CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Norberto Dueñas

SUBJECT: **2017-2018 CITY MANAGER'S BUDGET REQUEST AND 2018-2022 FIVE-YEAR FORECAST**

DATE: March 16, 2017

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's Adopted Budget process, this document provides both the recommended 2017-2018 City Manager's Budget Request (2017-2018 Budget Balancing Strategy Guidelines) and the 2018-2022 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 $12.4 million is projected for 2017-2018. This projection is derived by comparing the estimated revenues with the cost of delivering City Council-approved existing services as well as the services for which the City has already committed, such as the operation of new facilities or other capital projects scheduled to come on-line next year. In the remaining years of the Forecast, General Fund shortfalls are projected, ranging from $11.5 million to $34.8 million annually. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from -0.5% to -1.5% of the projected annual budget (combined total of revenues and expenditures). Over the five-year period, a total shortfall of $88.9 million is anticipated, which equates to approximately $17.8 million annually. This average shortfall figure equates to -0.8% of the projected General Fund annual budget (revenues and expenditures).

2018-2022 General Fund Forecast
Incremental General Fund Surplus/(Shortfall)

2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
($12.4 M)	($34.8 M)	($11.5 M)	($17.4 M)	($12.8 M)

- This Forecast reflects the Administration's best estimates on the projected revenues and expenditures over the next five years based on the information currently available. It does not, however, incorporate several elements that would impact the General Fund over the forecast period, including: 1) costs associated with services that were funded on a one-time basis in 2016-2017; 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.

- With shortfalls in each year, the General Fund position is worse when compared to the 2017-2021 Forecast issued in February 2016. In the previous forecast, a small surplus was projected in the first year, followed by small shortfalls (ranging from -$4.2 million to -$15.8 million) in the remaining four years. The change from the previous forecast reflects increased revenues that are more than offset by increased expenditures, primarily due to increases in personnel costs.

- The voter approved local Sales Tax (June 2016) and Business Tax Modernization (November 2016) measures significantly improved what would have otherwise been the City's General Fund position in 2017-2018. The local Sales Tax is currently projected to generate $35 million annually. The 2016-2017 Adopted Budget allocated approximately $16 million of this amount to ongoing uses, including funding for Police Department sworn and non-sworn staffing, Fire Department sworn staffing and overtime to eliminate fire station "brown-outs", and homeless rapid rehousing.

- As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document. For example, General Fund revenues may exceed or fall below expectations based on changes in economic or non-economic conditions. Various cost elements can also vary from year to year. As seen in recent years, retirement costs fluctuate and will likely continue to experience upward or downward swings based on actual performance of the retirement funds and changes in actuarial economic and demographic assumptions approved by the Federated and Police and Fire Department Retirement Boards. In 2017-2018, the Sales Tax revenue estimate, which is the City's second largest General Fund revenue source, is particularly difficult to project given the downward performance in the last two quarters during a period in which most other economically sensitive revenues are performing well. In addition, the Budget Office is in the process of implementing a new budget system, with the expenditure data continuing to undergo extensive data verification and refinement. Consistent with past practice, as part of the preparation for the 2017-2018 Proposed and Adopted Budgets, the Administration will bring forward revisions to both the revenue and expenditure estimates as new information becomes available.

- The chart on page 3 compares the 2017-2018 Forecast to the 2016-2017 Adopted Budget. The combined result of the Adopted to Forecast changes is a General Fund shortfall of $12.4 million. The first element of the chart is the carry-over from the 2016-2017 Adopted Budget of $32.8 million and represents the ongoing funding made available as part of the 2016-2017 Adopted Budget that was allocated to one-time needs, resulting in the carryover of ongoing resource capacity to the following year. This primarily reflects the additional local Sales Tax revenue that was approved by the voters in June 2016 (only $16 million of that funding was allocated to ongoing needs in 2016-2017) as well as budget balancing actions in 2016-2017 that did not allocate $8.0 million to ongoing uses to address a portion of the projected shortfall in 2017-2018. The next major comparison element is the change in revenue sources year-over-year. Ongoing revenues are projected to increase by $41.7 million, driven primarily by increases in the Property Tax, Business Tax, and Utility Tax revenue estimates. The decline in the Sales

Tax category reflects the lower performance in 2016-2017 that impacts the 2017-2018 estimate. When comparing expenditures (the third element), base costs are expected to increase by $86.9 million from 2016-2017 ongoing budget levels, with the largest increase in retirement costs and employee pay increases.

2017-2018 General Fund Forecast
Reconciliation from 2016-2017 Adopted Budget

2017-2018 General Fund Forecast Components (Ongoing)	$ in Millions
Carry-Over from 2016-2017 Adopted Budget	**$ 32.82**
Revenue Changes	
- Property Tax	$ 17.98
- Business Tax	14.20
- Utility Taxes	5.57
- Overhead Reimbursements	4.75
- Transfers	2.04
- Transient Occupancy Tax	1.77
- Franchise Fees	1.70
- Sales Tax	(6.70)
- Other Net Revenue Changes	0.35
Total Revenue Changes (Increase)	**$ 41.66**
Expenditure Changes	
- Retirement (Police/Fire $35.3 M, Federated/Other $8.0 M; Measure F $3.0 M)	$ 46.30
- Employee General Pay/Non-Management Step/ Management Pay-For-Performance (does not include associated retirement costs)	28.30
- Healthcare/Dental	4.20
- Water	2.04
- Cultural Facilities Capital Maintenance Reserve (TOT Growth)	1.77
- Transfers to Other Funds (support for Hayes Mansion, Municipal Golf Courses, Communications Capital Program, and general fleet vehicle replacement)	1.50
- Police Marked Vehicle Replacement	1.40
- Debt Service (e.g., City Hall, Energy Services Co. (ESCO), FMC)	1.15
- Workers' Compensation Program	1.10
- General Liability Claims	1.00
- Vehicle Maintenance and Operations	0.78
- Gas and Electric Utilities	0.77
- Contingency Reserve	0.50
- Committed Additions (Parks and Traffic)	0.43
- Capital Unanticipated/Emergency Maintenance	0.15
- Fire Apparatus Replacement	(0.35)
- Workers' Compensation Claims Payments	(1.00)
- Other Expenditure Net Savings	(3.15)
Total Expenditure Changes (Increase)	**$ 86.89**
2017-2018 Projected General Fund Shortfall	**($ 12.41)**

- For the 2017-2018 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 $826.5 million projected personal services total for 2017-2018, salary and other compensation costs total $467.4 million (56.6% of projected personal services), retirement costs total $297.6 million (36.0% of projected personal services), and health and other fringe benefits costs total $61.5 million (7.4% of projected personal services). In the out years of the forecast, annual personal services growth ranging from 3.9% to 6.5% is projected.

- Committed Additions, expenses that address previous City Council direction, are included and total $0.4 million in 2017-2018, rising to $2.0 million by the end of the forecast period. The largest expense in this category is the Arcadia Softball Complex.

- As is customary in the Forecast, two alternative forecasts have been developed to model the range of financial scenarios possible under varying economic conditions. "Optimistic" and "Pessimistic" Cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". At this time, it is assumed that the "Pessimistic Case" is more plausible than the "Optimistic Case".

- In approaching the 2017-2018 budget, the Administration proposes the use of the budget balancing strategy guidelines outlined in this memorandum (2017-2018 City Manager's Budget Request). The overall City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework, combined with City Council approval of the March Budget Message and priorities identified in prior policy sessions, will also guide the City's budget development efforts. The Administration recommends City Council approval of the proposed 2017-2018 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 relatively close alignment, the City is not able to address all the gaps in services that impact our community, from public safety to neighborhood services. 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, up 10% from the $330.5 million included in the 2017-2021 Adopted CIP. Construction and Conveyance (C&C) Tax receipts over the five-year period remained flat compared to the prior forecast due to the combination of increasing home prices and declining numbers of property sales. Increases to the Building and Structure Construction Tax (20%) and the Construction Excise Tax (25%) revenue estimates are included in this Forecast, due to higher construction activity valuation.

BACKGROUND

In compliance with City Charter Section 1204 and the City Council's Adopted Budget process, this document provides both the recommended 2017-2018 City Manager's Budget Request and the 2018-2022 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 2017-2018 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 2017-2018 is an integral part of the Administration's proposed approach to preparing the 2017-2018 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2017-2018, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2017-2018 City Manager's Budget Request; an overview of the 2018-2022 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program; and a description of the next steps in the 2017-2018 budget process.

2017-2018 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 2017-2018 Proposed Budget. These proposed guidelines have been formulated in the context of projections for General Fund deficits in each year of the Forecast period. The over-arching goals of these guidelines are to continue operational and fiscal stability while delivering services to our community in a cost-effective manner. This includes keeping General Fund revenues and expenditures in balance while maintaining or adding resources, in some limited cases, to continue programs funded on a one-time basis in 2016-2017, as appropriate, to address significant organizational or community risk, to fund unmet/deferred infrastructure needs, and/or 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, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework that are attached as an appendix to this document.

In accordance with the City Charter, the City is required to adopt a balanced budget each year, allocating any projected surplus or addressing any projected shortfall. In 2017-2018, a General Fund shortfall of $12.4 million is projected, representing 0.6% of the General Fund annual budget (revenues and expenditures). In the out years of the Forecast, General Fund shortfalls range from

-$11.5 million to -$34.8 million annually. These shortfall amounts are relatively small when put into context of the size of the projected General Fund budget, ranging from -0.5% to -1.5% of the projected annual budget, but point to a negative trend that would indicate that the City lacks capacity to address significant ongoing funding needs. 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 additions, to the extent possible. As in past years, the Administration recommends that one-time funding identified in the budget process be strategically invested to address one-time needs, such as addressing a portion of the City's unmet/deferred infrastructure and maintenance needs or building reserves.

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

- The costs to continue services funded on a one-time basis in 2016-2017 in the General Fund. The major items funded on a one-time basis include the following: Pavement Maintenance Program, San José Works, San José Learns, Police Department Downtown Foot Patrol, Parks, Recreation and Neighborhood Services Placemaking and Parks Activation, City Attorney's Office Legal Transactions and Litigation Division Staffing, Office of Immigrant Affairs, Policy and Ordinance Assistance, Sports Authority, Business Development and Economic Strategy Activities, Server Replacements, and Neighborhood-Led Beautification Days. Many of these programs and services will likely need to be re-evaluated for continued funding beyond 2016-2017. This analysis will be conducted during the 2017-2018 budget process and funding recommendations for these programs and services will be included in the 2017-2018 Proposed Operating Budget, as appropriate, and in context of other budgetary needs.

- The costs associated with ongoing unmet/deferred infrastructure and maintenance needs were updated and presented to the City Council on February 28, 2017 at $8.5 million annually in the General Fund ($144.0 million all funds). In addition, there is a one-time backlog of infrastructure needs totaling $56.1 million in the General Fund ($1.5 billion all funds).

- The costs associated with a Police Staffing Restoration Strategy (to increase budgeted sworn officers to 1,250 positions) that was approved with the adoption of the 2014-2015 budget. As part of this strategy, ongoing cost savings from new police officers who receive Tier 2 retirement benefits are to be dedicated to restoring sworn police staffing. However, accumulated savings through 2017-2018 were used to offset San Jose Police Officers' Association (SJPOA) increases approved in August 2015. In the out years, the forecast sets aside estimated sworn police retirement savings that grow to $8.1 million ongoing by 2021-2022.

- 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 2017-2018. 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.

2017-2018 Budget Balancing Strategy Guidelines

The 2017-2018 Budget Balancing Strategy Guidelines provide recommended direction on the general approaches to use in the development of the 2017-2018 Proposed Budget.

2017-2018 Budget Balancing Strategy Guidelines

1. Develop a budget that balances the City's delivery of the most essential services to the community with the resources available.
2. Balance ongoing expenditure needs with ongoing revenues to 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. Evaluate vacant positions to determine if any position changes should be brought forward to better meet departmental needs, with the goal of filling existing vacant positions before adding new net positions to the organization.
4. 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).
5. 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.
6. 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.
7. Explore redirecting and/or expanding existing revenue sources and/or adding new revenue sources.
8. 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.
9. Identify City policy changes that would enable/facilitate service delivery changes or other budget balancing strategies.
10. If ongoing resources are available, focus investments in the following areas: services included in the 2016-2017 budget on a one-time basis, as appropriate; and additions that address significant organizational or community risks.

11. If one-time resources are available, focus on investments that address the City's unmet or deferred infrastructure needs and/or leverage resources to or improve efficiency/effectiveness through technology and equipment or other one-time additions.
12. In addition to considering service restoration priorities previously identified by the City Council, take a holistic approach regarding the restoration of services. As outlined in the Guiding Principles for Restoring City Service Levels as approved by the City Council on March 20, 2012, allocate additional resources with the following goals in mind: ensure the fiscal soundness of the City; choose investments that achieve significant outcomes; and improve efficiency and effectiveness of service delivery. Using a multi-pronged approach to restoring direct services, take into consideration the following factors: adequate strategic support resources; adequate infrastructure; service delivery method to ensure efficient and effective operations; service delivery goals and current performance status; service sustainability; and staffing resources.
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.

These guidelines are very similar to those approved by the City Council as part of the Mayor's March Budget Message for Fiscal Year 2016-2017 with a couple of additions. Item #3 is added to focus on the need to fill existing vacant positions before adding net new positions to the City, and item #11 is included to describe the potential use of one-time resources.

Framework and Guiding Principles for Restoring City Service Levels

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

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

Incorporating Strategies into the 2017-2018 Budget Process

As noted above, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2017-2018 City Manager's Budget Request combined with the overall City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making Framework to approach the 2017-2018 budget development process.

In December 2016, the Administration directed the City departments to develop 2017-2018 budget proposals using a draft version of the 2017-2018 Budget Balancing Strategy Guidelines. At that time, no reduction targets were issued given the expectation that revenues and expenditures would remain in relatively close alignment. However, the funding demands and community expectations were again expected to far exceed the resources available in 2017-2018. Given this environment, departments were directed to take a targeted and very limited approach to budget proposal development. This included the pursuit of opportunities to reduce costs without impacting direct services, generate new revenues, and/or implement new service delivery models. Departments were also directed to evaluate program-level budgets and determine if there are opportunities to shift resources or reconfigure operations to close service delivery gaps or adjust to shifting community needs. Vacant positions were to be evaluated to determine if any position changes should be brought forward to better meet departmental needs, with the stated goal of filling existing vacant positions before adding new net positions to the organization. Budget proposals requesting a net addition of General Fund resources were to be limited to those that address truly significant community or organizational risks. The Administration will continue to consider cost reductions and service delivery efficiencies that make sense, but does not anticipate any direct service reductions in 2017-2018 consistent with the approach over the past five years.

The Mayor is scheduled to issue a proposed March Budget Message on March 17, 2017, 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 2017-2018 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 24, 2017 and May 1, 2017, respectively. As part of the 2017-2018 Mayor's March Budget Message, the Administration requests confirmation of the proposed 2017-2018 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 2017.

2018-2022 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2018-2022 Five-Year Forecast and Revenue Projections portion of this document is divided into five sections.

1. **Elements of the General Fund Forecast** – This section begins with a description of the overall economic outlook and the expected performance of the economy over the five-year period, followed by detailed descriptions of the assumptions made concerning each of the General Fund revenue and expenditure categories. The Elements of the General Fund Forecast section ends with information regarding the projected General Fund operating margin for each of the five years included in the forecast period.

2. **Base General Fund Forecast** – The forecast model is presented in this section. It includes projections for each of the General Fund revenue and expenditure categories. The expenditure summary is divided into two sections:

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

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

3. **Committed Additions to the Base General Fund Forecast** – This section describes the committed additions per previous City Council direction considered in the Forecast, including the financial impact in each year of the Five-Year Forecast. This section also includes a discussion of Budget Principle #8, which pertains to capital projects with General Fund operating and maintenance costs in excess of $100,000.

4. **Alternative Forecast Scenarios** – Because all forecasts are burdened with a large degree of uncertainty, two plausible alternative forecast scenarios are presented – an Optimistic Case and a Pessimistic Case that modify revenue assumptions. These cases are compared with the Base Case, with committed additions, to show the range of growth rates for revenues and the associated operating margins.

5. **Capital Revenue Forecast** – This section describes the estimates for construction and real estate related revenues that are major sources of funding for the City's Five-Year Capital Improvement Program.

6. **Appendices** – Three appendices are also included in this document. *Appendix A* includes the following: overall City Council-approved City of San José Budget Principles, the City Council-approved Guiding Principles for Restoring City Service Levels, and the Service Restoration Decision Making 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.

2018-2022 General Fund Forecast

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

2018-2022 General Fund Five-Year Forecast
($ in Millions)

	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Projected Revenues	$1,091.3	$1,121.3	$1,153.1	$1,187.1	$1,219.6
Projected Expenditures	$1,103.7	$1,168.5	$1,211.8	$1,263.2	$1,308.5
Total Cumulative Surplus/(Shortfall)	($12.4)	($47.2)	($58.7)	($76.1)	($88.9)
Total Incremental Surplus/(Shortfall)	**($12.4)**	**($34.8)**	**($11.5)**	**($17.4)**	**($12.8)**

Note: Does not include 1) costs associated with services that were funded on a one-time basis in 2016-2017; 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 2018-2022 Forecast, incremental General Fund shortfalls are anticipated in each year. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from -0.5% to -1.5% 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 2016-2017 Adopted Budget, the projected shortfall of $12.4 million for 2017-2018 is the result of the following: a surplus carryover from the 2016-2017

Adopted Budget of $32.8 million (primarily associated with the voter-approved Sales Tax measure that was not fully allocated to ongoing uses in 2016-2017 as well as budget balancing actions in 2016-2017 that did not allocate $8.0 million to ongoing uses to address a portion of the projected shortfall in 2017-2018), improved revenues of $41.7 million, offset by increased costs of $86.9 million.

General Fund revenues are estimated to improve $41.7 million when compared to the ongoing revenue performance assumed in the 2016-2017 Adopted Budget. Aside from Sales Tax, revenue performance in 2016-2017 continues to reflect moderate growth and is estimated to exceed current budgeted levels. General Sales Tax receipts for the first two quarters (July through December 2016) were down 9.4% and 3.1% when compared to same quarters in the prior year. Given the performance experienced in the first two quarters, no growth is projected for the remaining two quarters of 2016-2017, which would bring receipts to $180.0 million. This collection level is $8.8 million below the Adopted Budget estimate of $188.8 million and brings down the starting point for 2017-2018. In addition, the Local Sales Tax, a new ¼ cent local sales tax approved by San José voters in June 2016, is now estimated to generate $26 million in 2016-2017, which is $4 million below the estimate of $30 million used to develop the 2016-2017 Adopted Budget. Additionally, in 2017-2018, the Local Sales Tax is estimated at $35 million, which is $5 million less than the $40 million assumed when the ballot measure was brought forward. In 2017-2018, other revenue categories that are forecasted to grow year-over-year include: Property Tax based on the most recent information provided by the County of Santa Clara ($18.0 million); Business Tax ($14.2 million) primarily due to the Modernization of the San José business tax, which was approved by voters in November 2016; Utility Tax ($5.6 million); Overhead Reimbursements ($4.8 million); Transfers from Other Funds ($2.0 million); Transient Occupancy Tax ($1.8 million) with the additional funding allocated to a Cultural and Arts Facilities Capital Replacement and Maintenance Reserve per previous City Council direction; Franchise Fees ($1.7 million); and miscellaneous categories that have experienced a net changes based on actual collections experience ($0.4 million).

On the expenditure side, a number of upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of $86.9 million in 2017-2018. The largest change from the 2016-2017 Adopted Budget is the increase in retirement costs ($46.3 million). This increase reflects changes in retirement rates, the impact of salary increases, the annualization of positions that were added for a partial year in 2017-2018 (e.g., 19.0 Community Service Officers and 5.0 Crime and Intelligence Analyst positions), and the addition of positions scheduled to start in 2017-2018 (41 sworn Police positions to be added in February 2018). Employee pay increases account for the next largest change at $28.3 million and include general pay increases, non-management step increases, and management pay-for-performance. This figure also reflects the annualization of positions added in 2017-2018 and the addition of positions scheduled to start in 2018. The next largest increases are programmed for health and dental costs ($4.2 million), water costs, primarily in the Parks, Recreation and Neighborhood Services Department ($2.0 million), Transfers to Other Funds, including funds that support the Hayes Mansion, Municipal Golf Courses, Communications Capital Program, and general fleet vehicle replacement ($1.5 million), and Police Marked Vehicle Replacement ($1.4 million). Downward adjustments are included for Fire

Apparatus Replacement (-$0.35 million) and Workers' Compensation Claims Payments (-$1.0 million) based on projected needs for 2017-2018 and claims performance.

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 2017-2021 Adopted Capital Improvement Program or for projects approved by the City Council during 2016-2017. The costs of the additions total $0.4 million in 2017-2018 and increase to approximately $2.0 million by the end of the Forecast period.

2018-2022 General Fund Committed Additions
Maintenance and Operations Costs

	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
New Parks and Recreation Facilities	$257,000	$493,000	$676,000	$875,000	$997,000
New Traffic Infrastructure Assets	55,000	59,000	61,000	81,000	87,000
Measure P (Parks)	121,000	782,000	827,000	873,000	913,000
Total	**$433,000**	**$1,334,000**	**$1,564,000**	**$1,829,000**	**$1,997,000**

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 2018-2022 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 2018-

2022 Proposed Capital Improvement Program. If certified by the City Council, the operating and maintenance costs associated with these facilities would then be included in subsequent General Fund Five-Year Forecast documents. It should be noted that the maintenance and operations costs for the Arcadia Softball Complex (previously titled Softball Complex) and Vietnamese Cultural Heritage Garden projects are estimated to exceed $100,000; however, these projects were established prior to the adoption of Budget Principle #8 and did not need to be certified by City Council.

Alternative Forecast Scenarios

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 2017-2018 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios. In addition, as directed in the Mayor's March Budget Message for Fiscal Year 2014-2015, as approved by the City Council, the growth in Transient Occupancy Tax receipts over the 2013-2014 actual collection level are to be set aside in a Cultural and Arts Facilities Capital Replacement and Maintenance Reserve, therefore no change in Transient Occupancy Tax growth is modeled as part of these cases as there is no impact to the operating margin.

- *Base Case* – The Base Case Forecast is built on the assumption of slowing, but still positive, economic growth. In recent years, many of the City's economically sensitive revenues experienced rapid growth as the City recovered from the severe recession that started in the latter half of the last decade. This region 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 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.

- *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 a bit higher with a large infrastructure spending program and 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 tech 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 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.

- *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, would be 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 2017-2018 Capital Budget and the 2018-2022 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 [2018-2022]). 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 2017-2021 Adopted CIP. As shown below, revenues are anticipated to increase as compared to the prior Forecast with a projected increase of 10% over the 2017-2021 Adopted CIP, from $330.5 million to $364.9 million in the 2018-2022 Forecast.

Capital Revenue Forecast Comparison Summary
($ in Thousands)

	2017-2021 CIP	2018-2022 Forecast	Difference	% Change
Construction and Conveyance Tax	$176,000	$176,000	$0	0%
Building and Structure Construction Tax	65,000	78,000	13,000	20%
Construction Excise Tax	84,000	105,000	21,000	25%
Municipal Water System Fees	500	375	(125)	(25%)
Residential Construction Tax	875	1,000	125	14%
Sanitary Sewer Connection Fee	3,250	3,500	250	8%
Storm Drainage Connection Fee	875	1,000	125	14%
TOTAL	**$330,500**	**$364,875**	**$34,375**	**10%**

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 reaching $42.7 million in 2015-2016. While below the most recent peak in 2014-2015, revenues are expected to remain strong in 2016-2017. Based on increased home prices coupled with lower inventory and property transfers, collections in 2016-2017 are projected to end the year at $38 million. This collection level is 11% below the receipts of $42.7 million received in 2015-2016 but is slightly higher than the $36 million estimated in the 2017-2021 Adopted CIP. Based on recent collection trends and real estate activity, collections in this volatile revenue category are anticipated to drop slightly to $36 million in 2017-2018, decrease to $35 million in 2018-2019, and remain constant through the remainder of the forecast period. Estimated revenues in the 2018-2022 Forecast are projected to generate $176 million, which is flat to the estimate of $176 million in the 2017-2021 Adopted CIP.

The remaining economically sensitive capital revenue categories are directly linked to private development activity. Based on projections provided by the PBCE Department, construction activity valuation is anticipated to continue at high levels but lower than the peak levels experienced in 2013-2014. Construction valuation is estimated at $1.7 billion in 2016-2017, a 12% increase compared to $1.6 billion in 2015-2016. This level of activity is expected to decrease to $1.4 billion in 2017-2018 due to a decrease in new commercial construction and alterations activity, $1.3 billion in 2018-2019 and drop to approximately $1.2 billion annually, in 2019-2022 of the forecast as anticipated projects are completed. Though construction activity is anticipated to decrease from its current level over the next five years, overall activity is greater than the previous forecast period. For the largest categories, revenue increases over the previous forecast period are projected, including a 20% ($13 million) increase to the Building and Structure Construction Tax and a 25% ($21 million) increase to the Construction Excise Tax, due to strong residential and commercial development activity. Under the Downtown High-Rise Residential Development Incentive Program, 50% of construction taxes are waived for any residential tower in the downtown area that breaks ground by July 2018 and is completed by December 2020. It is anticipated that several major residential projects in Downtown will start in 2017-2018. Under the North San José Area Development Policy, any Building and Structure Construction Tax collected for new developments will need to be set aside in a reserve for future transportation improvement projects within that area.

Next Steps in the 2017-2018 Budget Process

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

March 2017

- 2017-2018 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2017

- 2017-2018 Proposed Capital Budget and 2018-2022 Capital Improvement Program Released

May 2017

- 2017-2018 Proposed Operating Budget and 2017-2018 Proposed Fees and Charges Released
- 2017-2018 Community Budget Meetings

- City Council Study Sessions and Initial Public Hearing on 2017-2018 Proposed Operating Budget, 2018-2022 Proposed Capital Budget and Capital Improvement Program, and 2017-2018 Proposed Fees and Charges

June 2017

- 2017-2018 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2017-2018 Operating Budget, 2017-2018 Capital Budget and 2018-2022 Capital Improvement Program, and 2017-2018 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 $12.4 million is projected in 2017-2018, followed by shortfalls ranging from $11.5 million to $34.8 million in the out years of the Forecast. While these margins are relatively narrow when put into context of the size of the projected General Fund budget, they point to an overall weakening of the City's economic position.

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 2016-2017; 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 2017-2018 will continue to be refined over the next several months as additional information becomes available. In 2017-2018, the Sales Tax revenue estimate, which is the City's second largest General Fund revenue source, is particularly difficult to project given the downward performance in the last two quarters during a period in which most other economically sensitive revenues are performing well. In addition, the Budget Office is in the process of implementing a new budget system, with the expenditure data continuing to undergo extensive data verification and refinement. Based on this additional data, any necessary adjustments will be incorporated into the 2017-2018 Proposed and Adopted Operating Budgets, as appropriate.

This document also provides the recommended 2017-2018 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 continue to consider cost reductions and service delivery efficiencies that make sense, but does not anticipate any direct service reductions in 2017-2018 consistent with the approach over the past five years.

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.

Norberto Dueñas
City Manager