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CITY OF OAKLAND AGENDA REPORT

TO: **President Kernighan and Members of the Oakland City Council**
FROM: **Finance Chair, Councilmember Libby Schaaf**
DATE: **May 29, 2014**

RE: **Recommendations To Amend Ordinance No. 13170 The Council's General Purpose Fund (GPF) Financial Policies Regarding Use Of Excess Real Transfer Tax Revenues And Establishing A Rainy Day Fund And Policy For Funding Debt And Unfunded Liabilities**

SUMMARY

The Mayor's proposed FY2014/15 mid-cycle budget requires the Council to approve using \$19.90 million of one-time revenues to pay for on-going expenses. The Mayor has asked the Council to make the certain modifications to its financial policy (Ordinance 13170 C.M.S.) in order that her proposed budget may be legally approved.

The Council should consider:

- Amending the process for allowing the use of one-time revenues to fund on-going expenses to be made by Ordinance requiring a supermajority minimum of 6 votes. Require that the Ordinance include (1) a statement explaining the necessity for passing a structurally unbalanced budget and (2) steps the city will take going forward to return to structural balance.
- Amending the definition of Excess Real Estate Transfer Tax (RETT) to the amount exceeding twelve percent of that year's general tax revenues, but only if a substantial portion of that Excess RETT is dedicated to a newly formed Rainy Day Fund that reserves money to stabilize operations during economic downturns and pays down debt and unfunded liabilities. Such new Rainy Day Fund will receive allocations from 25% of Excess RETT and 50% of year-end audited surplus.

Oakland needs a Rainy Day Fund so that we can get out of the boom or bust roller coaster cycles that always lead to the cutting of essential services. It is critical that we create a Rainy Day Fund that stabilizes Oakland's finances so that we can retain essential services even in tough times and so that we stop kicking our debts down the road, to the detriment of future generations.

BACKGROUND

The Council is asked to look at two aspects of our financial policies: (1) ensuring we adopt structurally balanced budgets that do not rely on non-recurring revenues to pay for on-going expenses, (2) ensuring we maintain appropriate policies and reserve funds to protect against extreme unforeseen events and urgent repairs, to stabilize operations during downturns, as well as to manage debt and adequately pre-fund our employee retirement obligations.

In 1994, the Council first adopted an ordinance establishing its Financial Policies. Amended over the years, it currently sets several requirements, including:

- Maintaining a 7.5% “undesigned, uncommitted fund balance” which may only be used to “fund unusual, unanticipated and seemingly insurmountable events of hardship of the City, and only upon declaration of fiscal emergency;”
- Hold in a Capital Improvements Reserve Fund, \$6 million, plus interest and revenue received from certain one time activities, for “unexpected emergency or major capital maintenance or repair costs to City-owned facilities and to fund capital improvement projects;”
- Use one-time revenues only for one-time expenditures and for paying off negative fund balances unless the city declares a fiscal emergency;
- Use excess RETT, which is defined as any amount over \$40 million, only for paying for one-time expenses or for funding reserves or liabilities unless the city declares a fiscal emergency; and
- Limit use of encumbrances and carryforwards.

Unlike many other municipal financial policies, Oakland’s policy does NOT:

- Establish or fund an operations stabilization or “Rainy Day” fund to help preserve service levels during economic downturns; nor does it
- Require any funding for reducing unfunded retirement liabilities or debt

The Mayor’s proposed FY2014/15 mid-cycle budget requires the Council to approve using \$19.90 million of one-time revenues to pay for on-going expenses. The Mayor has asked the Council to make the following modifications to its financial policy (Ordinance 13170 C.M.S.) in order that her proposed budget may be legally approved. The Mayor and Administration request:

The Council create a “less excessive” requirement than declaring a fiscal emergency before expending one-time revenues to fund on-going expenses. (FY 2014-15 Midcycle Policy Budget, pg. 7).

The Council amend its definition of “one-time” Real Estate Transfer Tax (RETT) from the current definition of any amount above \$40 million to those RETT revenues that are more than a fourteen percent (or alternatively twelve percent) of General Fund Taxes. (FY 2014-15 Midcycle Policy Budget, pg. 8); and

Budget staff stated that they would not bring these amendments forward as a formal proposal because the Ordinance is the Council’s policy and requested that I bring their proposed changes forward as the Council’s Finance Chair.

ANALYSIS

SHOULD THE COUNCIL MODIFY THE REQUIREMENT OF DECLARING A FISCAL EMERGENCY BEFORE DEVIATING FROM OUR FINANCIAL POLICY?

Staff states, "While it is not considered a best practice to use one-time funding for on-going expenditures, the declaration of a fiscal emergency to expend these funds may be excessive and not appropriate in all cases to address the City's budgetary needs. There are other approaches that can preserve the Council's original goal of fiscal prudence without the extraordinary need to make declarations as required by the existing policy. Adherence to this and other financial policies have been instrumental in improving the City's financial condition and weather the recent economic downturn. Prudent changes to this financial policy would allow additional budgetary flexibility, while maintaining the core goal." This existing policy is rooted in the common acknowledgement of the State's Department of Finance's (DOF) definition of "one-time costs," which is defined below:

A proposed or actual expenditure that is non-recurring (usually only in one annual budget) and not permanently included in baseline expenditures. Departments make baseline adjustments to remove prior year one-time costs and appropriately reduce their expenditure authority in subsequent years' budgets.

Declaring a fiscal emergency has been considered a pre-cursor to declaring bankruptcy, thus has the potential to trigger undue alarm among bond holders and rating agencies, risking possible downgrade of the city's credit rating.

GFOA's best practice advice for achieving a structurally balanced budget states:

For a variety of reasons, true structural balance may not be possible for a government at a given time. In such a case, using reserves to balance the budget may be considered but only in the context of a plan to return to structural balance, replenish fund balance, and ultimately remediate the negative impacts of any other short-term balancing actions that may be taken. Further, the plan should be clear about the time period over which returning to structural balance, replenishing reserves, and remediating the negative impacts of balancing actions are to occur.

Accordingly, staff did not know of any other city that requires a declaration of fiscal emergency when making exceptions to a structurally balanced requirement. For example, the City of Concord recently adopted a Fiscal Sustainability policy that requires any deviations to be made by Ordinance requiring a supermajority vote. Their report states, "an Ordinance requiring a 4/5 vote for any changes also sends a strong, positive message to the bond rating agencies that the City is addressing its unfunded liabilities and unmet infrastructure needs."

Oakland's declaration of fiscal emergency requires only a single vote of a simple majority of the Council, and does NOT require the city to explain the need for deviation or create a plan of correction. A policy like Concord's provides more transparency and notice to the public as to when and why the city is deviating from its policy.

It is also important this policy be applied to subsequent allocations or other actions that violate the structural balance principle outside of budget adoption. For example, if the Council approves an allocation for an on-going expense using one-time revenues after the budget is passed, that must require the same process.

- **RECOMMENDATION:** Amend the process for allowing the use of one-time revenues to fund on-going expenses to be made by Ordinance requiring a minimum of 6 votes. Require that the Ordinance include (1) a statement explaining the necessity for passing a structurally unbalanced budget and (2) steps the city will take going forward to return to structural balance. Extend this requirement to any Council action or allocation that violates the policy, not just adoption of the budget.

SHOULD OAKLAND MODIFY ITS DEFINITION OF EXCESS REAL ESTATE TRANSFER TAX?

Staff writes, "On May 13, 2014, Governor Brown released the May FY 2014-15 revised budget, which called for the establishment of a State Rainy Day Fund to be placed on the November 2014 ballot. The proposal would require that 1.5% of State General Fund funds be deposited into the Rainy Day Fund annually. In addition, any Capital Gains Tax in excess of 8% of General Fund tax revenues would also be deposited into the Rainy Day Fund. This limits the State's exposure to volatility in capital gains tax receipts.

"Following a similar model with Oakland's specific data, the RETT revenue over \$40 million per year is currently defined as one-time revenue. As real estate prices sustainably increase over time, the current \$40 million figure listed above may no longer be an appropriate threshold to measure "one-time" revenues. Staff recommends that the City Council consider adopting the State's model by using a percentage of RETT revenue in comparison to total GPF tax revenue."

Staff recommends replacing the \$40 million threshold with a threshold equal to fourteen percent, or alternatively twelve percent, of the RETT's share of general tax revenues. Applying this new methodology to the projected GPF revenue for FY 2014-15 (\$489 million), a 12% threshold would equate to \$46.3 million, while a 14% threshold would equate to \$54 million. Any RETT revenues above these amounts would be considered Excess RETT.

The RETT as a percent of General Tax Revenue varies depending on how many years you look back. While a trend analysis shows that the percent of RETT has been increasing over time, it would be prudent to set any new thresholds based on the percent of RETT at no more than twelve percent 12%.

Table 1: Percent of RETT in General Tax Revenues over Time

Period of Years	%RETT of GP Taxes
Last 5 Years – FY08/09 - FY12/13	10.5%
Last 10 Years – 03/04 - FY12/13	14.6%
Last 15 Years – 98/99 - FY12/13	14.4%
Last 20 Years – 93/94 – FY12/13	12.9%
Last 25 Years – 88/89 – FY12/13	11.7%

A trend analysis of actual RETT revenues over time similarly shows an increase, so replacing a fixed dollar amount with more flexible measure is supported by the data. The fact that the trend lines for both actual RETT revenues and RETT's percent of all general tax revenues go up over time further supports the recommendation to adopt a percentage as a more accurate formula that should be sustainable over time.

Table 2: RETT Revenues with Trend Line

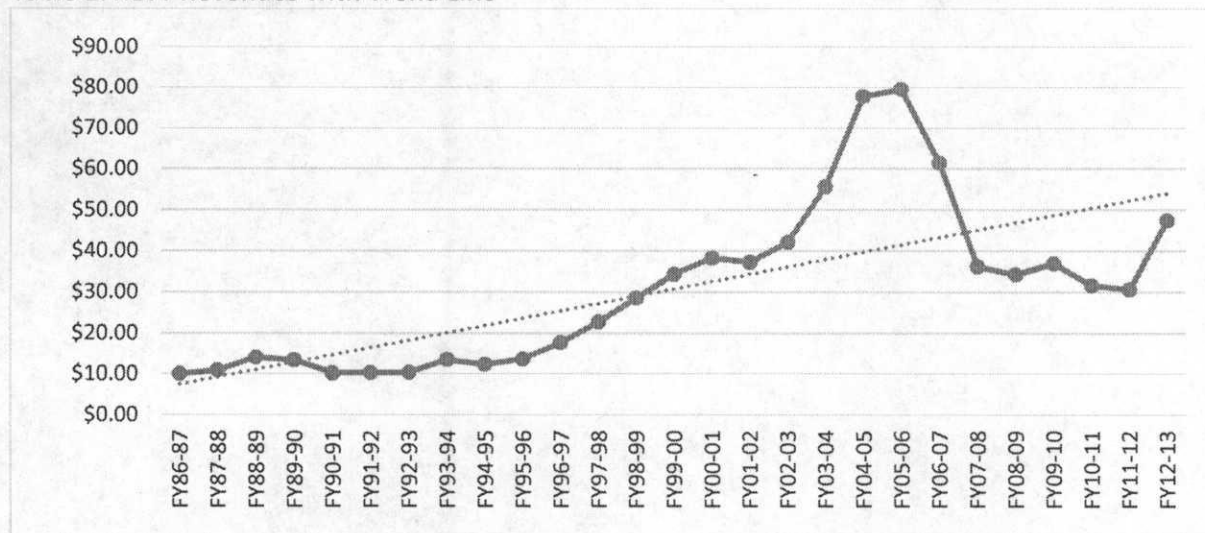
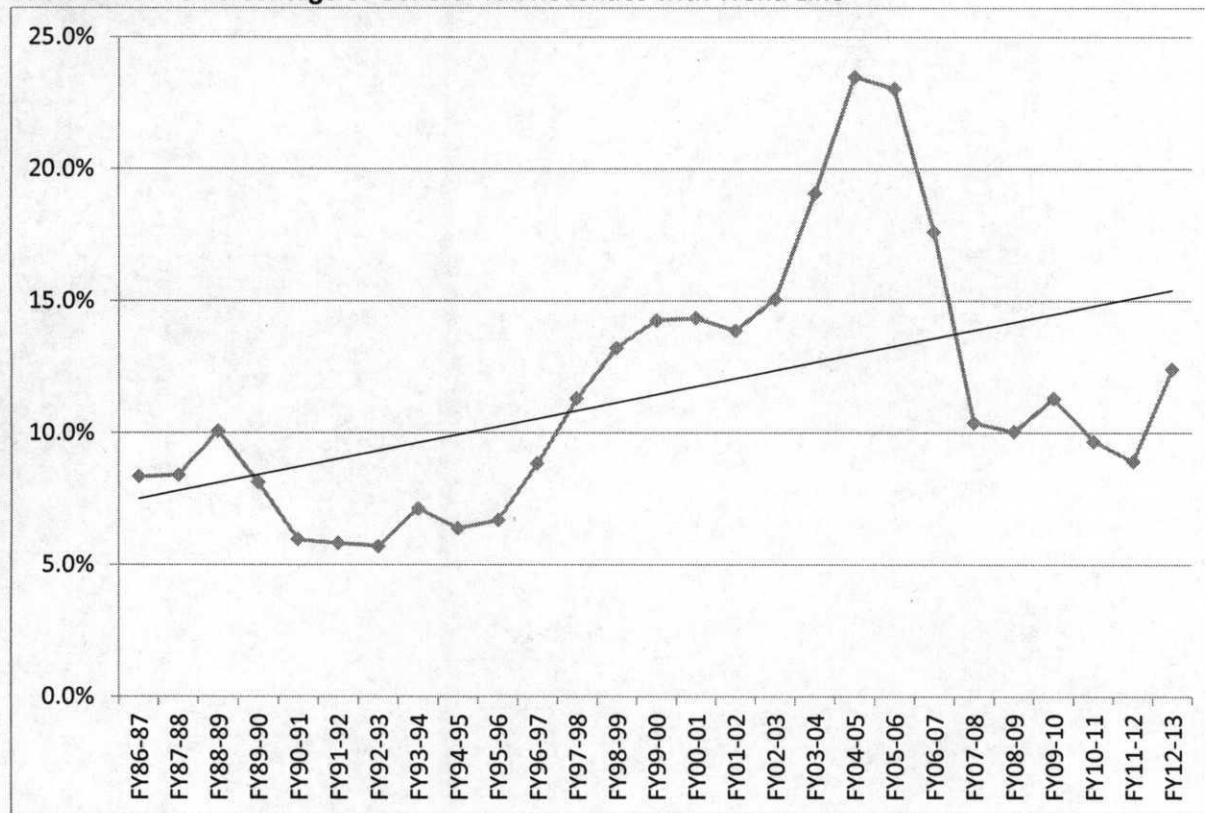


Table 3: RETT's Percentage of General Tax Revenues with Trend Line



While supported by data, this change could result in a policy with more risk of structural imbalance than the current policy of \$40 million. Additionally, it is particularly troubling to be asked to make a permanent change to our financial policies on the eve of adopting a proposed budget that is already structurally unbalanced by nearly \$20 million. That is why I urge the Council to not adopt this recommendation by the Administration without strengthening our financial policy in another way – by establishing a Rainy Day Fund.

RECOMMENDATION: Amend the definition of Excess RETT to the amount exceeding twelve percent of that year's general tax revenues, but only if a substantial portion of that Excess RETT is dedicated to a newly formed Rainy Day Fund that reserves money to stabilize operations during economic downturns and pays down debt and unfunded liabilities.

OAKLAND SHOULD ESTABLISH A RAINY DAY FUND FOR STABILIZING OPERATIONS AND PAYING DOWN DEBT & UNFUNDED LIABILITIES

While Oakland has reserves for extreme events (7.5%) and for capital improvements (\$6 million+), it lacks a Rainy Day or operations stabilization reserve which is widely regarded as a best practice. For example, the City of Emeryville maintains an operations stabilization reserve equal to fifty percent of their annual operating budget!

The Government Finance Officers Association provides the following guidance regarding reserves generally:

Management should consider specifying the purposes for which various portions of the fund balances are intended. For example, one portion of the fund balance may be for working capital, one for budgetary stabilization, and one for responding to extreme events.... Governments should also consider providing broad guidance in their financial policies for how resources will be directed to fund balance replenishment.... This might include non-recurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and if there is defensible rationale). Year-end surpluses are an especially appropriate source for replenishing fund balance.

Oakland should continue to follow Governor Brown's example, not just by changing our formula for determining Excess RETT, but also in establishing a Rainy Day Fund. Like the Governor's proposed Rainy Day Fund, Oakland should allocate half of Rainy Day deposits to paying down debt and unfunded liabilities with the other half set-aside in an operations stabilization reserve, which can only be used during economic downturns. As recommended by GFOA, a portion of audited year-end surplus should also go towards Oakland's new Rainy Day Fund.

Oakland is a city with urgent needs and competing demands on limited resources. Dedicating a portion of Excess RETT and year-end surplus will slowly build financial stability while not competing with pressing operational needs.

RECOMMENDATION: Oakland should establish a new Rainy Day Fund with the following features:

1. When projected Real Estate Transfer Tax (RETT) exceeds twelve percent of projected total general tax revenues, twenty-five percent of that Excess RETT shall be allocated through the

budget process: half to a newly established stabilization reserve and half to pay down debt or unfunded liabilities.

2. When Oakland completes its year-end audit, fifty percent of any surplus funds shall be allocated: half to the stabilization reserve and half to pay down debt or unfunded liabilities.
3. With regard to allocating funds to pay down debt or unfunded liabilities as part of the budget process and following annual audits, staff shall present its analysis and recommendations to the Council that it believes are in the best long-term financial interest of the city.
4. Funding the stabilization reserve may be reduced once it has accumulated a balance that exceeds 15% of general fund revenues.
5. Only in years when the city projects that total General Purpose Fund revenues for the upcoming fiscal year will be less than the current year's revenues, the adopted budget may appropriate funds from the stabilization reserve up to that revenue shortfall to preserve city operations; however, the budget may not appropriate more than sixty percent of the reserve balance in any year.
6. Any deviations from this policy must be made by Ordinance requiring a minimum of 6 votes. The Ordinance must include (1) a statement explaining the necessity for the deviation and (2) a plan for replenishing the reserve.

HOW WOULD THESE PROPOSED POLICY CHANGES CHANGE THIS YEAR'S BUDGET?

With FY2014/15 RETT revenues estimated at \$53 million, a twelve percent threshold applied to this year's proposed budget would produce \$6.7 million in Excess RETT rather than \$13 million. This would reduce slightly the proposed budget's reliance on one-time funds and make the first deposit into Oakland's new Rainy Day Fund.

2014/15 Budget Proposal	Under existing policy	Under proposed policy
On-going RETT Revenue	\$40 million	\$46.3 million
1-time RETT Revenue	\$13 million	\$5.03 million
\$ for Rainy Day Fund	\$0	\$1.68 million ¹
Reliance on 1-time Funds	\$19.9 million	\$13.6 million

PUBLIC OUTREACH/INTEREST

It is unfortunate that the time-sensitivity of staff's request did not allow time for adequate outreach. These policies are of great public concern and hopefully robust outreach and discussion will occur over the next month during the preparation and consideration of the actual Ordinance.

COORDINATION

This report was prepared in coordination with budget staff, the City Administrator and in consultation with municipal finance experts from other cities and the League of California Cities.

¹ \$838,000 to the Stabilization Reserve and \$838,000 to the Unfunded Liability Reserve. Note that the FY2014/15 Proposed Budget already includes \$1.16 million in additional reserves, so the new policy would not require significant changes to the proposed budget.

COST SUMMARY/IMPLICATIONS

Establishing a Rainy Day Fund will help reduce debt and unfunded liabilities and establish Oakland's first operations stabilization reserve. These actions will enhance fiscal management and ensure better long-term fiscal health for the City of Oakland. Rating Agencies should view the totality of these actions positively, which could translate into savings through reduced interest rates on future borrowing. Changing the definition of Excess RETT slightly increases the risk of structural unbalance, but data supports the change, particularly when coupled with a new Rainy Day policy.

SUSTAINABLE OPPORTUNITIES

Economic: The proposed resolution is likely to enhance economic sustainability through the city's own improved financial health.

Environmental: The proposed resolution is unlikely to lead to any environmental impact.

Social Equity: This resolution may increase social equity by protecting the ability for vulnerable residents who are most likely to be impacted by service reductions during economic downturns to continue receiving those services.

RECOMMENDED ACTION:

Direct staff to prepare an Ordinance for introduction to the full Council on June 17, 2014 amending the Council's Financial Policies Ordinance 13170 C.M.S. as follows:

1. Amend the process for allowing the use of one-time revenues to fund on-going expenses to be made by Ordinance requiring a minimum of 6 votes. Require that the Ordinance include (1) a statement explaining the necessity for passing a structurally unbalanced budget and (2) steps the city will take going forward to return to structural balance. Extend this requirement to any Council action or allocation that violates the policy, not just adoption of the budget.
2. Amend the definition of Excess RETT to the amount exceeding twelve percent of that year's general tax revenues.
3. Add the creation of a new Rainy Day Fund with the following features:
 - a. When projected Real Estate Transfer Tax (RETT) exceeds twelve percent of projected total general tax revenues, twenty-five percent of that Excess RETT shall be allocated through the budget process: half to a newly established stabilization reserve and half to pay down debt or unfunded liabilities.
 - b. When Oakland completes its year-end audit, fifty percent of any surplus funds shall be allocated: half to the stabilization reserve and half to pay down debt or unfunded liabilities.
 - c. With regard to allocating funds to pay down debt or unfunded liabilities as part of the budget process and following annual audits, staff shall present its analysis and recommendations to the Council that it believes are in the best long-term financial interest of the city.
 - d. Funding the stabilization reserve may be reduced once it has accumulated a balance that exceeds 15% of general fund revenues.

- e. Only in years when the city projects that total General Purpose Fund revenues for the upcoming fiscal year will be less than the current year's revenues, the adopted budget may appropriate funds from the stabilization reserve up to that revenue shortfall to preserve city operations; however, the budget may not appropriate more than sixty percent of the reserve balance in any year.
- f. Any deviations from this policy must be made by Ordinance requiring a minimum of 6 votes. The Ordinance must include (1) a statement explaining the necessity for the deviation and (2) a plan for replenishing the reserve.

Direct staff to prepare an Ordinance for introduction to the full Council on June 17, 2014 approving deviance from Oakland's Financial Policy by using up to \$13.6 million allowing passage of the FY2014/15 Budget that uses up to a specified amount of one-time revenues for on-going expenses that includes (1) an explanation of the necessity for passing a structurally unbalanced budget and (2) a plan for returning to structural balance.

Respectfully submitted,



Libby Schaaf
Finance Chair & Councilmember, District 4