



MEMORANDUM

DATE: August 24, 2023

TO: Mayor and the City Council

FROM: Alan Alton, Chief Financial Officer
Maraskeshia Smith, City Manager

SUBJECT: General Fund Status

Executive Summary

The City's General Fund is in a deficit which is projected to grow over the foreseeable future. The deficit will grow larger when the City enters into new agreements with all the City's labor groups when they expire on June 30, 2024. There is a brief period where the City can use Fiscal Stability Reserves assigned in the General Fund, which was established to preserve General Fund reserves, allowing time to develop, and put in place, expenditure reduction and revenue enhancement measures. Failure to do so will result in unsustainable General Fund operations.

General Fund Forecasting Methodology

The guiding principal used when budgeting in the General Fund is to develop a balanced budget. The City uses a long-range financial forecast as a tool to gauge the condition of the General Fund, identify potential surpluses or deficits for the Fund, and understand the causes of imbalance. The forecast covers a five-year period showing known revenues, expenditures, and transfers in and out of the Fund. Leading up to and including the COVID-19 pandemic, the City took a conservative approach to forecasting, resulting in forecasted deficits, but year-end results ended in surpluses. This was exacerbated during the Pandemic as the City took an ultra-conservative approach to estimating revenues and instituted a hiring freeze. This resulted in significantly higher than expected revenues, especially Sales Tax revenue, and higher than normal unspent salary and benefit appropriations from unfilled vacancies.

After the Pandemic, the City adopted a less conservative approach to forecasting General Fund revenues, beginning with a mid-year revenue adjustment of over \$9 million in early 2022. This adjustment reset our revenue estimates to be more reflective of actual revenue the City was receiving and provided a more realistic base from which to make future estimates. Beginning in Fiscal Year (FY) 2022-23, the City adopted a less conservative posture for forecasting General Fund revenues, estimating a "most likely" amount.

While expenditure forecasting has always been based on the best-known data, beginning in 2022, the City increased its vacancy credit to account for the unprecedented vacancy rates the City was

experiencing. These changes in budgeting and forecasting are intended to provide more resources for program budgeting and minimizing the amount of revenue exceeding estimates and unspent appropriations returning to the General Fund reserves. The FY 2022-23 General Fund budget was passed as balanced for the first time in nearly a decade.

Status of the General Fund

The General Fund balanced budget for FY 2022-23 was short-lived, and the FY 2023-24 was presented to Council with a \$2.5 million deficit and adopted with a \$3.3 million deficit. The initial deficit was a result of revenues easing off from higher prior year growth combined with adding key positions to round out the City's organizational structure. The deficit increased at budget adoption when approximately \$800,000 worth of ongoing positions were added to the budget.

While the economic condition of Santa Rosa continues to be positive, we are seeing an easing of past growth levels in Sales Tax and a decline in revenue from Real Property Transfer Tax (RPTT). These changes have been expected as the Federal and State stimulus packages in response to the COVID-19 Pandemic have been spent in the local economy. Also, while home prices have not declined, the volume of sales has, thus the decline in RPTT revenue. Finance staff closely monitors these revenues as the General Fund budget is programmed based on less conservative revenue estimates.

The General Fund deficit is an ongoing, budgetary structural deficit. This means that even though we are being more realistic with our revenue estimates to provide the highest level of resources as possible, our operating expenditures still outpace those revenues. Operating transfers, where funds are transferred out of the General Fund to fund projects and programs, contribute significantly to the ongoing deficit.

The current year deficit of \$3.3 million grows to \$9.9 million by FY 2027-28, without factoring impacts relating to changes in labor contracts. The deficit grows largely due to transfers from the General Fund without an offsetting revenue source. These include transfers to miscellaneous program including funds for free bus fare for Veterans (\$30,000); funds to subsidize the Bennett Valley Golf Course (BVGC) (\$229,000); Courthouse Square debt service (\$729,000); and transfers to the Capital Improvement Program (CIP) for ADA facility projects (\$1.2 million). Transfers to the CIP for Roseland Pavement (\$662,000) and the Parking Fund for parking enforcement services (\$1.3 million) are offset entirely by revenue from Sonoma County and parking fines, respectively.

In addition, the City transfers approximately \$4 million to \$5 million per year to support Homeless Programs and Services and Affordable Housing Production. Council Policy 000-48, "Policy to Designate General Funding for Homeless and Affordable Housing Production," mandates this transfer from the General Fund, and the amount of the transfer is tied to Real Property Transfer Tax (RPTT) revenue. As such, this transfer takes revenue supporting General Fund operations and redirects it to fund specific homeless services and programs, as well as affordable housing production. In 2018, the City Council amended this Council Policy to increase incrementally the mandated transfer amount until an amount equivalent to 100% of annual RPTT revenue is transferred from the General Fund to support those programs. Due to the expansion of the programs in recent years, the amount transferred from the General Fund to support these programs already exceeds the total RPTT revenue received annually.

The City was able to use ARPA funding to pay for homeless programs and services beginning in FY 2022-23, which in turn allowed all the General Funds transferred as mandated by Council

Policy 000-48 to go to affordable housing production. Beginning in FY 2024-25, when the ARPA period of performance ends, those homeless programs and services will once again be funded by the General Fund and therefore reduce the amount funded for Affordable Housing production. Other ARPA-funded programs, including Safe Parking and inRESPONSE, will also funding after December 2024, and the Council will need to decide whether to continue those programs by funding them in the General Fund. If the programs are to continue in the General Fund, the cost to operate the programs will take funding away from other General Fund operations.

The City established a Fiscal Stability Reserve within the General Fund using PG&E settlement funds resulting from the 2017 Tubbs Fire. These funds were assigned in the General Fund, meaning they could only be used for a specific purpose and with approval from the City Council. Specifically, these funds are designed to provide time for the City to correct the General Fund structural deficit, through revenue enhancements, or expenditure reductions, or both, while preserving unassigned General Fund reserves. Unassigned reserves must be preserved for several reasons. Should another significant natural disaster occur, these funds will be drawn down to provide resources to respond to the disaster. The 2017 Tubbs Fire showed that reimbursement from the federal government takes years. Additionally, there are critical facility infrastructure needs. These one-time project costs should be paid for with some of the funds in excess of the Council 17% reserve policy.

Prior to adopting the FY 2023-24 budget, the Fiscal Stability Reserves had a balance of \$27.3 million. Using \$3.3 million of those funds to offset the FY 2023-24 budget deficit reduced the balance to \$24 million. Using our base forecast, and not accounting for labor contracts in FY 2024-25, the Fiscal Stability Reserves is projected to be exhausted with the FY 2026-27 budget, with only a small remainder available FY 2027-28. At that point, the unassigned General Fund reserves would be used to offset the deficit going forward, as shown on the Base Forecast below.

Long Range Financial Forecast

Base Forecast

	FY 23-24 Budget	FY 24-25	FY 25-26	FY 26-27	FY 27-28	FY 28-29
Revenues	\$201.9	\$206.8	\$212.0	\$218.0	\$224.1	228.4
Transfers In	2.9	2.4	2.4	2.5	2.5	2.6
Total Revenues & TI	\$204.8	\$209.1	\$214.4	\$220.5	\$226.6	\$231.0
Expenditures	201.6	207.4	213.1	219.7	227.0	232.4
Transfers Out	6.4	7.7	9.1	9.3	9.5	9.1
Total Expenditures & TO	\$208.1	\$215.2	\$222.2	\$229.0	\$236.5	\$241.5
Surplus (Deficit)	(\$3.3)	(\$6.0)	(\$7.8)	(\$8.5)	(\$9.9)	(\$10.5)
Fiscal Stability Reserves (FSR)	27.3	24.0	18.0	10.2	1.6	
Use of FSR	(3.3)	(6.0)	(7.8)	(8.5)	(1.6)	
Ending FSR Balance	24.0	18.0	10.2	1.6	-	

At this writing, staff is completing the year-end close process and finalizing financial statements for audit review. This review typically starts at the end of September. Final fiscal year-end (FYE) 2022 unassigned reserves totaled \$53.9 million, or 27.4% of operating expenditures, which is

about \$20.4 million over the Council policy amount of 17% of operating expenditures. However, since FYE 2022, the reserves were reduced for various projects by about \$5.5 million. These reductions in reserves, and the results of the year-end close of FY 2022-23, will change the unassigned reserve amounts. Preliminary FYE 2023 unassigned reserve amounts should be available in October.

The Path Forward

The General Fund has a budgetary structural deficit, which will require reduced expenditures, increased revenue, or a combination of the two to bring it into balance, and the City needs to implement sound fiscal strategy immediately. Staff has modeled labor contract costs based on various scenarios, including a contract approved by Sonoma County for SEIU, and it shows that the Fiscal Stability Reserves will be significantly reduced with the projected FY 2024-25 deficit and fully exhausted the following year. The City must preserve unassigned General Fund reserves for emergency use, or high priority one-time needs. The following are short and long-term strategies to bring the General Fund into balance and be fiscally stable going forward.

Budget Priorities

- The City can no longer add general fund resources without a corresponding increase in revenue or reduction in expenditures to offset the increased cost to the General Fund. Furthermore, this offset must be immediate; not resulting from a potential revenue enhancement due to ballot measure or improved economic base in the future.
- Any new project or program must be analyzed to account for the potential of ongoing operations and maintenance costs associated with that project, whether those costs are direct or indirect. This includes real estate purchases.
- One-time funding must be used to address City facility infrastructure needs. The amount needed to fully address facility infrastructure is too much to address holistically. Instead, the City is forced to “triage” the worst problems, and take any general funds turned back as a source to fix those critical needs.
- The City needs a viable, ongoing revenue stream to address its infrastructure needs. While the City has debt capacity and looks for financing opportunities to fund infrastructure projects, currently there is no ability to pay the debt service.
- Preserving existing General Fund revenue sources is a must. Waiving and deferring fees or re-directing General Fund revenue sources away from existing services with grow short-term deficits. Staff must analyze the potential long-term benefits by defining the likelihood of occurrence, fiscal benefit, and weigh those against current operational impact.

Expenditure Reductions

- All departments, and General Fund departments in particular, must look for ways to reduce ongoing expenditures. Priority needs to be placed on reduced costs based on an analytical approach to reducing the budget programmatically, instead of arbitrary percentage-based cuts.
- Departments must identify true core services and build a budget around those; anything less than a core service should be available for reduction.

Revenue Enhancement

Given the potential size of the deficit within a five-year period of the General Fund forecast, the City cannot address the imbalance with expenditure reductions alone. The City needs to update its various tax ordinances to make them more equitable in the community and generate additional revenue. Below are examples of these types of updates.

- **Transient Occupancy Tax (TOT).** Santa Rosa has a TOT rate of 9% which is the lowest in Sonoma County. In addition to TOT, Santa Rosa has two tourism business improvement assessments (BIA): the Santa Rosa Tourism BIA which charges 3%, and the Sonoma County Tourism BIA which charges 2%. Taken together, the combined TOT and BIAs paid by a lodger staying in Santa Rosa is 14%; however, only the revenue generated by the 9% TOT goes to the General Fund. The SRTBIA is split between the City's Economic Development fund (30%) and Santa Rosa Tourism (70%). All the SCTBIA revenue goes to Sonoma County Tourism. While Santa Rosa's TOT rate is the lowest in the county, the combined TOT and BIA rate of 14% is third highest, behind Healdsburg (16%) and Sonoma (15%). Petaluma and Cloverdale have the lowest combined rate of 12%. The potential revenue from increasing the City's TOT rate by 1% is approximately \$600,000.
- **Utility Users Tax (UUT).** The City is one of a small number of cities in California that does not have a modern UUT ordinance, in that the Telephone UUT does not apply to mobile devices. The City could expand the revenue base for this tax by modernizing the ordinance to include mobile devices. This was tried in 2014 but was defeated by a significant "NO" campaign. While we're still analyzing the revenue potential of this change, it could be significantly better than the \$955,000 we currently receive and create more equity amongst taxpayers.
- **Business Tax.** The City charges a tax based on business group with a cap of \$3,000, regardless of size of business. City staff and the City's Business Tax Administrator (HdL) is currently analyzing the impact of removing the cap. Any change would be strategic to not harm existing small or mid-sized businesses but allow for larger businesses to pay a fairer share based on their revenues. Based on that analysis, we could even explore lowering the rate for certain businesses while still removing the cap for all business groups. In addition, the ballot measure would close the loophole that allows residential property rental operators with less than four units to be exempt from paying Business Tax.

The other significant revenue source is sales tax. The City has a current rate of 9.25%, with .75% coming from two transaction and use taxes: a quarter-cent public safety special tax; and a half-cent general tax. The half-cent general tax generates about \$23 million - \$25 million per year and is due to expire on June 30, 2031. The City cannot sustain its current General Fund operations without the extension of that tax. In addition, depending on the amount of additional revenue generated by updates to Business Tax, TOT, and UUT, the City could explore raising the existing half-cent tax. The increase in the sales tax is necessary for long-term sustainability to address increasing employee labor costs, and potential debt service for needed infrastructure projects.

Conclusion

The City's General Fund structural deficit is a reality and must be addressed immediately. The City has taken a "most likely" stance on revenue estimating to increase resources to General Fund operations, only to find that there are still not sufficient resources to support those operations. In addition, labor contract increases necessary to retain the City's workforce and ARPA funded

programs returning to the General Fund will exacerbate the General Fund's imbalance in the near term. The City must prioritize fiscal stability, utilizing the approaches outlined above, otherwise General Fund operations will cease to be sustainable.