Fitch: Los Angeles' FY 2018 Operational Deficit Remains Solvable, But Challenges Continue.

Fitch Ratings-San Francisco-09 March 2018: Los Angeles (Issuer Default Rating AA-/Stable) recently issued its midyear financial status report for fiscal 2018, highlighting the city's ongoing operational deficit. Based on recent years' experience, Fitch Ratings expects that the majority of the small projected general fund shortfall of $35 million (less than 1% of fiscal 2018's budgeted $5.83 billion in revenues) will likely be solved during the course of the year. Despite numerous past projected deficits that have varied widely in size, the city added to its unrestricted general fund balance every year between fiscal years 2011 and 2016. This was achieved in the face of increasing expenditures. However, ongoing expenditure pressures did result in an unrestricted general fund balance drawdown in fiscal 2017.

The city's recently released fiscal 2017 audit results show that general fund expenditures increased by almost 6% year-over-year, largely driven by increased employee remuneration and contractual service costs. Such ongoing expenditure pressures are anticipated by Fitch's 'a' expenditure framework assessment. By contrast, general fund revenues increased by just over 2%, largely due to increased receipts for most taxes given ongoing economic growth. Fitch's 'aa' revenue framework assessment incorporates the city's ability to capture revenues from across its wide range of economic activity.

In fiscal 2017, large transfers out of the general fund to support debt service obligations, capital costs, and non-general fund departmental operations, as well as a decrease in the reserve for inventories, resulted in a $142 million total general fund balance drawdown. Nevertheless, fiscal 2017 ended with a still strong total general fund balance of $886 million (16% of spending), down from $1.03 billion (20%) the prior year. The unrestricted general fund balance declined to a still healthy $841 million (15%) in fiscal 2017, from $903 million (19%) in fiscal 2016.

The city lists various revenue and expenditure concerns for fiscal 2018, most of which had previously been cited in fiscal 2017. These include local and federal funding uncertainties, a HUD settlement payment, and potential unbudgeted expenditures for liability claims. The city's multiyear projections (last published in June 2017 and due to be updated in April) indicate that structural balance could be achieved by fiscal 2022. However, this assumes that the city will solve each year's deficit with ongoing solutions, rather than general fund reserve drawdowns. This will likely be challenging given rising employee costs (particularly related to retirement benefits) and service expansion pressures.

The city measures reserves in terms of its emergency, contingency, and budget stabilization reserves, plus its unappropriated general fund balance. Currently, the city estimates these cumulative reserves at just under 8%, a slight drop since the last financial status report due to recommended expenditures from the unappropriated general fund balance to offset citywide shortfalls, unbudgeted expenses, and proposed loans. Cumulative reserves remain below the fiscal 2016 peak of 10%. Fitch measures reserves in terms of unrestricted general fund balance, which remain healthy at 15% of spending in fiscal 2017. Fitch would be concerned if the city continued to draw down its reserves to meet operational expenses, particularly during this period when the city's economy is performing well. Lower reserves could constrain the city's financial flexibility when it needs it most during a future economic downturn.

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