CITY OF OAKLAND

Office of the City Attorney

Legal Opinion

TO: President Jane Brunner and Members of the City Council

CC: Mayor Ronald V. Dellums
City Administrator Dan Lindheim
City Auditor Courtney Ruby

FROM: City Attorney John Russo

DATE: May 20, 2010

SUBJECT: Adoption of City of Oakland Fiscal 2010-11 Budget Based on Passage of a Future Tax Increase

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The City Council is creating a new City Budget for fiscal year 2010-11. As a part of its budget deliberations, the City Council is discussing putting onto the November 2010 ballot for voter approval one or more new tax measures. If approved, the measure or measures will provide new revenue to the City of Oakland.

The City Council has been discussing the adoption of the City's Fiscal Year 2010-2011 Budget based on the projected revenues from one or more tax measures.

The City Charter section 801 requires that the City have a budget "conforming to modern budget practices . . . ." and that it adopt by Resolution a budget of proposed expenditure and appropriations for the ensuing year. City Councilmember Ignacio de la Fuente has asked this office whether the City Council can pass a budget that is balanced in part by relying on the outcome of a future election.

Attached is the formal legal opinion of outside counsel, the law firm Richards, Watson, Gershon. The City Attorney's Office adopts this opinion as its own.

In sum, the opinion concludes that it would legal for City Council to adopt a Fiscal Year 2010-11 Budget which includes projected revenue from the proposed tax. However, such action involves significant risks and should be undertaken simultaneously with a proposed contingency budget that will specifically address the revenue shortfall if the tax measure fails. Furthermore, California state constitutional considerations demand that the City carefully monitor its expenses until the result of the November ballot is known.

Very truly yours,

JOHN A. RUSSO
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May 17, 2010

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Re: Adoption of City of Oakland Fiscal Year 2010-11 Budget Based on Passage of a Future Tax Increase

Dear John:

We are providing this letter in response to your request for advice on whether the City Council may adopt the City's Fiscal Year 2010-2011 Budget based on the projected revenues from one or more tax measures (the "tax measure") to be submitted to the City's voters at the upcoming November election. This letter summarizes our findings regarding the following questions:

(1) Is it illegal for the City Council to adopt a Fiscal Year 2010-11 Budget which assumes that the tax measure will be approved by the voters and that the City will be able to collect the revenue from the proposed tax on a timely basis?

(2) If the City Council indeed decides to include such revenue in the City's Fiscal Year 2010-11 budget, and if the tax measure fails in November, must the City Council take prompt action to amend the Budget?

* * *

I. ***It would not be illegal for the City Council to adopt a Fiscal Year 2010-11 Budget which includes projected revenue from the proposed tax. However, such action involves significant risks and should be done with a proposed contingency plan that will specifically address the Budget shortfall if the tax measure fails. Furthermore, State Constitution considerations demand that the City carefully monitor its expenses until the result of the November ballot is known.***

A. *Pursuant to the City's Charter Section 801 and City Council Resolution No. 77922, the City is required to adopt a balanced budget annually and follow the guidelines established by the Government Finance Officers Association ("GFOA") in its budget practices.*

There is no state law in California requiring a city to adopt a balanced budget each year. Nonetheless, the City is bound by the requirements set forth in Section 801 of its Charter, and Resolution No. 77922, adopted by the City Council on July 15, 2003. Section 801 of the Charter states:

> "<u>Each department, office and agency of the City shall provide in the form and at the time directed by the Mayor and City Administrator all information required by them to develop a budget conforming to modern budget practices and procedures as well as specific information which may be prescribed by the Council</u>. Under the direction of the Mayor and Council, the City Administrator shall prepare budget recommendations for the next succeeding fiscal year which the Mayor shall present to the Council, in a form and manner and at a time as the Council may prescribe by resolution. Following public budget hearings, <u>the Council shall adopt by resolution a budget of proposed expenditures and appropriations necessary therefor for the ensuing year</u>, failing which the appropriations for current operations of the last fiscal year shall be deemed effective until the new budget and appropriation measures are adopted." (Underline added.)

Resolution No. 77922, Section 1, further provides that "[t]he City shall adopt balanced budgets, i.e., containing appropriated revenues equal to appropriated expenditures."

The Charter does not elaborate on the meaning of "modern budget practices and procedures" in Section 801. However, California municipalities generally follow the budget guidelines established by GFOA. The City of Oakland has recognized this. For example, Resolution No. 77922 expressly recites that the City's balanced budget policy is based on the recommendations made by GFOA. GFOA's recommendations and guidelines for municipal budget practices are available on its website. GFOA's "Best Practices in Public Budgeting ("GFOA Best Practices") can be found at: http://www.gfoa.org/services/nacslb/. We conclude that the City Charter's reference to modern budget practices and procedures should be interpreted consistently with GFOA's budget recommendations and guidelines.

Section 801 further provides that "the Council shall adopt by resolution a budget of proposed expenditures and appropriations necessary therefore for the ensuing year...." Although this language does not use the term "balanced budget" or state explicitly like Section 1 of Resolution 77922 that the Budget must contain appropriated revenues equal to appropriated expenditures, Section 801 nonetheless requires the Council to appropriate sufficient revenues to pay for the budgeted expenditures or in other words adopt a balanced budget. Reading Section 801, the GFOA budget guidelines, and Council Resolution No. 77922 together leave no doubt that the City Council is required to adopt a balanced budget.

B. When developing its annual budget, the City should strive to include revenue projections that are as accurate as possible to the actual outcome. GFOA Best Practices recognize that assumptions may be made regarding revenue projections. However, key assumptions must be highlighted, discussed and considered carefully. Regarding whether to include the projected revenue from the proposed tax, the City should act cautiously in light of its balanced budget policy.

GFOA Best Practices, Practice 9.2 states, in part: "Revenue projections should generally strive for accuracy by coming as close as possible to the actual outcome." However, assumptions regarding projected revenues (as well as expenses) are a necessary part of budgeting that is recognized by GFOA. At this time, the City cannot predict whether the revenue from the proposed tax will be realized, and if so, exactly when and how much of such revenue will be collected. No one can know, with certainty, whether a ballot measure will pass until the votes have been counted after the election.

According to GFOA guidelines, key assumptions incorporated into a budget (such as the inclusion of the projected revenue from the proposed tax) should be highlighted, discussed and considered carefully. GFOA Best Practices, Practice 9.2a notes, in part: "An analysis of major revenue sources should identify factors that have influenced historical collections, forecasting assumptions, and any problems or concerns. Any trends should also be identified, along with an analysis of whether or not the trend is likely to continue. The analysis can be summarized in a separate document or used as an input into an overall revenue projection. Significant changes to major revenue sources - projected and actual - should be highlighted in the budget document." (Underline added.) The following statement can be found under Practice 10.1c: "Financial data presented in the budget documents should include comparisons of prior period actual results, current period budget and/or estimated actual results, and budget period projected figures. Key assumptions for revenues and expenditures should be highlighted." (Underline added.)

GFOA also recommends that a municipal government identify each major revenue source that may be unpredictable. The government should address the impact of this potential volatility and prepare contingency plans, in case that actual outcomes will differ from the assumptions included in the budget. GFOA notes in Practice 4.4a:

> "For each major unpredictable revenue source, a government should identify those aspects of the revenue source that make the revenue unpredictable. Most importantly, a government should identify the expected or normal degree of volatility of the revenue source.... A government should decide, in advance, on a set of tentative actions to be taken if one or more of these sources generates revenues substantially higher or lower than projected. The plans should be publicly discussed and used in budget decision making....
>
> Many of the most important revenue sources relied on by state and local governments are unpredictable to some degree. Examples may include intergovernmental revenues, inheritance taxes, taxes on mineral production, interest income, sales and use tax, lottery revenues, and revenues subject to future judicial rulings. These revenues are often used to fund ongoing programs. A financial plan for governments should take into account the unpredictable nature of key revenues. This ensures that a government

> understands the potential impact on its ability to cover service costs and develops contingency plans in advance to address unpredictable revenue fluctuations. Specific allocation and contingency plans do not have to be developed for all unpredictable revenues, but become increasingly necessary as the size or unpredictability of the revenue source increases. This practice may address or refer to a separate policy on the use of stabilization funds." (Underline added.)

The above comment applies particularly to the analysis regarding whether the City should include the projected revenue from the proposed tax measure. In light of the City's balanced budget policy, if the City includes the projected revenue from the tax in its Fiscal Year 2010-11 Budget, then the City likely will budget a similar amount of expenditures that it otherwise could not include. In other words, if the tax measure fails in November (or, even if it passes, the actual revenue amount turns out to be less than expected or comes in slower than expected), then the City's budgeted expenditures will likely exceed the actual revenues. At that point, the City either will have to immediately cut-back on its expenditures or, worse, may face default on some of its obligations, unless the City has a sufficiently large reserve fund to cover the difference. (This also will trigger implications relating to the State constitutional debt limit, which is discussed below).

Therefore, the City will need to consider the potential impact of multiple possibilities – including the passage and the failure of the proposed tax measure – in its budget deliberations. If the City Council decides to include the potential revenue in the Fiscal Year 2010-11 Budget, then contingency plans should be adopted in the event that the voters reject the measure in November or, even if the measure passes, that the timing or the amount of the revenue turn out differently than expected.

A key question is how specific must the proposed contingency plan be with respect to addressing the Budget shortfall that will result if the tax measure fails. In particular due to the balanced budget requirement of the City Charter and Council Resolution No. 77922, the contingency plan should describe the specific actions that the City will take to balance the budget. Simply directing staff to reduce expenditures by the amount of the shortfall would not seem sufficient as the GFOA Best Practices provides that *specific* contingency plans be prepared when the size or unpredictability of the revenue source increases. We recommend that a contingency plan be adopted as part of the Budget that addresses specific programs that will be eliminated or curtailed and the levels of staffing cuts that will be necessary by department.

C. The adoption of an annual city budget based on certain revenue assumptions (which later turn out to be different from the actual outcomes) does not, in and of itself, violate the law, including California's constitutional debt limitation (set forth in Cal. Const. Art XVI, Sec. 18). However, if the City decides to include the revenue from the proposed tax measure, it runs a significant risk of triggering such a violation later if the measure fails in November (or if the actual revenue turns out to be less than expected or comes in slower than expected).

As mentioned, in California, there is no general law requiring a city to annually adopt a budget. The City has self-imposed the requirement – to annually adopt a balanced budget – under City Charter Section 801 and Resolution No. 77922. However, the State Constitution, under Article XVI, Section 18, contains a restriction – on the balancing of a city's liabilities and revenues during each fiscal year – which effectively requires a city to adopt a balanced budget. This restriction is commonly referred to as the State constitutional debt limit. California Constitution Article XVI, Section 18(a) states, in relevant part:

> "No…city...shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose."

The inclusion of certain revenue or expense assumptions (which later turn out to be different from the actual outcomes) does not, in and of itself, violate the State constitutional debt limit at the time of budget adoption. This is because, generally, the City has not incurred "debt" within the meaning of the State constitutional debt limit by the mere act of adopting the budget. With respect to most budget items (e.g., salaries, utilities, leases), the budgeted expenditure amount is an authorization to spend up to that dollar amount if the liability should become real. An analogy may be made with the so-called "Offner-Dean" exception in public financing (named after two California Supreme Court cases: *City of Los Angeles v. Offner*, 19 Cal. 2d 483 (1942) and *Dean v. Kuchel*, 35 Cal. 2d 444 (1950)). California courts have recognized that a city may enter into a long-term, multi-year lease without violating the State constitutional debt limit, if the lease provides, among other things, that (i) the obligation to pay rent each year is contingent on the beneficial use of the leased premised during the year, and (ii) the rent is abated if the use and occupancy is not available. By the mere act of signing such a lease, the City has not yet "incurred debt" (i.e., the immediate and present obligation to pay), in violation of the State constitutional debt limit. Similarly, most budget items, such as the City's obligation to pay utilities bills, are generally contingent upon the actual usage. Just because the Ccity has budgeted up to a certain dollar amount to pay utilities, the City has not legally obligated itself to pay the utilities companies that exact budgeted amount. Absent some contractual or other legal obligations to which the City is otherwise subject, debt has not been "incurred" by the mere act of including a certain estimated expenditure in its budget.

Furthermore, as recognized by the GFOA, a city's annual budget necessarily includes certain assumptions regarding revenues and expenditures. The courts have recognized that the adoption of a city's budget is a legislative function and generally give deference to the judgment of its city council. *Scott v. Common Council of the City of San Bernardino*, 44 Cal. App. 4th 684, 690 (1996); *County of Butte v. Superior Court, 176 Cal.App.3d 693 (1985)*. So long as the City follows the GFOA guidelines in developing its budget in accordance with the City Charter, a court will likely find that the City has not violated any law by the mere act of adopting a budget that includes the revenue from the proposed tax measure.

Nonetheless, if the City indeed decides to include the revenue from the proposed tax measure, the City needs to carefully monitor its expenses until the result of the November ballot is known. Discretionary expenditures should be delayed where feasible until after the tax measure is adopted. Even though the City has not "incurred debt" within the meaning of the State constitutional debt limit by merely adopting the budget, the City may subsequently take actions that will actually incur liabilities pursuant to the budget authorization. Without closely monitoring expenses, the City could find itself in this position: By the time it becomes clear that the revenue from the proposed tax measure will not be realized, the City has incurred liabilities that exceed revenues for the fiscal year. At that time, the City will not only be in danger of defaulting on its obligations, it would be in violation of the State constitutional debt limit.

To summarize, so long as it follows the GFOA guidelines (including adopting a contingency plan that specifically addresses how the budget will be balanced if the tax measure fails), the City may include the projected revenue from the proposed tax measure in the Fiscal Year 2010-11 Budget. However, if it does so, the City would be undertaking a significant risk of violating the State constitutional debt limit if the measure fails in November (or if the actual revenue turns out to be less than expected or comes in slower than expected).

II. If the City Council decides to include the projected revenue from the proposed tax in the City's annual budget, and if the measure eventually fails at the November election, the City Council should take prompt action to amend the Budget, particularly to avoid incurring expenses which would exceed the City's revenues for Fiscal Year 2010-11 in violation of the State Constitution.

For all of the reasons stated above, if the City Council decides to include revenues from the proposed tax measure in the Fiscal Year 2010-11 Budget, the City Council should take action to amend the Budget as soon as it becomes clear that (a) the measure has failed at the November election, or (b) even if the measure passes, the projected revenue will come in less than expected or slower than expected. GFOA states in GFOA Best Practice, Practice No. 12.1: "A government should watch for significant deviations from expectations and make adjustments [to the budget] so that the plan is consistent with revised expectations." Moreover, the adjustments should be done as promptly as possible to avoid the incurrence of liabilities that would exceed the City's revenues for the fiscal year in violation of the State constitutional debt limit.

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Hopefully, the above discussion is helpful. If you have any questions or would like further assistance on this matter, please do not hesitate to contact me.

Very truly yours,

Gregory W. Stepanicich

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