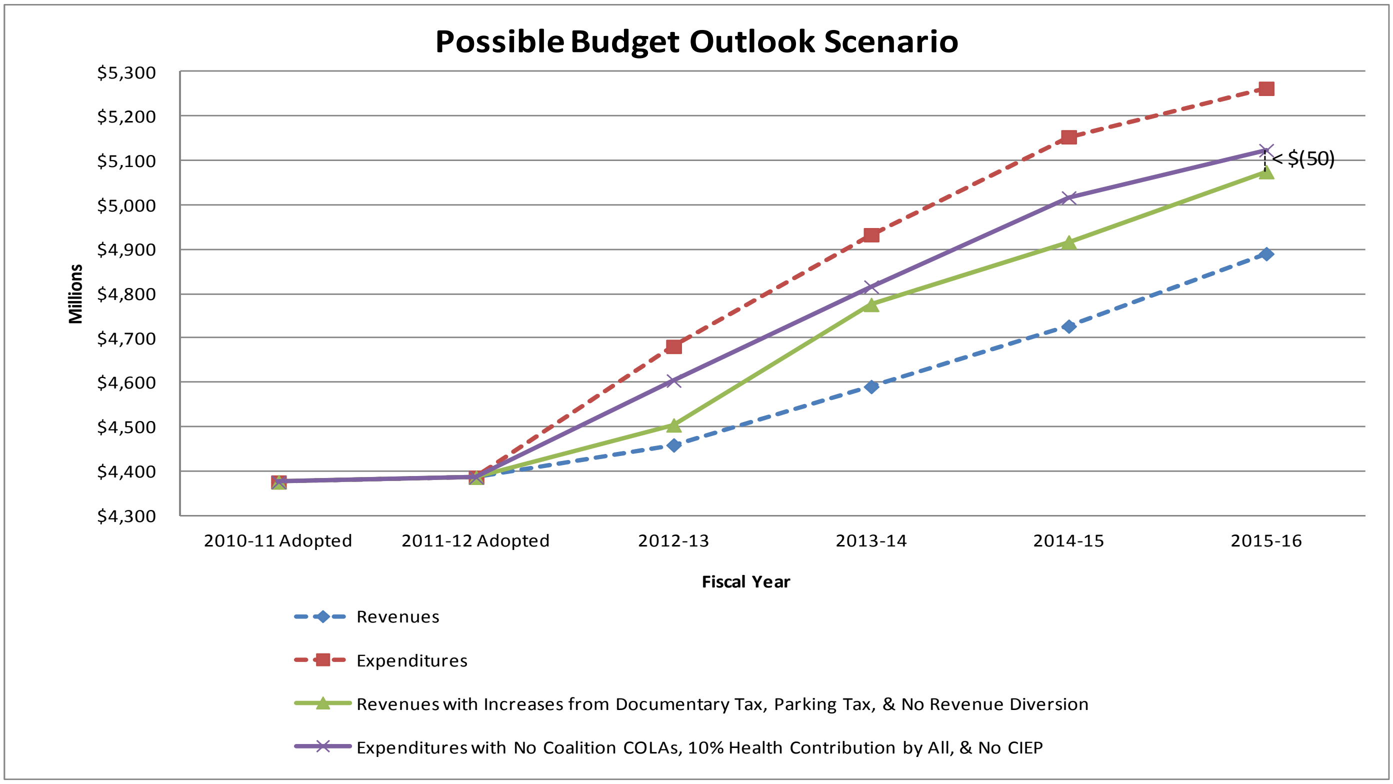
Achieving fiscal sustainability in light of the enormous deficits projected requires commitment and leadership. Over the course of the last several budget cycles, City leaders have demonstrated their commitment to address the structural deficit and leadership by making the tough decisions on eliminating positions; implementing layoffs; increasing employee contributions to retiree healthcare; lowering the entry level pay for police officers; and establishing a new pension tier for new sworn employees. <u>While progress has been made, it is critical that the City continue its efforts to eliminate the structural deficit through proactive measures.</u> These measures must continue to focus on the long-term financial health of the City and away from the one-time solutions that have been the staple of past City budgets.

The five guiding principles and the opportunities presented herein provide the framework for eliminating the structural deficit through ongoing and structural measures. They emphasize the City's need to reduce expenditures by addressing its key cost drivers: employee healthcare, workers' compensation, employee compensation, and retirement benefits. They also recognize the needs of the City's residents for a base level of service and outline an approach to strategically maintain or even enhance services through cost-sharing partnerships with non-profit organizations and the private sector. These alternative service delivery models can transition programs and services over time, thereby reducing the size of the workforce while avoiding layoffs. Moreover, these efforts allow the City to better control the growth of the City government during times of economic prosperity, thus ensuring that it is able to manage future economic downturns. Finally, the guiding principles and the opportunities presented reflect the reality that new revenues must identified to support the City's ongoing operating expenditures. <u>Only by focusing on both expenditures and revenues will the City be able to achieve structural balance.</u>

The following illustration depicts a possible scenario for the City in which significant progress is a made towards achieving structural balance. As shown in this scenario, the structural deficit is reduced by almost 90% over the next four years based on several expenditure reductions and revenue enhancement opportunities identified in this report.

Continued on Next Page

Chart 12



The expenditure reductions include eliminating future raises for members of the Coalition and the City Attorneys Association. This would cap the overall salary increase for members of these labor organizations from 24.5% to 15.25% based on their original agreements. These increases still represent a sizable enhancement to compensation in particular during the worst economic downturn since the Great Depression. Additional expenditure reductions are assumed to be achieved by increasing all employees' share of their healthcare premiums by 10%. Finally, a cost avoidance associated with a revised CIEP policy is incorporated based on the recommendation to refocus the policy on the useful life of infrastructure, the appropriate replacement cycle, criteria for investments, and the best financing methods for making these investments.

The revenue opportunities included in the scenario seek to maximize existing revenues while also raising new revenues. Specifically, this scenario assumes that any policy that is diverting revenue from the General Fund is suspended or repealed. The scenario also assumes that the SPRF policy on the transfer of surplus funds is amended to allow for annual fund transfers to the General Fund. Additionally, the revenue projections incorporated assume that the City succeeds in obtaining voter approval to increase the Documentary Transfer Tax rate and the Parking Occupancy Tax rate. Other assumptions included in this scenario are similar to those incorporated in the Budget Outlook with regard to economic recovery, the loss of any significant source of revenue such as the business tax, or the payout on liabilities with potentially large judgments.

There are many challenges to eliminating the structural deficit and no easy answers. Even reducing the structural deficit currently projected for Fiscal Year 2015-16 by over $300 million as shown in this scenario will not fully address the deficit. However, these and other tough choices must be made.

This update to the City's Three Year Plan to Fiscal Sustainability adopted in 2010 provides a number of strategies that the City must pursue to rein in costs and secure additional revenue. The options presented and recommendations being made will require significant effort on the part of the City's leaders, as well as the cooperation of the City's management, its employees, and its residents. Nevertheless, through effective leadership and cooperation, the City will make progress. More importantly, by pursuing the options depicted in the above scenario, the City can make significant progress towards eliminating the structural deficit in very short time, with limited impact on City services and employees, and with little to no additional burden on the majority of the City's residents.

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SUMMARY OF STRATEGIES

Under the five guiding principles, this Office has prepared a series of strategies and recommendations aimed at reducing the size and ongoing cost of our workforce, re-organizing our government to maximize service levels, and strengthening the status of our Reserve Fund.

I. Adhere to Responsible Management and Fiscal Practices
II. Focus on Core Services
III. Pursue Alternative Service Delivery Models
IV. Maintain a Sustainable Workforce
V. Raise New Revenues while Protecting and Maximizing Existing Sources

I. Adhere to Responsible Management and Fiscal Practices

The City's use of one-time solutions, which would have been otherwise effective in offsetting a cyclical problem as exemplified by a one-time dip in revenue, have failed to reduce the structural deficit after four years of negative or minimal growth in revenue. Additionally relying on fund transfers from the Special Parking Revenue Fund and the Reserve Fund to balance the budget has reduced resources available for future parking projects and for contingencies, respectively. Over the last several years, this Office has warned that in these difficult times, too often solutions are identified and adopted to address short-term needs that may not be in the best long-term interests of the City.

The Controller has emphasized the need to identify structural budgetary changes to address the continuing budget deficits, and this Office concurs. Therefore, if this City is to truly make the structural changes needed to restore long-term financial health and sustainability, we must adhere to responsible management and fiscal practices, comply with our adopted financial policies, and temporarily suspend those practices which divert funds away from core functions.

<u>Strategies</u>

A. Maintain a strong Reserve Fund

According to the Government Finance Officers Association (GFOA), governments should maintain adequate reserve fund levels to mitigate risks and provide a back-up for revenue shortfalls. The City of Los Angeles has adopted this principle as part of its financial policies and more recently as part of its Charter. Specifically, the City's financial policy calls for the entire Reserve Fund level to be at 5% of General Fund receipts. Through a voter-approved Charter change, the Reserve Fund's Emergency and Contingency Reserve have now been established as Charter accounts, with a minimum balance for the Emergency Reserve account set at 2.75% of General Fund receipts. Furthermore, an "urgent economic necessity" threshold has been established which specifies when the Emergency Reserve can be spent on the approval of at least two-thirds of the City Council and the Mayor.

A Budget Stabilization Fund has also been created to prevent overspending during prosperous years and provide resources to help maintain service levels during years of slow revenue growth or declining revenue. An initial deposit of $500,000 was made to the Budget Stabilization Fund in 2009-10. The development of policies and procedures for the deposit and withdrawal of these funds is still pending, including the identification of revenue sources for the fund.

The objective of these polices and mandates is for the City to be in a stronger fiscal position to weather periods of economic decline or slowdown. Maintaining a strong Reserve Fund also plays a pivotal role in the daily operation of the City, allowing the City to access the financial market at the lowest cost for cash flow management and for the financing of capital projects.

Recommendations

1. **Budget a Reserve Fund that is at least 5% of the General Fund in compliance with the City's Financial Policies.**

2. **Build a Budget Stabilization Fund to address liabilities from adverse decisions from existing lawsuits and/or unforeseen circumstances.**

B. Make smart investments

In addressing its financial challenges, the City's efforts have focused primarily on realigning its expenditures based on reduced revenues. As a result, significant budget cuts, service reductions, and layoffs have occurred and many more will undoubtedly be required as the City continues to deal with its structural deficit. However, each additional cut that is imposed results in less service being delivered to the public, disinvestment in the future of the City, and additional risk that a critical system or process will fail. At a certain point, the budget reductions will reach a critical mass such that the City's infrastructure, equipment, or systems will not be able to absorb. Outside factors such as shifts in the economy, natural disasters, legal challenges, and policy changes such as unfunded state or federal mandates may further exacerbate this problem. To ensure service continuity and mitigate risks associated with infrastructure, equipment, or system failures, the City must begin to make strategic investments in these areas. These investments will improve the effectiveness of services, enhance productivity, and avoid costly repairs and replacements of entire buildings, roadways, and/or equipment.

Recommendations

1. **Prioritize and fund deferred maintenance needs and critical capital improvements in the City in compliance with a redefined Capital Improvement and Expenditure Program policy that accounts for all investments in infrastructure including those funded from voter and non-voter approved debt.**

2. **Fund and implement best practices in risk management including training and improved tracking of costs to lower the City's liabilities.**

3. **Enhance risk management accountability across all departments by requiring departments to absorb liabilities resulting from failed management decisions and repeated mistakes.**

4. **Fund and implement citywide system upgrades in the most-cost effective manner based on a strategic plan for Information Technology Infrastructure that prioritizes the needs of the City.**

II. Focus on Core Services

The City needs to closely evaluate the various activities and services in which it is engaged and begin to question which of those services it should continue providing. Additionally, even for those activities and services which are deemed important to continue, the City must examine whether different service delivery models or different service levels are needed. In short, given anticipated shortfalls and the slow economic recovery, the City of Los Angeles has no other choice than to move away from being a full-service City, and focus on the core services of municipal governments. The first challenge in this effort is determining which services are considered core.

The central questions that must be asked of all services to make this determination are:

- Is the service core or discretionary?

- If discretionary, should the City be doing these activities in light of fiscal constraints?

- If yes, should the City provide these services at the current level? If not, what level is appropriate?

- Can the City provide a similar service but under a different model of service delivery? If so, what service delivery model makes the most sense and is the most cost effective?

- Are there opportunities to improve efficiencies or achieve cost savings by consolidating services/departments?

Even when the determination is made that a service is core, the City's fiscal crisis provides an opportunity to evaluate and reprioritize core services. Services that were once deemed to be core and immune from reductions may no longer be as critical today. Failure to capitalize on this opportunity to re-prioritize activities and services, or re-affirm core services, will result in the continuation of across-the-board measures the City has had to rely on throughout the last several fiscal years to balance the budget. This Office recommends and urges the careful consideration of all services within this context.

<u>Strategies</u>

A. Prioritize services and fund accordingly including support costs (do not assume priorities will get accomplished if not funded)

Through the adoption of policies and ordinances, the City has affirmed various activities and services as being core. Correspondingly, budgets must reflect these priorities and fund all aspects of the service delivery system in accordance with the outcomes being sought and available funding. These are the principles of performance-based budgeting. For example, in budgeting to achieve a certain number of street miles to be reconstructed, appropriate levels of funding must be provided to cover the salaries and indirect costs of all involved employees as well as for the necessary equipment, the maintenance of the equipment, and all other related expenditures such as fuel and testing of materials. Should sufficient funding not be available, the desired outcomes must be reevaluated to match the funding. Alternatively, additional funding may be made available through new revenue sources or through the elimination of programs or services of a lower priority.

Recommendations

1. **Initiate the transition to a performance-based budgeting (PBB) process beginning with the development of departmental performance metrics to be integrated into the City's budget document, which will be organized to reflect an outcome-centered organizational approach.**

2. **Facilitate the development of desired outcomes for every service provided by the City, the cost associated with achieving those outcomes, and identify the metrics that will demonstrate progress towards the outcomes is being made.**

B. Reestablish a base service level for priorities consistent with available funding

Over the years, the City has taken on additional responsibilities or adopted policies requiring a corresponding increase to the level of services provided. In some cases these service level increases were funded through fees charged to those individuals, groups, or projects accessing those services. However, for General Fund supported services, service level increases have often become the burden of departments to provide without additional funding. The capacity for departments to absorb these service enhancements without funding is gone. The City is now at a point where it must reestablish its base service levels consistent with available funding from its fees or the General Fund and in support of its mission and vision.

Recommendations

3. **Direct all departments to develop a five year strategic plan that re-establishes the mission and vision of the department as well as goals and base level service targets for their department.**

4. **Evaluate various options and best practices for the provision of emergency medical transport services in the City.**

5. **Conduct a third-party analysis of the constant staffing deployment model currently utilized by the Los Angeles Fire Department to determine the most efficient and effective deployment of fire department resources citywide.**

C. Realign services across departments based on core-competencies

The significant reductions in staff and funding for departments over the last several years have greatly impacted the ability of departments to be the self-contained and supporting entities they once were. Departments can no longer afford to have their own human resources, information technology, or accounting staff. In many cases, retirements, position elimination, and the City's hiring freeze have diminished the ability of departments to fulfill these roles on their own. With the existence of centralized departments whose primary mission is the delivery of these services, the City must pursue the consolidation of functions and the realignment of services across departments to ensure all departments continue to function properly.

Recommendations

1. **Implement the City's human resources consolidation plan.**

2. **Implement the consolidation of the Office of Public Safety into the Los Angeles Police Department to improve the deployment of safety and security resources citywide.**

3. **Develop a plan for the consolidation of all the bureaus within the Department of Public Works.**

4. **Examine opportunities to consolidate or realign accounting, auditing, and information technology services citywide.**

III. Pursue Alternative Service Delivery Models

The City's capacity to provide high quality services in every area of its service portfolio has deteriorated. In this era fiscal crisis, if the City expects to continue providing certain services, it must explore alternative service delivery models that meet the needs of the public, reduce cost, promote efficiency, and guarantee an acceptable quality and level of service. Two alternative service delivery models that the City must continue to pursue are Public-Private Partnerships (P3) and Managed Competition. Both models offer the City unique opportunities to preserve or enhance service levels and reduce cost.

Strategies

A. Implement alternative service delivery models.

With the initial adoption of the Three-Year Plan to Fiscal Sustainability, the Mayor and City Council concurred with this Office's recommendation to examine opportunities for Public-Private Partnerships for the following reasons:

- Cost containment
- Service efficiencies
- Market flexibility and innovation
- Transfer of risk
- Limit or reduce City financial leverage
- Improved service delivery

Our efforts in this regard initially focused on services where private firms had a strong presence in managing or providing parking structures. However, significant milestones with alternative service delivery models have been made in partnerships with non-profit organizations.

Recommendations

1. **Improve the long-term sustainability of the Los Angeles Zoo by partnering with a non-profit organization in the daily management and operation of the zoo.**

2. **Expand the City's capacity to provide services at its animal care centers and increase pet adoptions by collaborating with non-profit organizations in the management and operation of animal care centers.**

3. **Release a proposal to continue the City's collaboration with non-profit organizations at several cultural facilities and explore the feasibility of transferring the management of cultural facilities to organizations focused on the arts.**

B. Establish a managed competition process for select services

The tool of managed competition allows governments to seek the best price for providing a service through internal (City workforce) or external providers (outside contractors). Key to the decision making process on whether a service should be provided "in-house" or outsourced is cost-effectiveness. However, in addition to cost, other factors to consider are language within labor agreements, legal issues, desired service levels, efficiencies, effectiveness, quality of service, transition period, and the ability to monitor the service provider's work.

Furthermore, managed competition should not only be viewed within the context of choosing one provider over another. At times, the best outcome for the City may be achieved through a shared provision of services by the City workforce and outside contractors. As demonstrated by recent City projects, the City workforce may be better suited to provide a base level of service while outside contractors can assist with workflow increases or time constraints.

Recommendations

1. **Initiate a managed competition process to select the most cost-effective management services of the Los Angeles Convention Center.**

2. **Initiate a managed competition process to select the most cost-effective service providers that complement the City's base-level of custodial services.**

3. **Initiate a managed competition process to select the most cost-effective service providers that complement the City's base-level of fleet maintenance.**

4. **Initiate a managed competition process to select the most cost-effective service providers that complement the City's base-level of street maintenance services including but not limited to weed abatement and tree trimming.**

5. **Following a review and assessment of the City's technology services by a Strategic Advisor, initiate a process to procure the most cost-effective technology services for the City which will access current technological innovations and developments along with industry best practices, processes, and capabilities.**

IV. Maintain a Sustainable Workforce

The Los Angeles City government is in the business of delivering services to its residents. The City's workforce is at the core of delivering services. Thus, maintaining a sustainable workforce will ensure the City can continue to deliver services to its residents in the future.

During the last 10 years, the City's budget grew by about 60 percent, from $4.3 billion in 2000-01 to $6.9 billion in 2011-12. Yet during this time, the City's workforce has declined, from 34,406 in 2000-01 to 32,274 in 2012, and continues to drop. This contradiction simply shows that the cost of doing business has grown, while the City's overall capacity to deliver services has declined.

During the boom years of the last decade, the City was able to absorb the increases in costs. These increases have been driven by a steep growth in pension, healthcare, retiree health, workers' compensation and overall compensation. The Great Recession has exposed this unsustainable business model. Eventually, the City was headed to a crisis point, but the recession exacerbated the problem and forced us to address it in a very short period. Getting out of this crisis will take the remainder of the decade.

Strategies:

A. Reduce the ongoing cost of the City's workforce with minimal service impact

As the cost of the City's workforce increases due to previously negotiated compensation adjustments, increases to employee-sponsored health plans, and employee pensions, so too does the cost of the services being delivered. However, these service cost increases are not accompanied by service level increases. Rather, as the cost of providing the services escalates, budgetary decisions usually result in the diminishing of services. The end result is less services at a higher cost.

Workforce reductions have proven to be effective in containing some of the costs. However, these reductions have had a negative impact on the City's ability to deliver services. As a short-term solution, the City has also relied on furloughs as a means to reduce our current workforce costs. Nonetheless, furloughs are not structural solutions as they provide no relief on our cost drivers of healthcare, workers' compensation, pensions, and retiree health benefits. Without ongoing concessions in these areas from employee organizations, it is certain that the City's fiscal circumstances will continue to be in a state of emergency.

Recommendations

1. **Address the inequity of the upcoming compensation increases for the Coalition of Los Angeles City Unions and the City Attorneys Association, by initiating the process to eliminate these increases.**

2. **Maintain essential healthcare services for employees by increasing their share of the cost of healthcare premiums by 10%.**

3. **Establish a new pension tier for future civilian employees that increases the retirement age, lowers automatic cost of living adjustments, controls for future medical costs, averages final compensation over five years, and more equitably shares future funding risks between employer and employees while still providing a quality retirement benefit.**

4. **Lower the entry level compensation in all City classifications by 20% to reduce the City's annual salary costs.**

B. Reduce the ongoing cost of the City's workforce through strategic size reductions

To the extent the City's efforts to reduce the cost of the workforce without impacting services is unsuccessful, the City must resume reducing its workforce based on its established priorities, desired outcomes, and available funding.

Recommendations

1. **Continue the Managed Hiring Committee process to mitigate labor cost increases including salaries and benefits and until such time as a new pension tier for civilian employees is established and/or entry level compensation is reduced.**

2. **Make the necessary position eliminations, based on the City's established priorities, to ensure the City's budget is balanced and to reduce the structural deficit.**

V. Raise New Revenues while Protecting and Maximizing Existing Sources

A. Maximize the General Fund

The General Fund provides the City with the most discretion and flexibility in appropriating its limited resources. General Fund dollars, a majority derived from taxes, may be budgeted for general operating expenses including but not limited to salaries, health benefits, pensions, debt service, capital projects, and specific services. The lack of available General Funds to support the City's ongoing operating expenditures is the basis of the City's structural deficit.

Currently, the majority of the General Fund dollars are being used to pay for obligatory and non-discretionary expenditures. With significant increases in the City's non-discretionary expenditures such as employee benefits and pensions, the amount of General Funds available for discretionary programs and services has severely decreased. Combined with the economic upheaval experienced by the City over the last several years and the slow economic recovery, the General Fund has never been as strained as it is today.

Recommendations

1. **Adopt a full-cost recovery plan for special funded programs which phases-out their General Fund subsidies over the course of the next two to three years.**

2. **Examine all General Fund set-asides and suspend policies that divert General Fund dollars away from general operating expenses to allow for greater flexibility.**

3. **Establish a feasible target for the collection of aged receivables and implement a plan of action to improve the City's ability to collect on these accounts.**

B. Enhance existing or establish new revenues sources

As exemplified through this plan, the City must pursue multiple strategies for long-term financial health aside from expenditure reductions. The enhancement of existing revenue sources and/or the identification of new revenue sources are strategies that the City must embrace in order to become more resilient in its ability to adapt to severe economic adjustments or other forces beyond the control of the City. Keeping in mind the obstacles for increasing revenues in the State of California as a result of Propositions 218 and 26, the City cannot assume any immediate budget relief from this strategy but must rather consider enhancing existing or establishing new revenue sources as part of its long-term financial planning. Nonetheless, the City should target for $120 to $150 million in new revenues by 2013-14.

Bringing in additional revenues to the City to specifically fund certain programs, services, or projects or as General Fund receipts to fund general operating expenditures will provide the City with the flexibility and adaptability it needs to address unforeseen challenges. Moreover, new revenue sources will diversify the pool of revenue the City relies on for its everyday expenditures.

Recommendations

1. **Prepare a ballot initiative for the City's March 2013 election asking voters to increase the City's Parking Occupancy Tax rate from 10% to 15%.**

2. **Prepare a ballot initiative for the City's March 2013 election asking voters to double the City's Documentary Occupancy Tax rate.**

3. **Create a new economic development model with the larger economic goals of creating new jobs, attracting new business and industries, maximizing the City's assets, and increasing the General Fund revenue.**

ATTACHMENTS

Attachment 1: Four-Year Budget Outlook Budget and Finance Report ($ millions)

	2011-12 Adopted	2012-13	2013-14	2014-15	2015-16	2016-17
ESTIMATED GENERAL FUND REVENUE						
General Fund Base (1)	$ 4,371.6	$ 4,385.7	$ 4,458.7	$ 4,590.4	$ 4,726.6	$ 4,890.1
Revenue Growth (2)						
Property Related Taxes	24.0	41.5	57.0	63.3	87.4	92.0
Sales and Business Taxes	44.1	32.9	26.6	24.1	24.9	25.6
Utility Users' Tax	(26.8)	13.7	18.4	19.1	20.7	21.5
License, Permits and Fees	(53.1)	3.4	14.6	14.9	15.2	15.5
Other Fees, Taxes and Transfers (2a)	10.4	6.9	15.2	14.8	15.3	15.9
SPRF Transfer	6.5	(16.5)	-	-	-	-
Transfer from Reserve Fund	8.9	(8.9)	-	-	-	-
Total Revenue	**$ 4,385.7**	**$ 4,458.7**	**$ 4,590.4**	**$ 4,726.6**	**$ 4,890.1**	**$ 5,060.6**
General Fund Revenue Increase %	***0.2%***	***1.7%***	***3.0%***	***3.0%***	***3.5%***	***3.5%***
General Fund Revenue Increase $	***10.5***	***73.0***	***131.8***	***136.2***	***163.4***	***170.5***
ESTIMATED GENERAL FUND EXPENDITURES						
General Fund Base (3)	$ 4,375.2	$ 4,385.7	$ 4,681.0	$ 4,932.9	$ 5,153.7	$ 5,262.9
Incremental Changes to Base: (4)						
Employee Compensation Adjustments (5)	17.0	184.9	94.5	49.6	21.2	5.1
City Employees Retirement System (6)	55.8	(46.7)	38.2	41.2	39.5	25.4
Fire and Police Pensions (6)	97.4	25.3	111.8	80.3	48.7	44.5
Workers Compensation Benefits (7)	6.6	32.0	1.7	3.2	6.3	10.1
Health, Dental and Other Benefits (8)	1.3	12.5	25.0	29.3	29.8	29.9
Debt Service (9)	(19.1)	15.9	(5.1)	(3.6)	(22.2)	-
Delete Reso. Authorities/One-Time Costs (10)	(49.0)	-	-	-	-	-
Unappropriated Balance (11)	21.7	(3.3)	-	-	-	-
New Facilities (12)	4.4	1.1	1.5	1.9	1.8	5.3
City Elections (13)	(15.6)	17.0	(17.0)	17.5	(17.5)	17.5
CIEP (14)	0.5	38.1	1.3	1.4	1.6	(48.9)
Net - Other Additions and Deletions	(110.4)	18.4	-	-	-	-
Subtotal Expenditures	**$ 4,385.7**	**$ 4,681.0**	**$ 4,932.9**	**$ 5,153.7**	**$ 5,262.9**	**$ 5,351.8**
Expenditure Growth %	***0.2%***	***6.7%***	***5.4%***	***4.5%***	***2.1%***	***1.7%***
Expenditure Growth $	***10.6***	***295.2***	***251.9***	***220.8***	***109.2***	***88.9***
TOTAL BUDGET GAP	**$ -**	**$ (222.3)**	**$ (342.5)**	**$ (427.1)**	**$ (372.9)**	**$ (291.2)**
Incremental Increase %			***54.0%***	***24.7%***	***-12.7%***	***-21.9%***
Incremental Increase $			***(120.2)***	***(84.6)***	***54.2***	***81.6***

Attachment 2: Four-Year General Fund Budget Outlook Footnotes

REVENUE:

(1) General Fund (GF) Base: The revenue base for each year represents the prior year's estimated revenues.
(2) Revenue Growth: Revenue projections reflect the consensus of economists that economic recovery will be slow and that economy-sensitive revenues will take several years to return to pre-recession levels. Amounts represent projected incremental change to the base. Any one-time receipts are deducted from the estimated revenue growth for the following fiscal year.
(2a) California Senate Bill SB89 of 2011 eliminated, effective July 1, 2011, Vehicle License Fee (VLF) revenue allocated under California Revenue and Taxation Code 11005 to cities. As a part of the Legislature's efforts to solve the state's chronic budget problems, the bill shifted all city VLF revenues to fund law enforcement grants that previously had been paid by a temporary state tax and, prior to that, by the state general fund. The League of California Cities has challenged this action in court as a Constitutional violation. The projected ongoing loss in City revenue is approximately $15 million.

ESTIMATED GENERAL FUND EXPENDITURES:

(3) Estimated Expenditure General Fund Base: Using the 2010-11 General Fund budget as the baseline year, the General Fund base is the "Total Obligatory and Potential Expenditures" carried over to the following fiscal year.

(4) The 2011-12 incremental changes reflect funding adjustments to the 2010-11 General Fund budget. The Four-Year Outlook expenditures included for subsequent years are limited to those obligatory and major expenses known at this time and are subject to change. Amounts represent projected incremental change to the base.

(5) Employee Compensation Adjustments: This includes cost of living adjustment ("COLA"), change in number of working days, salary step and turnover effect, and full funding for partially financed positions from the prior year. The Outlook reflects various labor agreements.

<u>Coalition of Los Angeles City Unions and Management Attorneys ("Coalition")</u> : Salary adjustments are based on the Amendment to the Letter of Agreement between the City and Coalition, dated April 8, 2011, for the period April 2, 2011 to June 30, 2014. All Coalition bargaining units, except units 9, Plant Equipment Operators and Repair, and 29, Deputy City Attorneys, ratified the Amendment. Highlights of the agreement are presented in Table 1.

Table 1
Highlights of the April 2011 Coalition MOUs (except MOUs 09 and 29)
July 1, 2011 to June 30, 2014

	2010-11	2011-12	2012-13	2013-14
COLA - July 1st	n/a	0.75% (2.25% -1.5%)	3.75% (2.25%+1.5%)	1.75%
Step Adjustment - Jan. 1st	n/a	0%	0%	5.5%
Deferral Recovery – July 1st	n/a	0%	0%	0%
Cash Payment - Nov. 1st	n/a	0%	None (1.75% converted to paid Time off in 2012-13)	0%
Holiday Closure Days	n/a	4 paid in exchange for above 1.5% pay cut	4 paid (see above Cash Pay't note)	none
Retiree Health Contribution - July 1st	2% (Apr.2011)	2% (4% total)		

<u>Memorandum of Understanding ("MOU") 09, Plant Equipment Operators and MOU 29, Deputy City Attorneys</u>: Salary adjustments are made in accordance with Table 2 below.

Table 2 2007-12 Coalition MOUs Applicable to MOU 09 and 29 (Revised for 2010-11 Budget)				
	2009-10	2010-11	2011-12	2012-13
COLA - July 1st	0%	3%	2.25%	2.25%
Step Adjustment - Jan. 1st	0%	2.75%	2.75%	2.75%
Deferral Recovery – July 1st	0%	0%	0%	1.75%
Cash Payment - Nov. 1st	n/a	0%	0%	1.75%
Retirement Contribution	n/a	n/a	n/a	n/a

<u>MOUs 8, Professional Engineering and Scientific, and 17, Supervisory Professional Engineering & Scientific:</u> The term of MOUs 8 and 17, members of Service Employees International Union ("SEIU"), is July 1, 2010 to June 30, 2014 (Table 3).

<u>MOU 32, Management Attorneys:</u> Amendment No. 1 to the 2007-2012 MOU expires June 30, 2012 (Table 3).

Table 3 Highlights of Other MOUs (Various Terms)			
	2011-12	2012-13	2013-14
MOUs 8 and 17 (SEIU):			
Contribution Offset – July 3rd	0.5% (2% -1.5%)	0%	
Contribution Offset - June 30th	0%	3%	
Holiday Closure Days	4 paid in exchange for above 1.5% pay cut	4 paid in exchange for continued 1.5% pay cut	
Retiree Health Contribution - July 1st	4%		
MOU 32 Management Attorneys:			
COLA – July 1st	2.25%	n/a	n/a
Step Adjustment – June 29th	2.75%	n/a	n/a
Furloughs Days	13	n/a	
Retiree Health Contribution - July 1st	4%		

<u>MOU 00, Non-represented Employees, and MOU 61, Senior Administrative and Administrative Analysts</u>: The term of MOUs 00 and 61 is July 1, 2010 to June 30, 2013 (Table 4).

<u>MOU 05, Inspectors ("MCIA"):</u> The term of MOU 05 is July 1, 2011 to June 30, 2014 (Table 4).

Table 4 Highlights of Other MOUs (Various Terms)				
	2010-11	2011-12	2012-13	2013-14
MOU 00 and 61 (Non-Rep & FPPA):				
Contribution Offset – July 1st	0%	0%	0%	n/a
Contribution Offset – Jan. 1st	0%	3%	3%	n/a
Unpaid Holidays	n/a	4	4	n/a
Retiree Health Contribution – July 1st	n/a	2%		n/a
Retiree Health Contribution – Jan. 1st	n/a		2% (4% total)	n/a
MOU 05 MCIA:				
Contribution Offset – July 3rd	n/a	2%	0%	0%
Contribution Offset – Jan. 1st	n/a	0%	1.5%	1.5%
Unpaid Holidays (GF only)	n/a	6	5	4
Retiree Health Contribution - July 1st	n/a	4%		
EAA	n/a	n/a	n/a	n/a

<u>Engineers and Architects Association ("EAA"):</u> EAA ratified a one-year contract for 2010-11 and no EAA COLA's are assumed in 2010-11 and future years.

<u>Sworn Fire and Police Officers:</u> Table 5 reflects the City's contract with the Los Angeles Police Protective League ("LAPPL") and the United Firefighters of Los Angeles ("UFLAC") MOU for the period July 1, 2011 through June 30, 2014.

Table 5
Sworn MOUs

	2011-12	2012-13	2013-14	2014-15
LAPPL and UFLAC				
COLA – July 1st	0%	1%	1%	n/a
COLA – Jan. 1st	0%	2%	0%	n/a
COLA - Nov. 1st	0%	0%	1%	0%
COLA – March 1st	0%	0%	2%	0%

(6) City Employment Retirement System ("LACERS") and Fire & Police Pensions ("Pensions"): The LACERS and Pensions contribution are estimated based on information from the departments' actuaries and include COLA assumptions as noted above. The amounts reflected in the outlook represent incremental changes. The estimates are mostly driven by changes in assumptions and investment returns.

Table 6
LACERS and Pensions

Assumptions	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
LACERS						
6/30th Investment Returns	0%	7.75%	7.75%	7.75%	7.75%	7.75%
Rate without Retiree Health Contribution	27.66%					
Rate with 4% Retiree Health Contribution	24.01%					
Blended Contribution Rate		24.14%	26.07%	28.47%	31.10%	32.79%
Pensions						
6/30th Investment Returns	0%	7.75%	7.75%	7.75%	7.75%	7.75%
Contribution Rate	39.07%	39.94%	47.13%	52.35%	55.98%	59.30%

(7) Workers Compensation Benefits ("WC"): The WC budget increase is based on the draft January 2012 actuarial analysis that projects annual medical inflation of seven percent, a five percent annual cost increase in permanent disability costs and an increase in lien payments to fire and police medical providers. The WC line-item includes the State Assessment Fee and the following contracts: Third Party Administrator (TPA) for sworn claims, Utilization Review, Bill Review, Alternative Dispute Resolution and LINX maintenance.

(8) Health and Dental Benefits: Projections are based upon the City subsidy amounts provided in the MOUs as of January 1, 2012, assumed enrollment, as well as the civilian plan forecast provided by Mercer Consulting. Civilian FLEX medical premiums are expected to increase by 7.37% for 2013; 9.07% for 2014; 8.70% for 2015; 8.04% for 2016; and 7.67% for 2017. Police and Fire health benefits are historically higher due to the subsidy increases and type and level of coverage elected by sworn employees. Police and Fire enrollment projections are consistent with the hiring plan. It is anticipated that the health care reform laws of 2010 may cause changes to health plans starting in 2014; however, its impact is unknown at this time.

(9) Debt Service: The debt service amounts include Capital Finance and Judgement Obligation Bond budgets.

(10) Delete One-time Resolution Authorities and Other Costs: Reflects City practice of deleting programs and costs that are limited-term and temporary in nature at the start of the budget process. Funding for these positions, programs, and expenses is reviewed on a case-by-case basis and dependent upon continuing need for the fiscal year. Continued or new

items added are embedded in the “Net – Additions and Deletions” line item of the forecast. None are deleted in subsequent years to provide a placeholder for continuation of resolution authority positions for various programs, as well as equipment, and other one-time expenses incurred annually. As such, these costs are therefore incorporated into the beginning General Fund base of subsequent years.

(11) Unappropriated Balance (UB): One-time UB items are eliminated while ongoing items are continued the following year to provide a placeholder for various ongoing and/or contingency requirements in the future.

(12) New Facilities: Funding projections are based on preliminary departmental estimates for ongoing staffing and expenses that have not been prioritized.

(13) Elections: Citywide elections occur bi-annually.

(14) Capital Improvement Expenditure Program (CIEP): The 2011-12 Adopted Budget includes $6.5 million for various capital projects. For future years, the CIEP amounts assume compliance with the policy of budgeting 1% of the General Fund Revenue for capital improvement projects.

(15) Net-Other Additions and Deletions: Among the various other changes anticipated for 2012-13 are funding increases to the Los Angeles Public Library as prescribed by measure L, approved by City voters in the March 8, 2011 election (net of $6.2 million), and the Fire Department to address unanticipated expenditures from its constant staffing overtime account ($33.2 million). Deletion of short-term expenditures related to the second and final payment of the Early Retirement Incentive Program is also captured in this line item.