

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Norberto Dueñas

**SUBJECT: 2016-2017 CITY MANAGER'S
BUDGET REQUEST AND
2017-2021 FIVE-YEAR FORECAST**

DATE: February 29, 2016

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's Adopted Budget process, this document provides both the recommended 2016-2017 City Manager's Budget Request (2016-2017 Budget Balancing Strategy Guidelines) and the 2017-2021 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. Major highlights of this report follow.

As shown in the chart below, a small General Fund surplus of \$5.7 million is projected for 2016-2017. This projection is derived by comparing the estimated revenues with the cost of delivering City Council-approved existing services as well as the services for which the City has already committed, such as the operation of new facilities or other capital projects scheduled to come on-line next year. In the remaining years of the Forecast, General Fund shortfalls are projected, ranging from -\$4.2 million to -\$15.8 million annually. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from -0.7% to 0.3% of the projected annual budget (combined total of revenues and expenditures). Over the five-year period, a total shortfall of \$30.3 million is anticipated, which equates to approximately \$6.1 million annually. This average shortfall figure equates to 0.3% of the projected General Fund annual budget (revenues and expenditures).

**2017-2021 General Fund Forecast
Incremental General Fund Surplus/(Shortfall)**

2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
\$5.7 M	(\$11.1 M)	(\$15.8 M)	(\$4.2 M)	(\$4.8 M)

- This Forecast reflects the Administration's best estimates on the projected revenues and expenditures over the next five years based on the information currently available. It does not, however, incorporate several elements that would impact the General Fund over the Forecast period, including: 1) impacts associated with any new revenue measures; 2) the implementation of the alternative pension reform settlement framework agreements approved in August 2015 and December 2015 with the City's bargaining units; 3) costs associated with services that were funded on a one-time basis in 2015-2016; 4) costs associated with the restoration of key services (police, fire, community centers, and street maintenance) to

January 1, 2011 levels; 5) costs associated with a Police Staffing Restoration Strategy (to increase the number of budgeted sworn officers from 1,109 to 1,250 positions); 6) costs associated with unmet/deferred infrastructure and maintenance needs; and 7) one-time revenue sources or expenditure needs. It should also be noted that no net impacts associated with the Development Fee Programs are included due to the cost-recovery nature of these programs.

- In the out years of this Forecast, the General Fund position is worse than that presented in the previous Forecast with shortfalls ranging from -\$4.2 million to -\$15.8 million annually. In the February 2015 Forecast, a small shortfall of \$1.4 million was projected in only one year. This change reflects lower growth rates in the economically sensitive revenues, such as Property Tax and Sales Tax, due to an expected economic slowdown along with an overall increase in the expenditure growth rates. For example, retirement costs are increasing at a faster rate than in the prior Forecast and the Committed Additions are higher.
- While the City's revenues and expenditures remain in relatively close alignment, the City continues to run a "service deficit" and there is little room to address the major gaps in services that impact our community, from public safety to neighborhood and other basic services. There are also significant unmet deferred infrastructure and maintenance needs, especially for street repair and maintenance, that will have a long-term impact on the City.
- The chart on page 3 compares the 2016-2017 Forecast to the 2015-2016 Adopted Budget. The combined result of the Adopted to Forecast changes is a General Fund surplus of \$5.7 million. The first element of the chart is the carry-over from the 2015-2016 Adopted Budget of \$30,000 and represents the ongoing funding made available as part of the 2015-2016 Adopted Budget that was allocated to one-time needs, resulting in the carryover of ongoing resource capacity to the following year. The next major comparison element is the change in revenue sources year-over-year. Ongoing revenues are projected to increase by \$41.4 million, driven primarily by increases in the Property Tax, Sales Tax, and Transient Occupancy Tax revenue estimates. When comparing expenditures (the third element), base costs are expected to increase by \$35.7 million from 2015-2016 ongoing budget levels, with the largest increase in employee general pay.

**2016-2017 General Fund Forecast
Reconciliation from 2015-2016 Adopted Budget**

2016-2017 General Fund Forecast Components (Ongoing)	\$ in Millions
Carry-Over from 2015-2016 Adopted Budget	\$.03
Revenue Changes	
- Property Tax	17.42
- Sales Tax	6.14
- Transient Occupancy Tax	3.12
- Business Tax	4.00
- Overhead Reimbursements	2.11
- Licenses and Permits	2.03
- Utility Taxes	1.92
- Transfers	1.69
- Franchise Fees	1.32
- Beginning Fund Balance	1.10
- Departmental Charges	(2.44)
- Other Net Revenue Net Increases	2.97
Total Revenue Changes (Increase)	\$ 41.38
Expenditure Changes	
- Employee General Pay Increases (includes associated retirement costs)	20.80
- Non-Management Step/Management Pay-For-Performance Increases (includes associated retirement costs)	3.50
- Cultural Facilities Capital Maintenance Reserve (TOT Growth)	3.12
- Committed Additions (e.g., Police, Parks, Traffic, and Library)	1.86
- Healthcare/Dental	1.67
- Debt Service (City Hall and Energy Services Company)	1.52
- Living Wage	1.20
- Water	0.83
- Workers’ Compensation Claims	0.70
- Human Resources/Payroll/Budget System Maintenance	0.60
- Contingency Reserve	0.50
- Business Incentive Programs	0.30
- Vacancy Rate Adjustments	(3.83)
- Transfer to Other Funds (support for Hayes Mansion /Municipal Golf Courses)	(0.70)
- Retirement (Federated/Other \$1.8m; Police and Fire -\$2.5m)	(0.68)
- Other Expenditure Net Costs	4.36
Total Expenditure Changes (Increase)	\$ 35.75
2016-2017 Projected General Fund Surplus	\$ 5.66

- For the 2016-2017 General Fund Forecast, personal services costs continue to account for approximately three-quarters of the total cost in the General Fund. The personal services category has been broken down into three major components (salaries and other compensation, retirement, and health and other fringe benefits). Of the \$737.0 million projected personal services total for 2016-2017, salaries and other compensation costs amount to \$429.1 million (58.2% of projected personal services), retirement costs amount to \$253.3 million (34.4% of projected personal services), and health and other fringe benefits costs amount to \$54.6 million (7.4% of projected personal services). Over the forecast period, modest growth is expected in each of the personal services categories.

- Committed Additions, expenses that address previous City Council direction, are included and total \$1.9 million in 2016-2017, rising to \$3.8 million by the end of the forecast period. The largest expense in this category is the inclusion of costs related to the maintenance and operation of body worn cameras in the Police Department.
- As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year. As seen in recent years, retirement costs fluctuate and will likely continue to experience upward or downward swings based on actual performance of the retirement funds and changes in actuarial economic and demographic assumptions as approved by the Federated and Police and Fire Department Retirement Boards. Consistent with past practice, as part of the preparation for the 2016-2017 Proposed and Adopted Budgets, the Administration will continue to update the City Council on both the revenue and expenditure estimates as new information becomes available.
- As is customary in the Forecast, two alternative forecasts have been developed to model the range of financial scenarios possible under varying economic conditions. "Optimistic" and "Pessimistic" Cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". At this time, it is assumed that the "Pessimistic Case" is more plausible than the "Optimistic Case".
- In approaching the 2016-2017 budget, the Administration proposes the use of the budget balancing strategy guidelines outlined in this memorandum (2016-2017 City Manager's Budget Request). The overall City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework, combined with City Council approval of the March Budget Message and priorities identified in prior policy sessions, will also guide the City's budget development efforts. The Administration recommends City Council approval of the proposed 2016-2017 City Manager's Budget Request, with any desired revisions, as part of the Mayor's March Budget Message review and approval process later in March.
- Looking forward, the Administration's goal is to ensure multi-year fiscal stability while also addressing, to the extent possible, the City's basic service delivery needs and significant backlog of unmet/deferred infrastructure and maintenance needs. In addition, it is necessary to maintain competitiveness as an employer to ensure budgeted services can be delivered in an effective manner.
- Projections for the selected Capital Improvement Program (CIP) revenues are also included in this document. These revenues total \$330.5 million over the five-year period, up 2% from the \$325.6 million included in the 2016-2020 Adopted CIP. The projected collections for the Construction and Conveyance (C&C) Tax receipts over the five-year period are 1% above the revenue estimates used in the prior forecast. Modest increases to the Building and Structure Construction Tax (5%) and the Construction Excise Tax (1%) are also included in this Forecast.

BACKGROUND

In compliance with City Charter Section 1204 and the City Council's Adopted Budget process, this document provides both the recommended 2016-2017 City Manager's Budget Request and the 2017-2021 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. The City Manager's Budget Request and Five-Year Forecast are key components of the City's annual budget process and critical steps in developing the City's annual Operating and Capital Budgets and the Five-Year Capital Improvement Program (CIP).

The City Manager's Budget Request includes budget balancing strategy guidelines that the Administration recommends to be used in developing the 2016-2017 Proposed Budget. These guidelines are predicated on the most current projections for expenditure requirements and available revenue in the coming fiscal year. As the City's anticipated fiscal status for 2016-2017 is an integral part of the Administration's proposed approach to preparing the 2016-2017 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2016-2017, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2016-2017 City Manager's Budget Request; an overview of the 2017-2021 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program; and a description of the next steps in the 2016-2017 budget process.

2016-2017 CITY MANAGER'S BUDGET REQUEST

The City Manager's Budget Request includes a set of general budget balancing strategy guidelines recommended to be used in the development of the 2016-2017 Proposed Budget. These proposed guidelines have been formulated in the context of projections for a small General Fund surplus in 2016-2017 followed by deficits in the remaining four years of the Forecast period. The over-arching goals of these guidelines are to continue operational and fiscal stability while delivering services to our community in a cost-effective manner. This includes keeping General Fund revenues and expenditures in balance while maintaining or adding resources, in some limited cases, to continue programs funded on a one-time basis in 2015-2016, as appropriate, to address significant organizational or community risk, and/or to address key service restorations identified by the City Council as priorities. In addition to City Council's approval of the Mayor's March Budget Message and priorities identified in prior policy sessions, these guidelines will be used with the overall City Council-approved City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework that are attached as an appendix to this document.

In accordance with the City Charter, the City is required to adopt a balanced budget each year, allocating any projected surplus or addressing any projected shortfall. In 2016-2017, a General Fund surplus of \$5.7 million is projected, representing 0.3% of the General Fund annual budget (revenues and expenditures). In the out years of the Forecast, General Fund shortfalls range from

-\$4.2 million to -\$15.8 million annually. These shortfall amounts are relatively small when put into context of the size of the projected General Fund budget, ranging from -0.2% to -0.7% of the projected annual budget, but point to a negative trend that would indicate that the City lacks capacity to address significant ongoing funding needs absent new revenue sources. In order to avoid future service disruptions, it is critical that the City does not over-commit its resources in this environment. Although overall service levels are clearly not at adequate levels for the San José community, the Administration continues to recommend aligning new ongoing service commitments with ongoing funds to support additions, to the extent possible. As in past years, the Administration recommends that one-time funding identified in the budget process be strategically invested to address one-time needs, such as addressing a portion of the City's unmet/deferred infrastructure and maintenance needs or building reserves.

In addition to the difficulty of keeping forecasted revenues and expenditures in alignment, challenges remain in addressing other funding needs that are not included in the Forecast. When evaluating the annual General Fund shortfalls or surplus projected in this Forecast, it is important to keep in mind that these figures do not incorporate impacts associated with:

- Any new revenue measures identified in the City Council-approved Fiscal Reform Plan that are not yet implemented.
- The implementation of the alternative pension reform settlement framework agreements approved in August 2015 and December 2015 with the Police and Fire and Federated bargaining units, respectively, regarding Measure B, which included retiree healthcare. While the terms of the settlements have been reached, the implementation of the new agreements are underway. This forecast assumes the extension of current retiree healthcare rates until actual implementation of the alternative pension reform settlement framework agreements.
- The costs to continue services funded on a one-time basis in 2015-2016 in the General Fund. The major items funded on a one-time basis include San José Learns, San José Works, Police Department Downtown Foot Patrol and Police Video Unit, Office of Immigrant Affairs, Information Technology Department Critical Security Remediation, Small Business Activation and Assistance, Workers' Compensation Backlog and Pilot Program Extension, Business Development and Economic Strategy Activities, Manufacturing Jobs Initiative, Human Resources Department Employment Services and Service Delivery and Strategic Analysis Temporary Staffing, City Attorney's Office Training, Family College Success Center, and Silicon Valley Talent Partnership. Many of these programs and services will likely need to be re-evaluated for continued funding beyond 2015-2016. This analysis will be conducted during the 2016-2017 budget process and funding recommendations for these programs and services will be included in the 2016-2017 Proposed Operating Budget, as appropriate, and in context of other budgetary needs.
- The costs to restore key services, including police, fire, community centers, and street maintenance, to January 1, 2011 levels as previously directed by the City Council (see *Appendix A*).
- The costs associated with a Police Staffing Restoration Strategy (to increase budgeted sworn officers from 1,109 to 1,250 positions) that was approved with the adoption of the 2014-2015 budget. As part of this strategy, ongoing cost savings from new police officers who receive

Tier 2 retirement benefits are to be dedicated to restoring sworn police staffing. However, accumulated savings through 2016-2017 have been used to offset San Jose Police Officers' Association (SJPOA) increases approved in August 2015. In the out years, the forecast sets aside estimated unspent sworn police retirement savings that grow to \$3.3 million ongoing by 2020-2021.

- The costs associated with ongoing unmet/deferred infrastructure and maintenance needs were updated and approved by the City Council on February 9, 2016 at \$12 million annually in the General Fund (\$174 million all funds). In addition, there is a one-time backlog of infrastructure needs totaling \$34 million in the General Fund (\$1.08 billion all funds).
- One-time revenues that may become available or one-time expenditure needs. This includes one-time Sales Tax funding associated with the "Triple Flip" wind-down that is projected to generate approximately \$10 million to \$13 million in one-time funding in 2015-2016 that will be available for allocation in 2016-2017 as well as potentially higher Property Tax funding due to excess Educational Revenue Augmentation Fund (ERAF) funds as described in the Revenue Forecast section of this document. Because the Forecast compares ongoing revenues and expenditures, it does not factor in one-time funding elements that may be available or required in any given year.
- It should be noted that the Development Fee Programs (Building, Fire, Planning, and Public Works) are designed to be 100% cost recovery and have been programmed to have a neutral impact on the Forecast by adjusting the revenue and costs to be equal. In the Planning, Building, Fire, and Public Works Development Fee Programs, budget gaps are currently projected for 2016-2017. Sufficient fee program reserves are available in each of these programs to address these variances and have been programmed into the Forecast.

2016-2017 Budget Balancing Strategy Guidelines

The 2016-2017 Budget Balancing Strategy Guidelines provide recommended direction on the general approaches to use in the development of the 2016-2017 Proposed Budget.

2016-2017 Budget Balancing Strategy Guidelines

1. Develop a budget that balances the City's delivery of the most essential services to the community with the resources available.
2. Balance ongoing expenditure needs with ongoing revenues to ensure no negative impact on future budgets and to maintain the City's high standards of fiscal integrity and financial management. To the extent possible, establish a Future Deficit Reserve in the General Fund to cover any projected budgetary shortfall in the following year as a stopgap measure.
3. Focus on business process redesign in order to improve employee productivity and the quality, flexibility, and cost-effectiveness of service delivery (e.g., streamlining, simplifying, reorganizing functions, and reallocating resources).
4. Explore alternative service delivery models (e.g., partnerships with the non-profit, public, or private sector for out- or in-sourcing services) to ensure no service overlap, reduce and/or share costs, and use our resources more efficiently and effectively. The City Council Policy on Service Delivery Evaluation provides a decision-making framework for evaluating a variety of alternative service delivery models.
5. Analyze non-personal/equipment/other costs, including contractual services, for cost savings opportunities. Contracts should be evaluated for their necessity to support City operations and to identify negotiation options to lower costs.
6. Explore redirecting and/or expanding existing revenue sources and/or adding new revenue sources.
7. Establish a fee structure to assure that operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services, where appropriate.
8. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
9. If ongoing revenues are available, focus investments in the following areas: services included in the 2015-2016 budget on a one-time basis, as appropriate; additions that address significant organizational or community risks; service restorations to the baseline January 1, 2011 service levels previously identified by the City Council in the areas of fire, police, community centers, and street maintenance; and/or additions consistent with the Police Staffing Restoration Strategy.
10. In addition to considering service restorations previously identified by the City Council, take a holistic approach regarding the restoration of services. As outlined in the Guiding Principles for Restoring City Service Levels as approved by the City Council on March 20, 2012, allocate additional resources with the following goals in mind: ensure the fiscal soundness of the City; choose investments that achieve significant outcomes; and improve efficiency and effectiveness of service delivery. Using a multi-pronged approach to restoring direct services, take into consideration the following factors: adequate strategic support resources; adequate infrastructure; service delivery method to ensure efficient and effective operations; service delivery goals and current performance status; service sustainability; and staffing resources.
11. Engage employees in department budget proposal idea development.
12. Continue a community-based budget process where the City's residents and businesses are educated and engaged, as well as have the opportunity to provide feedback regarding the City's annual budget.
13. Use the General Plan as a primary long-term fiscal planning tool and link ability to provide City services to development policy decisions.

These guidelines are similar to those approved by the City Council as part of the Mayor's March Budget Message for Fiscal Year 2015-2016. A few adjustments have been incorporated, such as the strategy to establish a Future Deficit Reserve to address any projected General Fund shortfall in the second year of the Forecast and inclusion as funding priorities of programs funded on a one-time basis in 2015-2016 and additions that address organizational or community risk.

Framework and Guiding Principles for Restoring City Service Levels

When considering any additions to the budget, it is important to consider the overall City of San José Budget Principles (included in *Appendix A*) that were initially developed as part of the General Fund Structural Deficit Elimination Plan work. These principles, which were approved as part of the City Council's approval of the Mayor's March Budget Message for Fiscal Year 2008-2009 and subsequently amended on September 9, 2008, provide a meaningful framework for maintaining the financial discipline crucial to a large organization like the City of San José.

As the City Council is aware, it is important that the City take a holistic approach regarding the restoration of services as additional resources become available. The City Council-approved Guiding Principles for Restoring City Service Levels and the Service Restoration Decision Making Framework (both included in *Appendix A*) provide the broader context that should be considered when analyzing potential service restorations. The Guiding Principles for Restoring City Service Levels, which were approved by the City Council as part of the Mayor's March Budget Message for Fiscal Year 2012-2013, provide a solid guide to help the City determine not only the appropriate service levels and most cost-effective method for service delivery, but also the critical areas for investment. The principles include considerations such as infrastructure maintenance, technology improvements, and alternative service delivery models and fall into three general categories: ensure the fiscal soundness of the City; choose investments that achieve significant outcomes; and improve the efficiency and effectiveness of service delivery. The Service Restoration Decision Making Framework provides a multi-pronged approach to restoring direct services to the community that takes into consideration various factors, including adequate strategic support resources, adequate infrastructure, service delivery method to ensure efficient and effective operations, service delivery goals and current performance status, service sustainability, and staffing resources.

As mentioned previously, one of the goals of the City Council is to restore services to January 1, 2011 levels (included in *Appendix A* for Service Restorations Previously Identified by City Council (January 1, 2011 Levels)). Another City Council goal is to implement the Police Sworn Staffing Restoration Strategy.

Incorporating Strategies into the 2016-2017 Budget Process

As noted above, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2016-2017 City Manager's Budget Request combined with the overall City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework to approach the 2016-2017 budget development process. In December 2015, the Administration directed the City departments to develop 2016-2017 budget proposals using a draft version of the

2016-2017 Budget Balancing Strategy Guidelines. Reduction targets were not issued to departments as the revenues and expenditures were expected to remain in relatively close alignment for 2016-2017. Instead of service reductions, departments were asked to analyze their core responsibilities and functions to drive the creation of proposals that improve service delivery methods and outcomes without increasing costs. These may include organizational reconfigurations to close service delivery gaps or reallocation of existing resources to adjust to shifting community needs. Budget proposals requesting a net addition of General Fund resources were to be limited to those that address truly significant community or organizational risks. As a standard practice, opportunities to reduce costs without impacting direct services, generate new revenues, and/or implement new service delivery models were also to be pursued. The Administration will continue to consider cost reductions and service delivery efficiencies that make sense, but does not anticipate any direct service reductions in 2016-2017 consistent with the approach over the past four years.

The Mayor is scheduled to issue a proposed March Budget Message on March 18, 2016, which will then be discussed, amended if necessary, and adopted by the City Council. The contents of that Message will provide specific guidance for the preparation of the City Manager's 2016-2017 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 22, 2016 and May 2, 2016, respectively. As part of the 2016-2017 Mayor's March Budget Message, the Administration requests confirmation of the proposed 2016-2017 Budget Balancing Strategy Guidelines, with any desired revisions. As required by City Charter, those Proposed Budgets will contain comprehensive plans for how the City organization will address the highest priority needs of the community while maintaining the fiscal integrity of the City.

After the release of the Proposed Budgets, there will be a series of Proposed Budget Study Sessions and Public Hearings to discuss the budget proposals and the associated impacts on performance measures and service delivery. The Administration will also work with the City Council to provide informational meetings on the Proposed Budget in each City Council District in May 2016. Additional input by the City Council and community will be incorporated into the budget through these Proposed Budget Study Sessions, Public Hearings, and the Mayor's June Budget Message during the months of May and June 2016.

2017-2021 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2017-2021 Five-Year Forecast and Revenue Projections portion of this document is divided into five sections.

1. **Elements of the General Fund Forecast** – This section begins with a description of the overall economic outlook and the expected performance of the economy over the five-year period, followed by detailed descriptions of the assumptions made concerning each of the General Fund revenue and expenditure categories. The Elements of the General Fund Forecast section ends with information regarding the projected General Fund operating margin for each of the five years included in the forecast period.
2. **Base General Fund Forecast** – The forecast model is presented in this section. It includes projections for each of the General Fund revenue and expenditure categories. The expenditure summary is divided into two sections:

- *Base Case without Committed Additions* – This section describes projections associated with existing expenditures only.
- *Base Case with Committed Additions* – This section describes the existing expenditures (Base Case) along with those expenditures to which the City is committed by previous City Council direction and has less discretion, such as maintenance and operating costs for capital projects scheduled to come on-line during the next five years.

The Five-Year Forecast discussion is based on the Base Case with Committed Additions scenario, which is considered the most likely scenario for the upcoming year.

3. **Committed Additions to the Base General Fund Forecast** – This section describes the committed additions per previous City Council direction considered in the Forecast, including the financial impact in each year of the Five-Year Forecast. This section also includes a discussion of Budget Principle #8, which pertains to capital projects with General Fund operating and maintenance costs in excess of \$100,000.
4. **Alternative Forecast Scenarios** – Because all forecasts are burdened with a large degree of uncertainty, two plausible alternative forecast scenarios are presented – an Optimistic Case and a Pessimistic Case that modify revenue assumptions. These cases are compared with the Base Case, with committed additions, to show the range of growth rates for revenues and the associated operating margins.
5. **Capital Revenue Forecast** – This section describes the estimates for construction and real estate related revenues that are major sources of funding for the City's Five-Year Capital Improvement Program.
6. **Appendices** – Three appendices are also included in this document. *Appendix A* includes the following: overall City Council-approved City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, the Service Restoration Decision Making Framework; and the Service Restorations Previously Identified by City Council (January 1, 2011 Levels). *Appendix B* provides descriptions of the City's major General Fund revenue categories. *Appendix C*, prepared by the Planning, Building and Code Enforcement Department, documents the basis for that department's five-year projections for construction activity.

2017-2021 General Fund Forecast

The following table displays the projected General Fund revenues and expenditures over the next five years and the total cumulative shortfall. In addition to the cumulative shortfall, the incremental surplus or shortfall (assuming each preceding surplus or shortfall is addressed completely with ongoing solutions in the year it appears) for each year of the forecast is included. Because it is the City's goal to remain in balance on an ongoing basis, the incremental figure is useful in that it shows the additional surplus and/or shortfall attributed to a particular fiscal year. To the extent that a shortfall is not resolved or a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget gap or surplus will carry over to the following year.

**2017-2021 General Fund Five-Year Forecast
(\$ in Millions)**

	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
Projected Revenues	\$1,001.8	\$1,029.0	\$1,051.2	\$1,080.3	\$1,113.3
Projected Expenditures	\$996.1	\$1,034.4	\$1,072.5	\$1,105.8	\$1,143.6
Total Cumulative Surplus/(Shortfall)	\$5.7	(\$5.4)	(\$21.3)	(\$25.5)	(\$30.3)
Total Incremental Surplus/(Shortfall)	\$5.7	(\$11.1)	(\$15.8)	(\$4.2)	(\$4.8)

Note: Does not incorporate impacts associated with any new revenue measures; the implementation of the alternative pension reform settlement framework agreements approved in August 2015 and December 2015 with the City’s bargaining units; costs associated with services funded on a one-time basis in 2015-2016; costs associated with restoration of key services (police, fire, community centers, and street maintenance) to January 1, 2011 levels; costs associated with a Police Staffing Restoration Strategy (to increase the number of budgeted sworn officers from 1,109 to 1,250 positions); costs associated with unmet/deferred infrastructure and maintenance needs; or one-time revenues/expenses. It should also be noted that no net impacts associated with the Development Fee Programs are included due to the cost-recovery nature of these programs.

In the 2017-2021 Forecast, a small incremental General Fund surplus is anticipated in the first year, followed by shortfalls in each of the following years. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from -0.7% to 0.3% of the projected annual budget (revenues and expenditures). However, as stated previously, there are significant expenditure components that are not incorporated into the Forecast. The Forecast also does not incorporate any new revenue measures.

Given the decreasing level of precision to be expected in the later years of a multi-year forecast, the significance of the projections in the out years is not so much in terms of their absolute amounts, but rather in the relative size of the decrease or increase from the prior year. This information should be used to provide a multi-year perspective to budgetary decision-making, rather than as a precise prediction of what will occur.

When reconciling next year’s Forecast to the 2015-2016 Adopted Budget, the projected surplus of \$5.7 million for 2016-2017 is the result of the following: a surplus carryover from the 2015-2016 Adopted Budget of \$30,000, improved revenues of \$41.4 million, offset by increased costs of \$35.8 million.

General Fund revenues are estimated to improve \$41.4 million when compared to the ongoing revenue performance assumed in the 2015-2016 Adopted Budget. Revenue performance in 2015-2016 continues to reflect moderate growth and is estimated to exceed current budgeted levels. In 2016-2017, revenue categories that are forecasted to grow year-over-year include: Property Tax based on the most recent information provided by the County of Santa Clara (\$17.4 million), Sales Tax (\$6.1 million); Business Tax (\$4.0 million) primarily reflecting higher receipts in Marijuana and Cardrooms; Licenses and Permits (\$2.0 million); Transient Occupancy Tax (\$3.1 million) based on current year activity levels which will be allocated to a Cultural and Arts Facilities Capital Replacement and Maintenance Reserve per previous City Council direction, and miscellaneous categories that have experienced a net increase based on actual collections experience (\$8.7 million).

On the expenditure side, a number of upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of \$35.8 million in 2016-2017. The most significant expenditure changes include employee pay increases that were recently negotiated (\$20.8 million), non-management step/management pay-for-performance increases (\$3.5 million), and funding for the Cultural Facilities Capital Maintenance Reserve (\$3.1 million). These cost increases are partially offset by various vacancy rate adjustments (\$3.8 million) and other small adjustments.

Further detailed information regarding the General Fund revenues and expenditures and the assumptions used in the development of the Forecast can be found in *Section I – Elements of the General Fund Forecast* of this document.

General Fund Committed Additions

Cost estimates for a number of specific “Committed Additions” that address previous City Council direction are included in this Forecast in the years that they are projected to be required. The Committed Additions category, summarized in the chart below, reflects projected additional operating and maintenance costs for new or renovated capital projects in the 2016-2020 Adopted Capital Improvement Program or for projects approved by the City Council during 2015-2016. The costs of the additions total \$1.9 million in 2016-2017 and increase to approximately \$3.8 million by the end of the Forecast period.

**2017-2021 General Fund Committed Additions
Maintenance and Operations Costs**

	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
New Police Maintenance and Operations	\$1,300,000	\$1,339,000	\$1,379,000	\$1,420,000	\$1,463,000
New Parks and Recreation Facilities	354,000	789,000	977,000	1,095,000	1,204,000
New Traffic Infrastructure Assets	199,000	237,000	243,000	250,000	259,000
New Library Maintenance and Operations	11,000	11,000	11,000	11,000	11,000
Measure P (Parks)	0	435,000	738,000	783,000	830,000
Total	\$1,864,000	\$2,811,000	\$3,348,000	\$3,559,000	\$3,767,000

These Committed Additions are related to the maintenance and operation of body worn cameras in the Police Department, new parks and recreational facilities, new traffic infrastructure assets, Library Maker[Space]ship vehicle, and the Arcadia Softball Complex as part of the Measure P (Parks) Bond funds. A detailed listing of all committed additions with operating and maintenance costs are included in this 2017-2021 General Fund Forecast and can be found in *Section 3 - Committed Additions to the Base General Fund Forecast* of this document.

General Fund Capital Operating and Maintenance Costs/Budget Principle #8

General Fund Capital Operating and Maintenance Costs/Budget Principle #8 requires City Council certification that funding will be made available in the General Fund for capital projects with an estimated operating budget impact greater than \$100,000 at the time of taking beneficial use of the facility or project, and that this operations and maintenance funding will not require a decrease in existing basic neighborhood services. Capital projects with operating and maintenance costs over \$100,000 that have been previously certified by the City Council, or are recommended for certification in the future, are identified in Chart A in Section III. Certification for potential new projects or modifications to existing projects identified after the release of this Forecast that have not been approved by the City Council may be recommended for certification as part of the 2017-2021 Proposed Capital Improvement Program. If certified by the City Council, the operating and maintenance costs associated with these facilities would then be included in subsequent General Fund Five-Year Forecast documents. It should be noted that the maintenance and operations costs for the Arcadia Softball Complex (previously titled Softball Complex) and Vietnamese Cultural Heritage Garden projects are estimated to exceed \$100,000; however, these projects were established prior to the adoption of Budget Principle #8 and did not need to be certified by City Council.

Alternative Forecast Scenarios

In order to model the range of budgetary scenarios possible under varying economic conditions, two alternative forecasts have been developed in addition to the "Base Case." "Optimistic" and "Pessimistic" cases model economic scenarios considered possible, but less likely to occur than the "Base Case." These alternatives are presented to provide a framework that gives perspective to the Base Case. The Base Case Forecast is still considered, however, the most likely scenario and is being used for planning purposes for the 2016-2017 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios. In addition, as directed in the Mayor's March Budget Message for Fiscal Year 2014-2015, as approved by the City Council, the growth in Transient Occupancy Tax receipts over the 2013-2014 actual collection level are to be set aside in a Cultural and Arts Facilities Capital Replacement and Maintenance Reserve, therefore no change in Transient Occupancy Tax growth is modeled as part of these cases as there is no impact to the operating margin.

The Base Case Forecast is built on the assumption of slowing, but still moderate, economic growth. At the local level, venture capital investment in the technology industry is reduced, resulting in a slowing of job growth, employment levels, and real estate activity. However, this is balanced against near-term foreign investment in the technology industry and local real estate market. Overall, this will result in a subdued decline in the growth rate of the local economy and ultimately the City's revenues. In the Base Case Forecast, General Fund revenue collections are anticipated to experience slow growth over the forecast period.

The Optimistic Case assumes somewhat faster economic growth than anticipated in the Base Case, but still slower than that experienced in recent years. When compared to the Base Case scenario, the real estate market remains strong with increased housing prices and increased non-residential construction. These factors contribute to higher inflation growth than in the Base Case. The optimistic case presumes that employment will continue to expand beyond what was

included in the Base Case. This stronger growth results in increased collections in the economically sensitive revenue categories, such as Property Tax and Sales Tax. In the Optimistic Case, the City would experience a surplus of \$9.5 million in 2016-2017, followed by deficits in the next two years of \$8.7 million in 2017-2018 and \$8.8 million in 2018-2019 and slight surpluses in the last two years of \$2.6 million 2019-2020 and \$3.1 million in 2020-2021.

The Pessimistic Case assumes that a combination of adverse factors deflate economic growth rates at a much more rapid rate than in the Base Case. Significantly lower growth is assumed for several of the key determinants of the City's revenue; local employment, local housing prices and number of sales, and local inflation are all lower than those of the Base Case. However, this scenario does not assume an economic crash at the national or international level. In this scenario, the City's revenues, particularly Property Tax and Sales Tax, would be significantly impacted by an economic slowdown. In the Pessimistic Case, the City would experience a slight surplus of \$584,000 in 2016-2017 followed by shortfalls of \$20.9 million in 2017-2018, \$25.1 million in 2018-2019, \$12.0 million in 2019-2020, and \$12.8 million in 2020-2021.

Capital Revenue Forecast

Section V of this report describes the Capital Revenue Forecast that will be used to develop several major elements of the 2016-2017 Capital Budget and the 2017-2021 Capital Improvement Program (CIP). As in past years, the construction-related revenue estimates included in this report are derived from construction activity projections provided by the Planning, Building and Code Enforcement (PBCE) Department and an analysis of actual collection patterns. The projections and their basis are described in a report prepared by the PBCE Department, which is included as *Appendix C* of this document (Development Activity Highlights and Five-Year Forecast [2017-2021]). This activity forecast includes a review of specific projects that are in progress as well as a general prediction of expected levels of new construction.

The following table compares the estimates for the economically sensitive capital revenue categories included in this Five-Year Forecast with those included in the 2016-2020 Adopted CIP. As shown below, revenues are anticipated to continue at the same levels as the prior Forecast with a projected increase of 2% over the 2016-2020 Adopted CIP, from \$325.6 million to \$330.5 million in the 2017-2021 Forecast.

Capital Revenue Forecast Comparison Summary (\$ in Thousands)

	2016-2020 CIP	2017-2021 Forecast	Difference	% Change
Construction and Conveyance Tax	\$175,000	\$176,000	\$1,000	1%
Building and Structure Construction Tax	62,000	65,000	3,000	5%
Construction Excise Tax	83,000	84,000	1,000	1%
Municipal Water System Fees	500	500	0	0%
Residential Construction Tax	950	875	(75)	(8%)
Sanitary Sewer Connection Fee	3,400	3,250	(150)	(4%)
Storm Drainage Connection Fee	750	875	125	17%
TOTAL	\$325,600	\$330,500	\$4,900	2%

Real estate activity (primarily housing sales) determines the collection level of one of the major capital revenue sources, the Construction and Conveyance Tax. After reaching a record setting high of \$49 million in 2005-2006, tax collections continuously fell for several years following the real estate slowdown and financial market crisis, dropping to \$20.5 million in 2008-2009. However, collections have rebounded in recent years with revenues reaching \$41.2 million in 2014-2015. While below the most recent peak in 2014-2015, revenues are expected to remain strong in 2015-2016. Based on increased home prices and property transfers through December 2015 and the expectation for relatively strong performance in the second half of the year, collections in 2015-2016 are projected to conservatively end the year at \$38 million, higher than the estimated \$35 million in the 2016-2020 Adopted CIP. However, to hedge against volatility in this category, estimated revenues in the 2017-2021 Forecast are projected to generate \$176 million, which is generally consistent with the estimate of \$175 million in the 2016-2020 Adopted CIP.

The remaining economically sensitive capital revenue categories are directly linked to private development activity. Based on projections provided by the PBCE Department, construction activity valuation is anticipated to continue at high levels but lower than the peak levels experienced in 2013-2014. Construction valuation is estimated at \$915 million in 2015-2016, a 33% decrease compared to \$1.4 billion in 2014-2015. This level of activity is expected to increase to \$1.2 billion in 2016-2017, then drop to approximately \$1 billion each year in the out years of the forecast as projects move through the development pipeline and complete construction. For the largest categories, revenue increases are projected, including a 5% (\$3 million) increase to the Building and Structure Construction Tax and a 1% (\$1 million) increase to the Construction Excise Tax, due to an increase in industrial and commercial development activity as several projects are anticipated to be under construction in 2016-2017. Although development activity is projected to increase, the revenue estimates for Building and Structure Construction Tax and Construction Excise Tax discount some of this increased activity because several major projects fall within the Downtown High Rise Development Incentives Program and the North San José Area Development Policy. Under the Downtown High Rise Development Incentives Program, a single new high rise project for employment uses (Office R&D, Hotel, and Office) to obtain building permits by December 31, 2016 within the Downtown area will be exempt from the Building and Structure Construction Tax and the Construction Excise Tax. Under the North San José Area Development Policy, any Building and Structure Construction Tax collected for new developments will need to be set aside in a reserve for future transportation improvement projects within that area.

Next Steps in the 2016-2017 Budget Process

The next major steps in the budget development process include the following:

March 2016

- 2016-2017 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2016

- 2016-2017 Proposed Capital Budget and 2017-2021 Capital Improvement Program Released

May 2016

- 2016-2017 Proposed Operating Budget and 2016-2017 Proposed Fees and Charges Released
- 2016-2017 Community Budget Meetings in Each City Council District
- City Council Study Sessions and Initial Public Hearing on 2016-2017 Proposed Operating Budget, 2017-2021 Proposed Capital Budget and Capital Improvement Program, and 2016-2017 Proposed Fees and Charges

June 2016

- 2016-2017 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2016-2017 Operating Budget, 2016-2017 Capital Budget and 2017-2021 Capital Improvement Program, and 2016-2017 Fees and Charges adopted by City Council

CONCLUSION

This document compares the projected revenues and expenditures for the General Fund over the next five years as well as provides estimates for some of the key revenues that support the City's Capital Improvement Program. In 2016-2017, a small General Fund surplus of \$5.7 million is projected. However, in the remaining years of the Forecast, General Fund shortfalls ranging from -\$4.2 million to -\$15.8 million are projected annually. While these margins are relatively narrow when put into context of the size of the projected General Fund budget, they point to an overall weakening of the City's economic position, particularly when compared to the February 2015 Forecast that reflected surpluses in all but one year.

As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document, and it is important to keep in mind that this Forecast does not reflect several elements that would impact the General Fund over the Forecast period, including: 1) impacts associated with any new revenue measures; 2) the implementation of the alternative pension reform settlement framework agreements approved in August 2015 and December 2015 with the City's bargaining units; 3) costs associated with services that were funded on a one-time basis in 2015-2016; 4) costs associated with the restoration of key services (police, fire, community centers, and street maintenance) to January 1, 2011 levels; 5) costs associated with a Police Staffing Restoration Strategy (to increase the number of budgeted sworn officers from 1,109 to 1,250 positions); 6) costs associated with unmet/deferred infrastructure and maintenance needs; and 7) one-time revenue sources or expenditure needs. It should also be noted that no net impacts associated with the Development Fee Programs are included due to the cost-recovery nature of these programs.

The revenue and expenditure projections for 2016-2017 will continue to be refined over the next several months as additional information becomes available. This is particularly important in the areas of Sales Tax and Property Tax. For example, Sales Tax data for the second quarter of 2015-2015, which covers the 2015 holiday period, will be received in March 2016. Based on this additional data, any necessary adjustments will be incorporated into the 2016-2017 Proposed

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Operating Budget, as appropriate. Similarly, as additional Property Tax data becomes available, it may be necessary to adjust the 2016-2017 revenue estimates.

This document also provides the recommended 2016-2017 City Manager's Budget Request (Budget Balancing Strategy Guidelines) for consideration by the City Council as part of its review of the Mayor's March Budget Message. With a projected surplus of only 0.3% of the budget in 2016-2017 and projected shortfalls in the out years of the Forecast, the Administration does not anticipate any major service enhancements this year. However, efforts will be taken to continue programs funded on a one-time basis in 2015-2016, as appropriate, to address the most urgent community needs and organizational risks, and to identify modifications to improve service delivery methods and outcomes without significantly increasing costs.

Over the past many years, the Mayor and City Council have remained committed to ensuring the fiscal health of the City while delivering essential services in the most cost-effective manner. This diligence served the City well as it navigated through the most difficult financial crisis in recent history. Continued commitment to these strategies will help ensure the fiscal sustainability of the City's services moving forward.



Norberto Dueñas
City Manager