CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: David Sykes

SUBJECT: **2018-2019 CITY MANAGER'S BUDGET REQUEST AND 2019-2023 FIVE-YEAR FORECAST**

DATE: March 6, 2018

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's Adopted Budget process, this document provides both the recommended 2018-2019 City Manager's Budget Request (2018-2019 Budget Balancing Strategy Guidelines) and the 2019-2023 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 General Fund shortfall of $7.3 million is projected for 2018-2019. 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 $8.9 million to $15.5 million are projected through 2021-2022 and a surplus of $10.8 million is projected in the 2022-2023, the last year of the Forecast. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from -0.7% to 0.4% of the projected annual budget (combined total of revenues and expenditures). Over the five-year period, a total shortfall of $31.4 million is anticipated, which equates to approximately $6.3 million annually. This average shortfall figure equates to -0.3% of the projected General Fund annual budget (revenues and expenditures).

2019-2023 General Fund Forecast
Incremental General Fund Surplus/(Shortfall)

	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
Incremental Surplus/(Shortfall)	($7.3 M)	($15.5 M)	($8.9 M)	($10.5 M)	$10.8 M
% of Budget (Revenues and Expenditures)	(0.3%)	(0.7%)	(0.4%)	(0.4%)	0.4%

- 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 2017-2018; 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 General Fund position has improved when compared to the 2018-2022 Forecast issued in March 2017. In the previous Forecast, shortfalls ranging from -$11.5 million to -$34.8 million were projected in each year of the Forecast. The change from the previous forecast reflects the improvement in revenues as well as lower growth in projected costs, particularly retirement costs.

- 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 these 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". At this time, it is assumed that the "Pessimistic Case" is more plausible than the "Optimistic Case".

- The chart on page 3 compares the 2018-2019 Forecast to the 2017-2018 Adopted Budget. The combined result of the Adopted to Forecast changes is a General Fund shortfall of $7.3 million. The first element of the chart is the small carry-over shortfall from the 2017-2018 Adopted Budget of $416,000. The next major comparison element is the change in revenue sources year-over-year. Ongoing revenues are projected to increase by $15.2 million, driven primarily by increases in the Property Tax, Sales Tax, and Business Tax revenue estimates. These increases are partially offset by the elimination of the Successor Agency to the Redevelopment Agency (SARA) reimbursement related to the Convention Center lease payment of $15.2 million. A corresponding reduction is reflected in the City-Wide Expenditures category to reflect the elimination of the Convention Center lease payment. When comparing expenditures (the third element), base costs are expected to increase by $22.0 million from 2017-2018 ongoing budget levels, with the majority of the net increase associated with employee pay increases.

2018-2019 General Fund Forecast
Reconciliation from 2017-2018 Adopted Budget

2018-2019 General Fund Forecast Components (Ongoing)	$ in Millions
Carry-Over from 2017-2018 Adopted Budget	**($ 0.42)**
Revenue Changes	
- Property Tax	$ 28.61
- Sales Tax	4.10
- Business Tax	3.70
- Overhead Reimbursements	2.48
- Use of Money and Property	1.14
- SARA Reimbursement for Convention Center Lease Payment	(15.24)
- Other Revenue	(5.11)
- Fines, Forfeitures, and Penalties	(1.05)
- Other Net Revenue Changes	(3.47)
Total Revenue Changes (Increase)	**$ 15.16**
Expenditure Changes	
- SJ Police Officers' Association Pay Increase (includes associated retirement costs)	$12.82
- Employee Pay Increases (except SJPOA) (includes associated retirement costs)	14.64
- Non-Management Step and Management-Pay-for-Performance Increases	6.22
- Retirement Contributions (Police: $5.9 million; Federated/Fire/Other: -$2.4 million	3.53
- Transfer to the San José Arena Capital Reserve Fund	1.60
- Police Marked Vehicle Replacement	1.23
- Microsoft Office 365 licenses	0.66
- 41.0 Sworn Police Officers (Added June 2019 per 2017-2018 Adopted Budget)	0.63
- Committed Additions (Parks and Traffic)	0.62
- Fire Apparatus Replacement	0.60
- Parks Water Costs	0.54
- Convention Center Lease Payments	(15.24)
- SARA Administration	(0.88)
- Health Plans and Other Benefits	(0.80)
- Arena Traffic Control	(0.34)
- Workers' Compensation Claims	(0.29)
- Other Expenditure Net Savings	(3.51)
Total Expenditure Changes (Increase)	**$22.03**
2018-2019 Projected General Fund Shortfall	**($ 7.29)**

- For the 2018-2019 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 $868.7 million projected personal services total for 2018-2019, salary and other compensation costs total $497.2 million (57.3% of projected personal services), retirement costs total $314.8 million (36.2% of projected personal services), and health and other fringe benefits costs total $56.8 million (6.5% of projected personal services). In the out years of the forecast, annual personal services growth ranging from 1.6% to 4.8% is projected.

- Committed Additions, expenses that address previous City Council direction, are included and total $619,000 in 2018-2019, rising to $1.7 million by the end of the forecast period. The largest expense in this category is the Arcadia Softball Complex.

- In approaching the 2018-2019 budget, the Administration proposes the use of the budget balancing strategy guidelines outlined in this memorandum (2018-2019 City Manager's Budget Request). The overall City of San José Budget Principles and the Service Delivery 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 2018-2019 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 significant 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 $364.9 million over the five-year period, which is equal to the amount included in the 2018-2022 Adopted CIP. Construction and Conveyance (C&C) Tax projections over the five-year period increased $6 million (3%) compared to the prior forecast based on the strong performance in this category. The Building and Structure Construction Tax and the Construction Excise Tax revenue estimates dropped slightly in this Forecast from a combined total of $183 million to $177 million (down 3%) to account for some slowdown in development activity over the forecast period from the high levels experienced in recent years.

- Consistent with past practice, as part of the preparation for the 2018-2019 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 2018-2019 City Manager's Budget Request and the 2019-2023 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 2018-2019 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 2018-2019 is an integral part of the Administration's proposed approach to preparing the 2018-2019 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2018-2019, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2018-2019 City Manager's Budget Request; an overview of the 2019-2023 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program; and a description of the next steps in the 2018-2019 budget process.

2018-2019 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 2018-2019 Proposed Budget. These proposed guidelines were formulated in the context of projections for General Fund shortfalls over 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 2017-2018, 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 2018-2019, a General Fund shortfall of $7.3 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 $8.9 million to $15.5 million through 2021-2022 with a surplus of $10.8 million projected in 2022-2023 primarily due to lower projected retirement costs. These annual variances are relatively small when put into context of the size of the projected General Fund budget, ranging from -0.7% to 0.4% of the projected annual budget (revenues and expenditures), 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.

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 2017-2018 in the General Fund. Major items funded on a one-time basis include the following: San José Works, San José Learns, Pavement Maintenance Program, Police Department Downtown Foot Patrol, Parks, Recreation and Neighborhood Services Placemaking and Parks Activation, Sports Authority, Workers' Compensation Program Temporary Staffing, and Business Development and Economic Strategy Activities. Many of these programs and services will likely need to be re-evaluated for continued funding beyond 2017-2018. This analysis will be conducted during the 2018-2019 budget process and funding recommendations for these programs and services will be included in the 2018-2019 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 presented to the City Council on March 6, 2018 at $7.9 million annually in the General Fund ($111.9 million all funds). In addition, there is a one-time backlog of infrastructure needs totaling $55.5 million in the General Fund ($1.4 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 Planning, Building, Fire, and Public Works Development Fee Programs, budget gaps are currently projected for 2018-2019. 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. However, for the Planning Development Fee Program, other budget balancing strategies will be necessary as the reserve is insufficient to cover the projected gap between revenues and expenditures.

2018-2019 Budget Balancing Strategy Guidelines

The 2018-2019 Budget Balancing Strategy Guidelines provide recommended direction on the general approaches to use in the development of the 2018-2019 Proposed Budget.

2018-2019 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 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. 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 protecting vital core City services for both the short-and long-term. Analyze all existing services and target service reductions or eliminations in those areas that are least essential; limit, to the extent possible, service disruptions to the public.
4. When considering whether to scale back or completely eliminate a service, evaluate the impact to the community, the quality of the services to be delivered across the department, the ability of the department to manage the range of services, and alternative service provider options in the community.
5. 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.
6. 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 2017-2018, and/or respond to specific City Council direction and organizational risks.
7. 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).
8. 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. The City Council Policy on Service Delivery Evaluation provides a decision-making framework for evaluating a variety of alternative service delivery models.
9. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
10. 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.
11. Explore expanding existing revenue sources and/or adding new revenue sources.
12. 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.
13. 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 2017-2018 for which ongoing funding is not available; and/or 4) increase budget stabilization reserves to address any potential future budget uncertainty.
14. Engage employees in department budget proposal idea development.
15. 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.
16. 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 include some revisions to those approved by the City Council as part of the Mayor's March Budget Message for Fiscal Year 2017-2018 to reflect strategies associated with potential budget reductions.

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 method to ensure efficient and effective operations, service delivery goals and current performance status, service sustainability, and staffing resources.

Incorporating Strategies into the 2018-2019 Budget Process

As noted above, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2018-2019 City Manager's Budget Request combined with the overall City of San José Budget Principles, and the Service Delivery Framework to approach the 2018-2019 budget development process.

In December 2017, the Administration directed the City departments to develop 2018-2019 budget proposals using a draft version of the 2018-2019 Budget Balancing Strategy Guidelines. At that time, General Fund reduction targets totaling $25 million were issued to generate potential budget balancing options based on a preliminarily forecasted shortfall of $20 - $25 million. The reduction target level represented approximately 2% of the 2018-2019 General Fund base 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 implement new service delivery models. 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.

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 9, 2018, 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 2018-2019 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 23, 2018 and May 1, 2018, respectively. As part of the 2018-2019 Mayor's March Budget Message, the Administration requests confirmation of the proposed 2018-2019 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 2018.

2019-2023 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2019-2023 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.

2019-2023 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.

2019-2023 General Fund Five-Year Forecast
($ in Millions)

	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
Projected Revenues	$1,121.7	$1,155.1	$1,189.9	$1,220.2	$1,248.8
Projected Expenditures	$1,129.0	$1,177.9	$1,221.6	$1,262.4	$1,280.2
Total Cumulative Surplus/(Shortfall)	($7.3)	($22.8)	($31.7)	($42.2)	($31.4)
Total Incremental Surplus/(Shortfall)	**($7.3)**	**($15.5)**	**($8.9)**	**($10.5)**	**$10.8**
% of Budget (Revenues and Expenses)	**(0.3%)**	**(0.7%)**	**(0.4%)**	**(0.4%)**	**0.4%**

Note: Does not include 1) costs associated with services that were funded on a one-time basis in 2017-2018; 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 2019-2023 Forecast, small incremental General Fund shortfalls are anticipated in four of the five years with an incremental surplus projected in the final year of the Forecast. These margins are relatively narrow when put into context with the size of the projected General Fund budget, ranging from -0.7% to 0.4% of the projected annual budget (revenues and expenditures). However, as stated previously, there are significant expenditure components that are not incorporated into the Forecast.

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 2017-2018 Adopted Budget, the projected shortfall of $7.3 million for 2018-2019 is the result of the following: a small carryover shortfall of $416,000, improved revenues of $15.2 million, offset by increased costs of $22.0 million.

General Fund revenues are estimated to improve by $15.2 million when compared to the ongoing revenue performance assumed in the 2017-2018 Adopted Budget. Overall, revenue performance in 2017-2018 continues to reflect moderate growth and is estimated to exceed current budgeted levels. In 2018-2019, several revenue categories are forecasted to grow year-over-year, including: Property Tax ($28.6 million), which is based on the most recent information provided by the County of Santa Clara and includes an additional $12 million associated with the SARA bond refunding in December 2017; Sales Tax ($4.1 million), which is primarily due to stronger than anticipated performance in the Local Sales Tax category; Business Tax ($3.7 million), which is primarily due to higher than anticipated Marijuana Business Tax revenue; Overhead Reimbursements ($2.5 million); and Use of Money and Property ($1.1 million) that is primarily related to higher interest earnings. The increased revenue estimates in these categories are partially offset by declines in other areas, the largest of which is the elimination of the SARA reimbursement of $15.2 million related to the Convention Center lease payment (a corresponding reduction to the City-Wide expense is also included). In addition, the Other Revenue category is down $5.1 million, which is primarily due to the reduction of funding received for the SAP Arena in accordance with the term sheet with Sharks Sports Entertainment.

On the expenditure side, a number of upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of $22.0 million in 2018-2019. The largest change from the 2017-2018 Adopted Budget is the increase to employee salary costs and associated retirement costs ($27.5 million). This includes the negotiated increases for the San José Police Officers’ Association (SJPOA) of 6% (3.25% pensionable and 2.75% non-pensionable) totaling $12.8 million, as well as anticipated increases of $14.6 million for the remaining bargaining units that have contracts expiring in June 2018 and are under negotiation. Non-management step increases and management pay-for-performance increases result in an increase of $6.2 million from the 2017-2018 Adopted Budget. A net increase in retirement costs of $3.5 million is also anticipated. The next largest increases are programmed for a Transfer to the San José Arena Capital Reserve Fund ($1.6 million), Police Marked Vehicle Replacement ($1.2 million), increased costs for Microsoft Office 365 licenses ($0.7 million), committed additions for Parks and Traffic capital assets ($0.6 million), and fire apparatus replacement ($0.6 million). The addition of 41.0 Police positions (1.0 Police Lieutenant, 7.0 Police Sergeants, and 33.0 Police Officers) is also assumed starting June 2019 per the 2017-2018 Adopted Budget at a cost of $0.6 million in 2018-2019; the annualized cost of these positions is $7.7 million. Downward adjustments are included for Convention Center lease payments (-$15.2 million, offset by a reduction to the SARA reimbursement for this expense), the elimination of Successor Agency to the Redevelopment Agency (SARA) Administration costs (-$0.9 million) that are no longer necessary, Health Plan costs and other benefits (-$0.8 million), Arena Traffic Control services (-$0.3 million), and Workers’ Compensation Claims (-$0.3 million).

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 2018-2022 Adopted Capital Improvement Program or for projects approved by the City Council during 2017-2018. The costs of the additions total $619,000 in 2018-2019 and increase to $1.7 million by the end of the Forecast period.

2019-2023 General Fund Committed Additions
Maintenance and Operations Costs

	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
New Parks and Recreation Facilities	$216,000	$523,000	$667,000	$725,000	$809,000
New Traffic Infrastructure Assets	22,000	45,000	69,000	82,000	95,000
Measure P (Parks)	381,000	677,000	715,000	755,000	790,000
Total	**$619,000**	**$1,245,000**	**$1,451,000**	**$1,562,000**	**$1,694,000**

These Committed Additions are related to new parks and recreational facilities, new traffic infrastructure assets, 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 2019-2023 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 2019-2023 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) 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

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 2018-2019 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. In recent years, several of the City's economically sensitive revenues experienced strong growth as the City recovered from the severe recession that started in the latter half of the last decade. This region has also benefitted from continued venture capital investment in the technology industry, solid employment growth, and a 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.

- *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. On a national level, economic growth is slightly higher with increased defense spending. This increased defense spending positively impacts technology sectors, which benefits the local economy. Local conditions are very strong and the area's largest technology employers are doing much better than in the Base Case scenario. Venture capital expenditures are steady, as is the flow of foreign funds into the region. Local employment continues to expand 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 and Transient Occupancy Tax.

- *Pessimistic Case* **–** The Pessimistic Case assumes that a combination of adverse factors results in lower economic growth rates 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 local, national, or international levels. In this scenario, the City's revenues, particularly Property Tax, Sales Tax, and Transient Occupancy Tax, are significantly impacted by an economic slowdown.

Capital Revenue Forecast

Section V of this report describes the Capital Revenue Forecast that will be used to develop several major elements of the 2018-2019 Capital Budget and the 2019-2023 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 [2019-2023]). 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 2018-2022 Adopted CIP.

As shown below, revenues are anticipated to remain flat as compared to the prior Forecast at $364.9 million.

Capital Revenue Forecast Comparison Summary
($ in Thousands)

	2018-2022 CIP	2019-2023 Forecast	Difference	% Change
Construction and Conveyance Tax	$176,000	$182,000	$6,000	3%
Building and Structure Construction Tax	78,000	76,000	(2,000)	(3%)
Construction Excise Tax	105,000	101,000	(4,000)	(4%)
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**	**$364,875**	**$0**	**0%**

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 the year at $42.0 million in 2017-2018. This collection level is 3% below the actual receipts received in 2016-2017 ($43.3 million), but is substantially higher than the $36.0 million estimated in the 2018-2022 Adopted CIP. Based on recent collection trends and real estate activity, collections in this extremely volatile revenue category are forecasted to drop to $38.0 million in 2018-2019 and then decrease to $36.0 million annually for the remaining years of the forecast period. Estimated revenues in the 2019-2023 Forecast are projected to generate $182.0 million, $6 million or 3% higher than the estimate of $176.0 million in the 2018-2022 Adopted CIP.

The remaining economically sensitive capital revenue categories are directly linked to private development activity. Based on projections provided by the PBCE Department, though performing stronger than originally anticipated, construction activity valuation is anticipated to be lower than the prior year: $1.8 billion for 2017-2018, a 5% decrease compared to $1.9 billion in 2016-2017. This level of activity is expected to decrease to $1.4 billion in 2018-2019 due to a decrease in commercial and industrial alterations activity, $1.3 billion in 2019-2020, and drop to approximately $1.2 billion annually in 2020-2023 as projects move through the development pipeline. Construction activity forecasts for the five-year projection for the Building and Structure Construction Tax collections totals $76.0 million, $2 million (or 3%) below the estimate included in the 2018-2022 Adopted Capital Improvement Program. It is projected that collections will drop from the 2017-2018 estimate of $20.0 million to $16.0 million in 2018-2019 and to $15.0 million for the remainder of the forecast period as projects are completed and activity levels slightly decrease. Construction Excise Tax collections are projected to total $101.0 million over the five-year forecast period, with proceeds estimated at $21.0 million in 2018-2019, and decreasing to $20.0 million in 2019-2020 through 2022-2023. This collection level represents a slight decrease of $4.0 million (or 4%) from the 2018-2022 Adopted CIP. Under the Downtown High-Rise Residential Development Incentive Program, 50% of construction taxes for any residential tower in the downtown area that breaks ground by July 2018 and is completed by December 2020 will be waived. 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 in that area.

NEXT STEPS IN THE 2018-2019 BUDGET PROCESS

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

March 2018

- 2018-2019 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2018

- 2018-2019 Proposed Capital Budget and 2019-2023 Capital Improvement Program Released

May 2018

- 2018-2019 Proposed Operating Budget and 2018-2019 Proposed Fees and Charges Released
- 2018-2019 Community Budget Meetings
- City Council Study Sessions and Initial Public Hearing on 2018-2019 Proposed Operating Budget, 2019-2023 Proposed Capital Budget and Capital Improvement Program, and 2018-2019 Proposed Fees and Charges

June 2018

- 2018-2019 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2018-2019 Operating Budget, 2018-2019 Capital Budget and 2019-2023 Capital Improvement Program, and 2018-2019 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 shortfall of $7.3 million is projected in 2018-2019, followed by shortfalls ranging from $8.9 million to $15.5 million through 2021-2022 and a surplus of $10.8 million in 2022-2023. When considering the size of the General Fund budget that totals $1.1 billion to $1.3 billion over the forecast period, these margins are relatively narrow totaling less than 1% of the overall budget (revenues and expenditures).

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 2017-2018; 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 2018-2019 will continue to be refined over the next several months as additional information becomes available. This includes additional Sales Tax data for the second quarter of the 2017-2018 fiscal year that will be available in March 2018 and additional Property Tax roll growth data that is updated each month. Based on this additional data, any necessary adjustments will be incorporated into the 2018-2019 Proposed and Adopted Operating Budgets, as appropriate.

This document also provides the recommended 2018-2019 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. The Administration will consider cost reductions and service delivery efficiencies with the goal of balancing the budget with no significant service level or employee impacts.

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