REPORT FROM

OFFICE OF THE CITY ADMINISTRATIVE OFFICER

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To: Antonio R. Villaraigosa, Mayor
Herb J. Wesson, Council President
Paul Krekorian, Chair, Budget and Finance Committee

From: Miguel A. Santana, City Administrative Officer

Subject: **REVENUE OPTIONS TO ADDRESS THE STRUCTURAL DEFICIT**

SUMMARY

For the past four fiscal years, the City has confronted unprecedented budget deficits as a result of the collapse of the real estate market and its resulting impact on property values, employment and the overall economy. The resulting drop in General Fund revenue and losses in pension system investments, in combination with multiyear contractual increases in employee compensation and growing health care expenditures, have produced deficits of $529 million, $485 million, $336 million and $238 million from Fiscal Years 2009-10 through 2012-13. Deficits are likewise projected for outgoing years with estimated revenue growth of 2.5 percent for the next four year outpaced by estimated expenditure increases of 3.9 percent. Most of the expenditure increase is related to workforce related expenses (salaries, pensions, healthcare, and workers' compensation) where the projected average growth for this same period is 4.2 percent.

Prior City actions to address the structural deficit in the respective budget years have allowed the City to reduce projected deficits or defer to outgoing years, from $1.1 billion (as projected in in January 2010) to $216 million for fiscal year 2013-14. However, additional action is required to address the structural imbalance of expenditures and revenues in order to end the cycle of cost-cutting during budget development and at mid-year. Previous actions implemented by the City include solutions that resulted in an on-going reduction to the structural deficit, as well as one-time solutions that have provided temporary budget relief. These include:

<u>*Employee compensation (on-going)*</u>

- Permanent staff reductions through layoffs and retirements.
- General Fund staff reductions from the transfer of employees to special fund and proprietary department positions.
- Savings from attrition from the implementation of the managed hiring process.
- Savings through mutual gains bargaining from restructuring bonuses and overtime payouts.
- Reduced Fire Department constant staffing expenditures with the implementation of various modified staffing plans.

Employee compensation (one-time)

- Savings through mutual gains bargaining to defer cost of living increases and overtime, sick time, bonuses and other additional payouts.
- Reduced salary costs from imposed mandatory furloughs and the implementation of a voluntary furlough program.

Healthcare Expenditures (on-going)

- Reduced healthcare expenditures from civilian healthcare plan design changes as approved by the City's Joint Labor Management Benefits Committee (JLMBC).
- Savings through mutual gains bargaining from employee's 5 percent contribution towards healthcare costs.

Retirement Expenditures (on-going)

- Reduced City pension contributions from the elimination of the costly retirement contribution subsidy for employees hired before 1983.
- Cost shifting of pension and retiree health care contributions (increased to 7 percent and 4 percent, respectively) to employees achieved through the mutual gains bargaining process.
- Freezing the retirement health subsidy for employees that opted not to contribute.
- Reduced volatility of pension funding with the modification to the civilian and sworn pension systems' asset smoothing period and a market value corridor.
- Future-year reduction of sworn retirement contributions with the creation of a new pension tier for sworn officers and firefighters of the Los Angeles Fire and Police Pensions, as approved by voters.

Other Expenditures (on-going)

- Labor and expense savings from the elimination of two City departments, Environmental Affairs and Human Services, and the consolidation of the Offices of the Treasurer and Finance.
- Reduced expenditures with the renegotiation of contracts with vendors and service providers.
- Reduced General Fund subsidy of the Solid Waste Fee Lifeline Subsidy Program with an audit to verify participant eligibility.

Other Expenditures (one-time)

- Debt financing of larger than usual court settlements with the issuance of Judgment Obligation Bonds in lieu of cash payments.
- Suspension of the annual appropriation made to the Matching Campaign Trust Fund.
- Suspension of the annual one percent General Fund revenue contribution for infrastructure and capital improvements that is required by the City's Financial Policies.
- Non-essential expenditures reductions through freezing non-essential, non-salary spending.

Revenue (on-going)

- Increased revenue from ensuring cost recovery of services.
- The transfer of Special Parking Revenue surpluses to the General Fund.

Revenue (one-time)

- The escheatment Fire Hydrant and Main Installation Fund for transfer into the Reserve Fund.
- Sale of surplus property.

Reserve Fund (one-time)

- Use of the Reserve Fund to allow the City to complete the year within budget.

Additionally, the City has benefited from the State's dissolution of the California redevelopment agencies, with the return of incremental property tax dollars to the General Fund.

Despite the City's efforts to reduce expenditures and increase revenue, a structural imbalance of expenditures and revenues remains. Permanent solutions are required to maintain City services for those who live in, do business in, or visit our City. While the City has exhausted many of its most workable options, several opportunities for reducing the deficit were addressed in this Office's report on the Four-Year Budget Outlook and Update to the Three-Year Plan to Fiscal Sustainability. The most significant solutions available to the City will require additional support of City residents.

Options for New Revenue

The City has made significant efforts to maximize revenue within the limits of Proposition 218. The greatest impact has been realized in Licenses, Permits, Fees and Fines with actions to increase fees for services, fines, and overhead reimbursements each fiscal year to ensure full cost recovery for providing services. The cumulative effect of these actions means additional fee increases in future years will have negligible impact. In order to fund the cost of services demanded by City residents, voters should be given the opportunity to support them with increased taxes. The following options may be included on the March 5, 2013 election. Council will need to direct the City Attorney to prepare ballot measure resolutions by October 31, 2012.

Documentary Transfer Tax

The Documentary Transfer Tax, as it is currently structured, has been collected by the City since fiscal year 1991-92. The City currently receives $4.50 for each $1,000 of the home's value at the time of the sale. It is proposed that the documentary tax be increased from $4.50 to $9.00, or less than one-half percent of the sale value. Based on the median home price of $385,000 in the City for the month of July, the City's documentary transfer tax would increase from $1,733 to $3,465 for a home sale.

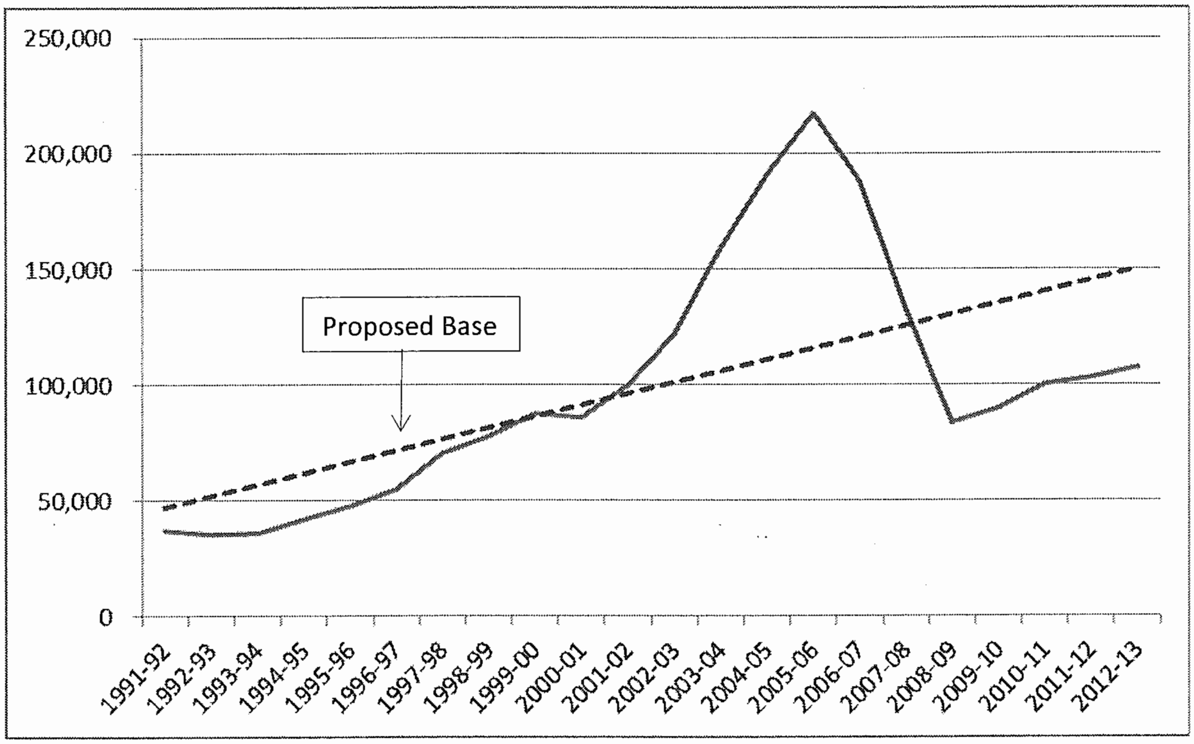
Table 1. Documentary Transfer Tax Rates in Select California Cities (2012)
(per $1000 of value)

Oakland	$15.00
Berkeley	$15.00
San Francisco	$5.00 - $15.00 (*depending on sale price*)
Culver City	$4.50
Los Angeles	*$4.50*
Santa Monica	$3.00
Pomona	$2.20
Redondo	$2.20
Most Others	$0.55

Because transfer tax revenue—a product of the number of sales and the home sale value—is collected only at the time of the sales transactions, it is more vulnerable to a volatile real estate market than property tax. For this reason, revenue from the tax skyrocketed with the real estate boom and fell with property tax with the collapse of the market. Revenue has been gradually increasing as home values have stabilized and the number of sales have increased; however, it is well below the peak of $217 million received in fiscal year 2005-06. Current projection for revenue for the current fiscal year is $108 million, or 50 percent of the peak. By increasing the rate, revenue from this stream would return to levels nearer its peak in 2005-06, assuming similar sales volume and stable home prices.

Additionally, it is recommended that any revenue above the proposed base—$150 million based on the linear trend of receipts since 1992—be used to fund one-time expenditures, such as capital improvement projects or large court settlements, or be deposited in the City's Budget Stabilization Fund to provide the City with a source of funds in times of declining revenue. The base of $150 million, to be adjusted annually, may continue to be used towards the funding of department operations.

Chart 1. Documentary Transfer Tax Annual Receipts
($ thousands)



The proposed increase in the transfer tax, which was included in the Mayor's Proposed Budget for Fiscal Year 2012-13, has been criticized by the real estate industry for its volatility and its burden on a small fraction of City residents, specifically those completing home sales. The revenue source's volatility is addressed in the proposed recommendations discussed above to use revenues above base for one-time expenditures. While the documentary transfer tax may not place an equal burden on every City taxpayer, it is part of balanced approach to City revenue which includes property, sales, business, utility, hotel and parking tax. An individual revenue source may fall disproportionally on a segment of taxpayers, but combined, they more equitably distribute the tax burden. Moreover, approval of the increase to the Documentary Transfer Tax would only occur with the approval of City voters, including that of property owners. The general tax measure would require 50 percent plus one vote of the electorate to pass.

Parking Occupancy Tax

The Parking Occupancy Tax is currently 10 percent of the parking charge with projected revenue of $91.7 million projected for Fiscal Year 2012-13. In conjunction with City efforts to maximize existing revenue from parking lot operators who are delinquent on the remitting the tax, it is proposed that the tax rate be increased to 15 percent. A sample of the tax rates of other large cities shows significant variance in the rate, with 15 percent at the low end of the range. Based on projected revenue for the current year and assuming no change in parking use, it is estimated that the increase will net an addition $45 million in revenue.

Table 2. Parking Occupancy Tax Rates in Select National Cities (2012)

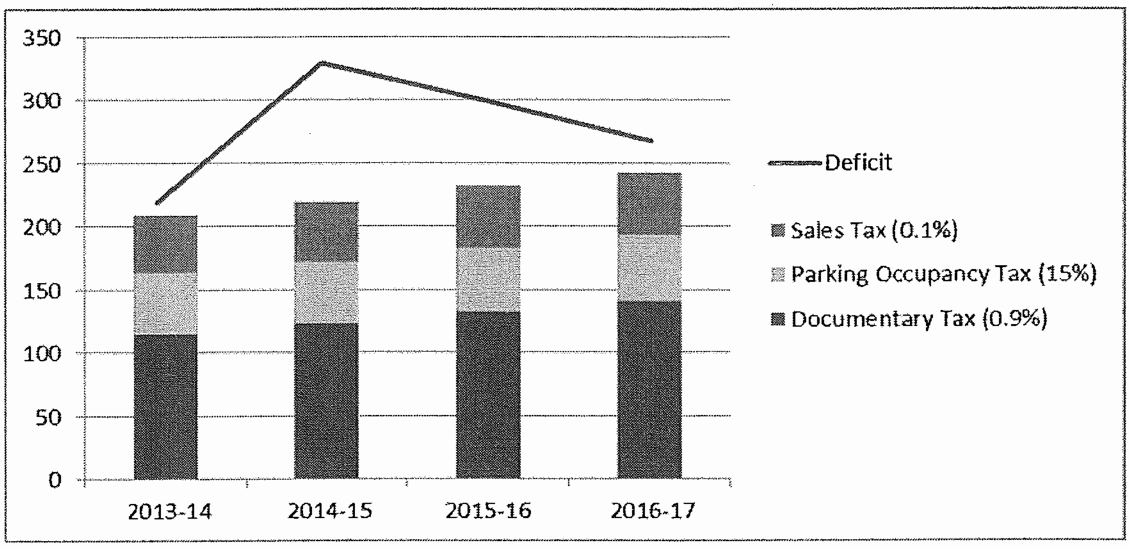
Pittsburgh	45%
San Francisco	25%
Chicago	19.75% to 50%
Philadelphia	20%
New York	10.375% to 18.375%
Miami	15%
Oakland	10%
Seattle	10%
Los Angeles	*10%*

Council may opt to adopt a policy to set aside approximately 40 percent of the increase, or 2 percent of the 15 percent rate, to provide approximately $18 million for improving transportation within the City. However, this use will need to be a City financial policy rather than language incorporated in the ballot language, in order to avoid designating a special tax that requires a higher threshold for voter approval. A general tax measure would require 50 percent plus one vote of the electorate to pass. To include language to dedicate the tax to transportation improvements as part of the ballot measure, a two-thirds vote of the electorate is required for passage.

Sales Tax

State law currently allows local jurisdictions to assess up to 2 percent sales tax above the state rate of 7.25 percent. Currently, Los Angeles County has utilized 1 percent for two transportation initiatives. (Measure R was excluded from the 2 percent cap.) The City has the ability to increase the sales tax by another 1 percent, raising the sales tax rate up to 9.75 percent. It should be noted, however, that sales tax for a majority of California cities is 8.75 percent or lower, which may result in diverting sales to nearby cities. Local cities with higher tax rates include Santa Monica and Avalon (9.25 percent) and Pico Rivera and South Gate (9.75 percent). It is projected that for each 0.1 percent increase will result in a $44 million increase to the General Fund, which will provide sufficient revenue to address the structural deficit in fiscal year 2013-14. A half percent increase will more than offset the deficit for fiscal year 2014-15. The general tax measure would require 50 percent plus one vote of the electorate to pass.

Chart 2. Impact of proposed tax increases on the General Fund deficit.



Entertainment Tax

Several municipalities assess a tax on the sale of tickets to entertainment events which may take the form of a sales tax or gross receipts tax. These assessments are alternatively called entertainment tax, amusement tax, or admission tax and may be assessed for concerts, sports games, movie theaters and other events. The City is home to several venues that are the site of large sporting, concert and other entertainment events, including Dodger Stadium, Staples Center, and the Los Angeles Coliseum. A 5 percent tax on a ticket's face value, comparable to other cities that assess such a tax, may provide additional revenue for the City. However, it should be noted that the City currently does receive revenue from entertainment events including taxes on gross receipts from promoters, venues, and on-site food and merchandise sales, parking occupancy tax revenue for paid parking, and a portion of the state sales tax, where applicable. Additionally, a tax on tickets may result in events being relocated to venues outside the City.

Table 3. Entertainment (Sales) Tax Rates in Select National Cities (2012)

New York City, NY	Sales and Use Tax Horse Race Admissions Tax	4.5%, places of amusement 3%, horse race admissions
Philadelphia, PA	Amusement Tax	5%
Phoenix, AZ	Privilege License Tax	2%
Pittsburgh, PA	Amusement Tax	5%
San Fernando, CA	Admissions Tax	$0.28 on each admission charge
Santa Cruz, CA	Admission Tax	5%
Seattle, WA	Admission Tax	5%

Further study on the entertainment tax concept will be required to determine how the tax should be implemented (e.g., which events should the tax be applied), how much revenue would be received with its implementation and whether other taxes, such as the business tax should be modified. The general tax measure would require 50 percent plus one vote of the electorate to pass.

Other Taxes

Other revenue possibilities exist to augment the General Fund, such as increasing existing utility or transient occupancy tax rates or implementing a new use or gross receipts tax on the extraction of petroleum. The general tax measure would require 50 percent plus one vote of the electorate to pass.

Additionally, the City may opt to place a parcel tax before voters to enhance services; although approval of a special use tax will require two-thirds of voters to approve. While the additional special tax revenue will not be available to reduce the structural deficit, it may be used to restore services that have been cut back as a result of the economic crisis, such as street maintenance and fire services.

RECOMMENDATIONS

1. Instruct the Offices of the Chief Legislative Analyst and the City Administrative Officer, with the assistance of the City Attorney, to report back to Council with an analysis of a proposed documentary transfer tax revenue ballot measure and necessary recommendations before October 1, 2012; and,

2. Instruct the Offices of the Chief Legislative Analyst and the City Administrative Officer, with the assistance of the City Attorney, to report back to Council with an analysis of a proposed parking occupancy tax revenue ballot measure and necessary recommendations before October 1, 2012.

FISCAL IMPACT

Approval of proposed tax increases by Los Angeles City voters will reduce the structural deficit in outgoing years.

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