

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: David Sykes

**SUBJECT: 2019-2020 CITY MANAGER’S
BUDGET REQUEST AND
2020-2024 FIVE-YEAR FORECAST**

DATE: March 7, 2019

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council’s Adopted Budget process, this document provides both the recommended 2019-2020 City Manager’s Budget Request (2019-2020 Budget Balancing Strategy Guidelines) and the 2020-2024 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 very small General Fund surplus of \$3.5 million is projected for 2019-2020. This projection is derived by comparing 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 ranging from \$1.7 million to \$15.6 million are projected for three of four years with a surplus of \$11.4 million projected in 2022-2023. These margins are relatively narrow when put into context of the size of the total projected General Fund Base Budget, ranging from -1.2% to 0.9%. Over the five-year period, total shortfalls of \$16.2 million are anticipated, which equates to approximately \$3.2 million annually. This average shortfall figure equates to -0.3% of the projected General Fund Base Budget, which ranges from \$1.2 billion to \$1.4 billion over the period.

**2020-2024 General Fund Forecast
Incremental General Fund Surplus/(Shortfall)**

	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024
Incremental Surplus/(Shortfall)	\$3.5 M	(\$15.6 M)	(\$13.7 M)	\$11.4 M	(\$ 1.7 M)
% of Budget (Based on Expenditures)	0.3%	(1.2%)	(1.0%)	0.9%	(0.1%)

- 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) costs associated with services that were funded on a one-time basis in

2018-2019; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) 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 Forecast is built on the assumption of slowing, but still positive, economic growth. The General Fund position is fairly consistent with the 2019-2023 Forecast issued in March 2018. In the previous Forecast, shortfalls ranging from -\$7.3 million to -\$15.5 million were projected for four years of the Forecast with one surplus of \$10.8 million projected in 2022-2023.
- As with all forecasts, there is a level of 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. The City's two largest General Fund revenues, Property Tax and Sales Tax, have experienced significant fluctuations in the past. 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 approved by the Federated and Police and Fire Department Retirement Boards.
- As is customary in the Forecast, two alternative forecasts have been developed to model the range of budgetary 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". Over the five-year period, the Optimistic Case would generate a surplus of \$31.5 million, while the Pessimistic Case would result in a shortfall of \$72.5 million. Given the length of the current economic expansion, it is assumed that the "Pessimistic Case" is more plausible than the "Optimistic Case". It is important to note that a recession is not modeled in the Pessimistic Case nor is there a change in the expenditure assumptions. To provide additional context on the potential impacts of an economic downturn and the lowering of the discount rates for the retirement plans, a Recession Scenario has been developed, which results in a General Fund shortfall of \$153.1 million over the Forecast period.
- The chart on page 3 compares the 2019-2020 Forecast to the 2018-2019 Adopted Budget. The combined result of the Adopted to Forecast changes is a General Fund surplus of \$3.5 million. There was no surplus or shortfall remaining from the 2018-2019 Adopted Budget that would carry-over into 2019-2020. The next major comparison element is the change in revenue sources year-over-year. Ongoing revenues are projected to increase by \$70.8 million, driven primarily by increases in the Property Tax and Sales Tax revenue estimates. When comparing expenditures (the third element), base costs are expected to increase by \$67.3 million from 2018-2019 ongoing budget levels, with the majority of the net increase associated with employee pay increases and increased retirement costs.

**2019-2020 General Fund Forecast
Reconciliation from 2018-2019 Adopted Budget**

2019-2020 General Fund Forecast Components (Ongoing)	\$ in Millions
Carry-Over from 2018-2019 Adopted Budget	\$ 0
Revenue Changes	
- Property Tax	\$ 30.40
- Sales Tax	24.80
- Use of Money and Property (interest earnings, small cell revenue/digital inclusion)	6.31
- Transient Occupancy Tax	2.90
- Business Tax	2.80
- Transfers/Reimbursements/Overhead	1.33
- Utility Tax	(2.83)
- Other Net Revenue Changes	5.07
Total Revenue Changes (Increase)	\$ 70.78
Expenditure Changes	
- Employee Pay Increases (includes associated retirement costs)	\$27.33
- Retirement Plans Discount Rate Change (from 6.875% to 6.75%)	10.89
- Non-Management Step and Management-Pay-for-Performance Increases	5.84
- Health Plan and Other Benefits	4.56
- Homeless Rapid Rehousing	4.00
- Police Department Personal Services Vacancy Factor Change (from 2% to 1%)	3.37
- Digital Inclusion Program	2.20
- Workers’ Compensation Third Party Administrator Contract	1.74
- Contingency Reserve (3% Policy)	1.50
- General Liability Claims	1.00
- Public Works Animal Care and Shelter	0.76
- Sanitary Sewer Fees	0.51
- City Attorney’s Office Litigation	0.50
- Parks Water	0.42
- Unanticipated/Emergency Maintenance	0.35
- Library/San José State University Contract	0.34
- Cultural Facilities Capital Maintenance Reserve	0.30
- Transfer to Vehicle Maintenance and Operations Fund	0.30
- Tax Revenue Anticipation Notes Debt Service	(2.11)
- Other Net Expenditure Changes	3.53
Total Expenditure Changes (Increase)	\$67.33
2019-2020 Projected General Fund Surplus	\$ 3.45

- For the 2019-2020 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 \$933.7 million projected personal services total for 2019-2020, salary and other compensation costs total \$534.2 million (57.2% of projected personal services), retirement costs total \$334.7 million (35.8% of projected personal services), and health and other fringe benefits costs total \$64.8 million (7.0% of projected personal services). In the out years of the forecast, annual personal services growth ranging from 1.8% to 4.7% is projected.

- Committed Additions, expenses that address previous City Council direction, are included and total \$86,000 in 2019-2020, rising to \$11.4 million by the end of the forecast period. The largest expense in this category are the operating and maintenance costs for Measure T bond projects, approved by voters in November 2018, such as the Fire Station 37 (\$4.3 million), Police Training Facility (\$2.5 million) and Substation Activation (\$3.2 million).
- In approaching the 2019-2020 budget, the Administration proposes the use of the budget balancing strategy guidelines outlined in this memorandum (2019-2020 City Manager's Budget Request). The overall *City of San José Budget Principles* and the *Service Delivery Framework* included in Appendix A, combined with City Council approval of the Mayor's March Budget Message will also guide the City's budget development efforts. The Administration recommends City Council approval of the proposed 2019-2020 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.
- While the City's revenues and expenditures remain in close alignment, the City is not able to address all the gaps in services that impact our community. There are also unmet deferred infrastructure and maintenance needs that will have a long-term impact on the City. 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 the backlog of unmet/deferred infrastructure and maintenance needs.
- Projections for the selected Capital Improvement Program (CIP) revenues are also included in this document. These revenues total \$360.9 million over the five-year period, which is slightly less than the \$364.9 assumed in the 2019-2023 Adopted CIP. Construction and Conveyance (C&C) Tax projections of \$180 million over the five-year period are down \$2 million (1%) compared to the prior forecast based on a recent decrease in revenues. The Building and Structure Construction Tax and the Construction Excise Tax revenue estimates also reflect a slight drop in this Forecast from a combined total of \$177 million to \$175 million (down 1%).
- Consistent with past practice, as part of the preparation for the 2019-2020 Proposed and Adopted Budgets, the Administration will bring forward revisions to both the revenue and expenditure estimates as new information becomes available.

BACKGROUND

In compliance with City Charter Section 1204 and the City Council's Adopted Budget process, this document provides both the recommended 2019-2020 City Manager's Budget Request and the 2020-2024 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 2019-2020 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 2019-2020 is an integral part of the Administration's proposed approach to preparing the 2019-2020 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2019-2020, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2019-2020 City Manager's Budget Request; an overview of the 2020-2024 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program; and a description of the next steps in the 2019-2020 budget process.

2019-2020 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 2019-2020 Proposed Budget. These proposed guidelines were formulated in the context of General Fund projections that are relatively in balance, with a small General Fund surplus in 2019-2020 followed by shortfalls and one surplus in the remaining years of the Forecast period. The over-arching goals of these guidelines are to continue operational and fiscal stability while minimizing any service delivery impacts to our community as well as impacts to our employees. These goals are accomplished by keeping General Fund revenues and expenditures in balance; seeking cost savings and revenue generation opportunities; and effectively allocating one-time funding. The potential uses of the one-time funding include continuing, in some cases, programs funded on a one-time basis in 2018-2019, addressing unmet/deferred infrastructure needs, investing in technology that improves efficiency, and setting aside funding in reserves to address potential future budget uncertainty. In a very limited number of cases, ongoing budget additions may be necessary to address key service needs 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, and the Service Delivery Framework that are attached as *Appendix A* 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 2019-2020, a General Fund surplus of \$3.5 million is projected, representing 0.3% of the General Fund Base Budget of \$1.2 billion. In the out years of the Forecast, General Fund shortfalls ranging from \$1.7 million to \$15.6 million are projected for three of four years with a surplus of \$11.4 million projected in 2022-2023. These annual variances are small when put into context of the size of the projected General Fund budget, ranging from -1.2% to 0.9% of the projected annual budget, but continue to highlight that the City lacks capacity to address significant ongoing funding needs. To avoid future service disruptions, it is critical that the City does not over-commit its resources in this environment.

Although overall service levels fall below desired levels for the San José community, the Administration continues to recommend aligning new ongoing service commitments with ongoing funds to support these additions. 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. Increasing the Budget Stabilization Reserve is particularly important given the length of the current economic expansion and the sensitivity to changes in the economically driven revenue categories in the General Fund Forecast.

In addition, 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:

- The costs to continue services funded on a one-time basis in 2018-2019 in the General Fund that totaled over \$16 million. Major items funded on a one-time basis include the following: Transfer to the Self-Insured Medical Fund; Pavement Maintenance Program; Police Department Recruiting and Backgrounding; Police Department Downtown Foot Patrol; Sports Authority; Parks, Recreation and Neighborhood Services Placemaking and Parks Activation; and Business Development and Economic Strategy Activities. Many of these programs and services will likely need to be re-evaluated for continued funding beyond 2018-2019. This analysis will be conducted during the 2019-2020 budget process and funding recommendations for these programs and services will be included in the 2019-2020 Proposed Operating Budget, as appropriate, and in context of other budgetary needs.
- The costs associated with ongoing unmet/deferred infrastructure and maintenance needs that were updated and scheduled for City Council review on March 12, 2019 at \$6.9 million annually in the General Fund (\$86.8 million all funds). In addition, there is a one-time backlog of infrastructure needs totaling \$57.5 million in the General Fund (\$1.5 billion all funds).
- One-time revenues that may become available or one-time expenditure needs. 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 Building, Fire, and Public Works Development Fee Programs, budget gaps are currently projected for 2019-2020. It is assumed that a combination of program reserves that are available in each of these programs, fee changes, and/or cost reductions will be used to address these variances. For purposes of the Forecast, the use of program reserves is assumed.

2019-2020 Budget Balancing Strategy Guidelines

The 2019-2020 Budget Balancing Strategy Guidelines provide recommended direction on the general approaches to use in the development of the 2019-2020 Proposed Budget.

2019-2020 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. Consider current needs in the context of long-term service delivery priorities.
2. Balance ongoing expenditures with ongoing revenues to maximize service delivery within existing resources, to ensure no negative impact on future budgets, and to maintain the City's high standards of fiscal integrity and financial management.
3. 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.
4. When bringing forward any position reductions, make every effort to eliminate vacant positions rather than filled positions, if operationally feasible, to minimize the number of employees displaced by reductions with the goal of no significant employee impacts.
5. Evaluate program-level budgets and determine if there are opportunities to shift resources or reconfigure operations to close service delivery gaps, generate new revenues, address truly significant community or organizational risks, fund programs added on a one-time basis in 2018-2019, and/or respond to City Council direction and organizational risks. Factor in performance measure data in the development of proposals.
6. Focus on business process redesign to improve employee productivity and the quality, flexibility, and cost-effectiveness of service delivery (e.g., streamlining, simplifying, reorganizing functions, and reallocating resources).
7. Explore alternative service delivery models (e.g., partnerships with non-profit, public, or private sector for out- or in-sourcing services) to ensure no service overlap, reduce and/or share costs, and use City resources more efficiently and effectively.
8. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
9. 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.
10. Explore expanding existing revenue sources and/or adding new revenue sources.
11. Establish a fees, charges and rates structure designed to fully recover operating costs, while considering the impacts on fee and rate payers, and explore opportunities to establish new fees and charges for services, where appropriate.
12. Focus any available one-time resources on investments that 1) address the City's unmet or deferred infrastructure needs; 2) leverage resources to or improve efficiency/effectiveness through technology and equipment or other one-time additions; 3) continue high-priority programs funded on a one-time basis in 2018-2019 for which ongoing funding is not available; and/or 4) increase budget stabilization reserves to address future budget uncertainty.
13. Engage employees in department budget proposal idea development.
14. 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.
15. Use the General Plan as a primary long-term fiscal planning tool and link ability to provide City services to development policy decisions.

Guiding Budget Principles and Service Delivery Framework

When considering changes 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 several years ago. 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 fiscal 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 when either adding or reducing resources and programs. The Service Delivery Framework (included in *Appendix A*) provides a multi-pronged approach to delivering direct services to the community that takes into consideration various factors, including adequate strategic support resources, adequate infrastructure, service delivery methods to ensure efficient and effective operations, service delivery goals and current performance status, service sustainability, and staffing resources.

2019-2020 Budget Process

As noted above, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2019-2020 City Manager's Budget Request combined with the overall City of San José Budget Principles, and the Service Delivery Framework to approach the 2019-2020 budget development process.

In January 2019, the Administration directed City departments to develop 2019-2020 budget proposals using a draft version of the 2019-2020 Budget Balancing Strategy Guidelines. At that time, departments were directed to submit General Fund reduction proposals to generate potential budget balancing options based on a preliminarily forecasted shortfall of \$10 - \$15 million. This estimated shortfall represented approximately 1% of the 2019-2020 General Fund Base Budget expenditure level. Given the challenging budget environment, departments were directed to focus on opportunities to reduce costs while minimizing impacts to direct services, generate new revenues, and/or restructure departmental operations and staff to effectively deliver services. Departments could also develop proposals that use one-time bridge funding to bring about ongoing reductions that may take time to implement so as to minimize and/or avoid community and employee impacts. In addition, departments were directed to evaluate program-level budgets and determine if there are opportunities to shift resources or reconfigure operations to reduce costs, close service delivery gaps and/or adjust to shifting community needs. When bringing forward position reductions, departments were to make every effort to eliminate vacant positions rather than filled positions, if operationally feasible, to limit employees displaced by reductions. Budget proposals requesting a net addition of General Fund resources were to be limited to those that address truly significant community or organizational risks and/or respond to specific City Council direction. For special and capital funds, departments were directed to develop proposals that balance within the total resources of the fund, identify the impact on fees or rates and, to the extent possible, minimize fee and rate increases. While the General Fund position has improved slightly since departments received this direction, the overall outlook continues to necessitate conservative budget planning.

The City's short-term goal is to balance the budget with no significant service level or employee impacts. The long-term goal continues to be to build capacity to address our significant service delivery and infrastructure needs while ensuring that the General Fund revenues and expenditures remain in alignment.

The Mayor is scheduled to issue a proposed March Budget Message on March 8, 2019, which will then be discussed, amended if necessary, and adopted by the City Council. The contents of that Message will provide guidance for the preparation of the City Manager's 2019-2020 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 22, 2019 and May 1, 2019, respectively. As part of the 2019-2020 Mayor's March Budget Message, the Administration requests confirmation of the proposed 2019-2020 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 to the community on the Proposed Budget. 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 2019.

2020-2024 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2020-2024 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 and the Service Delivery Framework. *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.

2020-2024 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 shortfalls and surplus (assuming each preceding shortfall or surplus 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 shortfall or surplus 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.

**2020-2024 General Fund Five-Year Forecast
(\$ in Millions)**

	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024
Projected Revenues	\$1,207.8	\$1,244.8	\$1,279.7	\$1,314.3	\$1,351.5
Projected Expenditures	\$1,204.3	\$1,257.0	\$1,305.6	\$1,328.7	\$1,367.7
Total Cumulative Surplus/(Shortfall)	\$3.5	(\$12.2)	(\$25.9)	(\$14.4)	(\$16.2)
Total Incremental Surplus/(Shortfall)	\$3.5	(\$15.6)	(\$13.7)	\$11.4	(\$1.7)
% of Budget (Based on Expenditures)	0.3%	(1.2%)	(1.0%)	0.9%	(0.1%)

Note: Does not include 1) costs associated with services that were funded on a one-time basis in 2018-2019; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) 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 2020-2024 Forecast, small incremental General Fund surpluses and shortfalls between \$11.4 million and -\$15.6 million are anticipated. These margins are relatively narrow when put into context with the size of the projected General Fund budget, ranging from -1.2% to 0.3% of the projected annual budget of \$1.2 billion to \$1.4 billion. However, as stated previously, there are significant expenditure components that are not incorporated into the Forecast, including programs funded on a one-time basis in 2018-2019 and unmet/deferred infrastructure needs.

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 2018-2019 Adopted Budget, the projected surplus of \$3.5 million for 2019-2020 is the result of improved revenues of \$70.8 million, partially offset by increased costs of \$67.3 million. General Fund revenues are estimated to improve by \$70.8 million when compared to the ongoing revenue performance assumed in the 2018-2019 Adopted Budget. Overall, revenue performance in 2018-2019 continues to reflect moderate growth and is estimated to exceed current budgeted levels. In 2019-2020, several revenue categories are forecasted to grow year-over-year, including: Property Tax (\$30.4 million), which is based off the most recent information provided the County of Santa Clara; Sales Tax (\$24.8 million), which is due to stronger than anticipated growth in General Sales Tax and Local Sales Tax as well as additional revenue anticipated for out of state internet sales that will be collected beginning in spring 2019; Use of Money/Property (\$6.3 million), which is primarily due to increased interest earnings as the result of higher interest rates as well as higher cash balances as the City will no longer pre-pay retirement contributions; and Transient Occupancy Tax (\$2.9 million), reflecting growth of 7% in the revenue category. The increased revenue estimates in these categories are partially offset by declines in other areas, the largest of which is reduced Utility Tax revenues (\$2.8 million), which is primarily related to decreases in Electricity, Water, and Telephone Utility Tax revenue based on actual performance.

On the expenditure side, a number of upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of \$67.3 million in 2019-2020. The largest change from the 2018-2019 Adopted Budget is the increase as the result of employee pay increases and associated retirement costs (\$27.3 million). This includes negotiated increases for the San José Police Officers’ Association (SJPOA) totaling \$8.8 million, the International Association of Fire Fighters (IAFF) totaling \$8.2 million, and the remaining bargaining units totaling \$10.3 million. An estimated increase of \$10.9 million results from the retirement discount rate change (from 6.875% to 6.75%) as approved by the Retirement Boards. Non-management step and management pay-for-performance increases result in an increase of \$5.8 million from the 2018-2019 Adopted Budget. The next largest increases are programmed for Health Plan and Other Benefits (\$4.6 million), Homeless Rapid Rehousing (\$4.0 million), the lowering of the Police Department personal services vacancy factor (\$3.4 million), Digital Inclusion Program (\$2.2 million, offset by revenue), Workers’ Compensation Third Party Administrator Contract (\$1.7 million), Contingency Reserve (\$1.5 million), General Liability Costs (\$1.0 million), Public Works Animal Care and Shelter costs (\$0.8 million), Sanitary Sewer Fees (\$0.5 million), and City Attorney’s Office litigation costs (\$0.5 million). One downward adjustment is included for the elimination of Tax Revenue Anticipation Notes (TRANS) Debt Service costs (-\$0.2 million) because the City will no longer prefund the employer retirement contributions for pension and retiree health benefits.

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 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 2019-2023 Adopted Capital Improvement Program or for projects approved by the City Council during 2018-2019. The costs of the additions total \$86,000 in 2019-2020 and increase to \$11.4 million by the end of the Forecast period.

**2020-2024 General Fund Committed Additions
Maintenance and Operations Costs**

	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024
New Parks and Recreation Facilities	\$60,000	\$491,000	\$790,000	\$1,084,000	\$1,240,000
New Traffic Infrastructure Assets	26,000	75,000	117,000	148,000	170,000
Measure T Bond	-	2,685,000	7,380,000	9,661,000	9,951,000
Total	\$86,000	\$3,251,000	\$8,287,000	\$10,893,000	\$11,361,000

These Committed Additions are related to new parks and recreational facilities, new traffic infrastructure assets, and the new projects funded by Measure T Bond funds. A detailed listing of all committed additions with operating and maintenance costs are included in this 2020-2024 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 2020-2024 Proposed Capital Improvement Program, including the Measure T Bond projects. 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.

Alternative Forecast Scenarios

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 in Section 4 of the report 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 2019-2020 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios.

- *Base Case* – The Base Case Forecast is built on the assumption of slowing, but still positive, economic growth. This region has significantly benefitted from a high level of venture capital investment in the technology industry, solid employment growth, and an extremely strong real estate market. Over the forecast period, activity in most of these areas is expected to moderate, which will result in a slowing rate of local expansion and ultimately lower growth in the City's revenues. In the Base Case Forecast, General Fund revenue collections are anticipated to experience slow growth over the forecast period, with lower growth in the out years of the Forecast. In this scenario, the total General Fund shortfall over the five-year period totals \$16.2 million.
- *Optimistic Case* – The Optimistic Case assumes somewhat faster economic growth than anticipated in the Base Case, but still slower than that experienced in recent years. Venture capital investments, the key driver of the technology sector of the economy, are extremely high in each year of the forecast in the Optimistic Case. As a result, the area's largest technology employers are doing much better than in the Base Case. Local employment

continues to expand at a high rate and, because of this solid employment growth, housing prices remain at high levels and grow through the entire forecast period. Inflation is also expected to be higher than in the Base Case. This stronger growth results in increased collections in the economically sensitive revenue categories, such as Property Tax, Sales Tax, and Transient Occupancy Tax. In this scenario, there is a General Fund surplus of \$31.5 million over the five-year period.

- *Pessimistic Case* – The Pessimistic Case assumes that a combination of adverse factors results in lower economic growth rates than in the Base Case, but it does not assume a recession. 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 a recession at the local, national, or international levels. The City’s revenues, particularly Property Tax, Sales Tax, and Transient Occupancy Tax, are significantly impacted by an economic slowdown. In this scenario, the total General Fund shortfall over the five-year period totals \$72.5 million.
- *Recession Scenario* – While not modeled over the Forecast period, a Recession Scenario is included to provide additional context on the potential impacts of an economic downturn. In this scenario, a recession is experienced in 2021-2022, impacting the City’s economically sensitive revenues. Sales Taxes, Transient Occupancy Tax, and Business Taxes experience declines in both 2021-2022 and 2022-2023 and Property Tax growth rates dramatically slow. On the expenditure side, the discount rate for the retirement plans declines by one-eighth percent in both 2020-2021 and 2021-2022. In this scenario, the total General Fund shortfall over the five-year period totals \$153.1 million.

**General Fund Operating Margins
(Base, Optimistic, Pessimistic, and Recession Scenarios)**

	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	Five-Year Surplus/ (Shortfall)
Base Case	\$3.45 M	(\$15.65 M)	(\$13.7 M)	\$11.4 M	(\$ 1.7 M)	(\$16.2 M)
Optimistic Case	\$6.5 M	(\$12.1 M)	(\$2.1 M)	\$22.1 M	\$17.1 M	\$31.5 M
Pessimistic Case	(\$3.6 M)	(\$27.9 M)	(\$28.1 M)	(\$1.5 M)	(\$ 11.5 M)	(\$72.5 M)
Recession Scenario	(\$3.6 M)	(\$38.9 M)	(\$76.6 M)	(\$25.2 M)	(\$8.8 M)	(\$153.1 M)

Capital Revenue Forecast

Section V of this report describes the Capital Revenue Forecast that will be used to develop several major elements of the 2019-2020 Capital Budget and the 2020-2024 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 [2020-2024]). 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 2019-2023 Adopted CIP. As shown below, revenues are anticipated to decrease slightly as compared to the Adopted CIP, from \$364.9 million to \$360.9 million.

Capital Revenue Forecast Comparison Summary
(\$ in Thousands)

	2019-2023 CIP	2020-2024 Forecast	Difference	% Change
Construction and Conveyance Tax	\$182,000	\$180,000	(\$2,000)	(1%)
Building and Structure Construction Tax	76,000	75,000	(1,000)	(1%)
Construction Excise Tax	101,000	100,000	(1,000)	(1%)
Municipal Water System Fees	375	375	0	0%
Residential Construction Tax	1,000	1,000	0	0%
Sanitary Sewer Connection Fee	3,500	3,500	0	0%
Storm Drainage Connection Fee	1,000	1,000	0	0%
TOTAL	\$364,875	\$360,875	(\$4,000)	(1%)

Real estate activity (primarily housing sales) determines the collection level of 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 expected to end 2018-2019 at \$42.0 million. This collection level is 13% below the actual receipts received in 2017-2018 (\$48.1 million), but is higher than the \$38 million estimated in the 2019-2023 Adopted CIP. Based on recent downward collection trends and real estate activity, collections in this extremely volatile revenue category are forecasted to drop to \$36 million in 2019-2020 and remain at that level through the remainder of the forecast period. Estimated revenues in the 2020-2024 Forecast are projected to generate \$180.0 million, \$2 million or 1% lower than the estimate of \$182.0 million in the 2019-2023 Adopted CIP.

The remaining economically sensitive capital revenue categories are linked to private development activity. Based on projections provided by the PBCE Department, construction activity valuation is anticipated to be lower than the prior year with \$1.4 billion in 2018-2019, an 18% decrease compared to \$1.7 billion in 2017-2018. This level of activity is expected to decrease to \$1.1 billion in 2019-2020 through 2023-2024 due to a decrease in residential and commercial new construction activity and commercial and industrial alterations activity as projects move through the development pipeline.

Building and Structure Construction Tax collections are projected to total \$75.0 million over the forecast period, \$1 million (or 1%) below the estimate included in the 2018-2022 Adopted Capital Improvement Program. It is projected that collections will drop from the 2018-2019 estimate of \$16 million to \$15 million in 2019-2020 and through the remainder of the forecast period as projects are completed and activity levels slightly decrease. Construction Excise Tax collections are projected to total \$100 million over the five-year forecast period, with proceeds estimated at \$20 million in 2019-2020 through 2023-2024. This collection level represents a slight decrease of \$1 million (1%) from the 2019-2023 Adopted CIP. Under the North San José Area Development Policy, any Building and Structure Construction Tax collected for new developments in North San José will need to be set aside in a reserve for future transportation improvement projects in that area.

NEXT STEPS IN THE 2019-2020 BUDGET PROCESS

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

March 2019

- 2019-2020 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2019

- 2019-2020 Proposed Capital Budget and 2020-2024 Capital Improvement Program Released

May 2019

- 2019-2020 Proposed Operating Budget and 2019-2020 Proposed Fees and Charges Released
- 2019-2020 Community Budget Meetings
- City Council Study Sessions and Initial Public Hearing on 2019-2020 Proposed Operating Budget, 2020-2024 Proposed Capital Budget and Capital Improvement Program, and 2019-2020 Proposed Fees and Charges

June 2019

- 2019-2020 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2019-2020 Operating Budget, 2019-2020 Capital Budget and 2020-2024 Capital Improvement Program, and 2019-2020 Fees and Charges Adopted by City Council

CONCLUSION

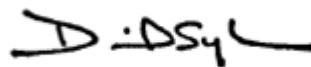
This document compares the projected revenues and expenditures for the General Fund over the next five years as well as provides estimates for some of the key revenues that support the City's Capital Improvement Program. A General Fund surplus of \$3.5 million is projected in 2019-2020, followed by shortfalls and a surplus ranging from -\$15.6 million to \$11.4 million. These margins are narrow when considering the size of the General Fund budget that totals \$1.2 billion to \$1.4 billion annually over the forecast period.

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) costs associated with services that were funded on a one-time basis in 2018-2019; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) 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 2019-2020 will continue to be refined over the next several months as additional information becomes available. This includes additional Property Tax roll growth data that is updated each month. Based on this additional data, any necessary adjustments will be incorporated into the 2019-2020 Proposed and Adopted Operating Budgets, as appropriate.

This document also provides the recommended 2019-2020 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. 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.

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. Continued commitment to these strategies will help ensure the fiscal sustainability of the City's services moving forward.



David Sykes
City Manager