



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Jennifer A. Maguire

SUBJECT: 2022-2023 CITY MANAGER'S
BUDGET REQUEST AND
2023-2027 FIVE-YEAR FORECAST

DATE: February 28, 2022

INFORMATION

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's Adopted Budget process, this document provides both the recommended 2022-2023 City Manager's Budget Request (2022-2023 Budget Balancing Strategy Guidelines) and the 2023-2027 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program (CIP). Major highlights of this report follow.

As shown in the chart below, a modest General Fund surplus of \$27.7 million is projected for 2022-2023, which constitutes approximately 2% of the General Fund Base Budget. This projection is derived by comparing estimated revenues with the cost of delivering City Council-approved ongoing services in the General Fund 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. If the 2022-2023 surplus is fully allocated on an ongoing basis, the remaining four years of the Forecast show additional incremental surpluses ranging from \$22.7 million to \$28.9 million (1.6% - 2.0%), which are relatively narrow margins when put into context of the size of the General Fund Budget. Over the five-year period, a total net General Fund surplus of \$128.8 million translates to an average annual surplus of \$25.8 million, which equates to 2.0% of the projected average annual General Fund Base Budget. The incremental surpluses are larger than figures included in the 2022-2026 Five-Year Forecast due to higher-than-expected levels of economic activity and corresponding revenue growth, paired with decreasing retirement costs attributable the City's retirement systems' strong returns in 2020-2021.

2023-2027 General Fund Forecast Incremental Surplus

	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	Five-Year Surplus
Incremental Surplus ¹	\$27.7 M	\$26.0 M	\$23.5 M	\$22.7 M	\$28.9 M	\$128.8 M
% of Budget (Based on Expenditures)	2.1%	1.9%	1.7%	1.6%	2.0%	

Note: Does not include 1) costs associated with services that were funded on a one-time basis in 2021-2022; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) one-time revenue sources or expenditure needs.

- This Forecast reflects the Administration’s best estimates on 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 2021-2022, including resources to support the City’s community and economic recovery efforts; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) one-time revenue sources or expenditure needs.
- The 2021-2022 Modified Budget is unique in that it includes substantial levels of one-time funding for important community services, most significantly from the American Rescue Plan Fund and the General Fund. While these services are not funded on an ongoing basis in 2022-2023, their discontinuation would likely cause negative service impacts that no one would want for our City. Therefore, from a practical perspective, when including these one-time funded critical programs currently budgeted in the American Rescue Plan Fund and the General Fund as part of our ongoing service level needs – and, for planning purposes only, assuming the continuation of half of the programs and services currently budgeted in the American Rescue Plan Fund – the City faces a service level/structural shortfall in the General Fund, as illustrated below.

**Estimated Service Level/Structural Shortfall in 2022-2023 for Planning Purposes
(\$ in Millions)**

	2022-2023
February 2022 Incremental Surplus/(Shortfall)	\$27.7 M
Community and Economic Recovery Workstreams in the American Rescue Plan Fund Continued at 50% of 2021-2022 Modified Budget Level	(\$52.5 M)
Programs Previously Funded on a One-Time Basis in the General Fund	(\$20.4 M)
Estimated Service Level/Structural Shortfall for Planning Purposes	(\$45.2 M)

- The Forecast is built on the assumption of the economy continuing to grow, but at a more moderate pace after the sharp rebound experienced in 2021. 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, are sensitive to changes in the local economy and may fluctuate to a significant degree depending on future conditions. Various cost elements can also vary from year to year. While retirement contributions as a percentage of the General Fund have decreased from prior forecasts due to the strong market returns in 2020-2021, future contributions 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.

- Two alternative forecasts have been developed to model the range of budgetary scenarios possible under varying economic conditions. Optimistic and Pessimistic Cases have been created to model economic scenarios considered possible, but less likely to occur than the “Base Case”. Over the five-year period, the Optimistic Case would generate a surplus of \$153.1 million, while the Pessimistic Case would result in a shortfall of \$79.5 million. It is important to note that due to the significant impact the pandemic has had on the local economy, it is challenging to forecast the economic recovery over the next five years.
- As this Forecast document was finalized, Russia invaded the sovereign nation of Ukraine. While the human toll of this conflict is already substantial, its economic impact to the City and the Five-Year Forecast is uncertain. Possible economic impacts associated with the invasion may include increased global energy prices, which may in turn prompt the Federal Reserve to take more immediate and significant action to counter inflation that would impede the currently forecasted economic growth. Negative impacts to financial markets may also result in lower than anticipated returns from the City’s retirement investments, which could cause an increase to the City’s contribution to the retirement systems beginning in 2023-2024. The Administration will closely monitor the conflict to assess its impact on the local economy. Any adjustments will be considered and brought forward in the 2022-2023 Proposed Budget process, as appropriate.
- The chart on page 4 compares the 2022-2023 General Fund Forecast to the 2021-2022 Adopted Budget. The combined result of the Adopted to Forecast changes is a General Fund surplus of \$27.7 million. Of the \$38.3 million General Fund ongoing shortfall resolved by the City Council’s approval of the 2021-2022 Adopted Operating Budget, \$31.6 million was resolved on a one-time basis, which is then carried forward as a starting point for 2022-2023. The next major comparison element is the change in revenue sources year-over-year. Ongoing revenues are projected to increase by \$141.9 million, driven primarily by increases in Sales Tax, Property Tax, Real Property Transfer Tax, Business Tax, Utility Taxes, Fees, Rates, and Charges (Parks, Recreation and Neighborhood Services Department Fee Activity), Transfers and Reimbursements, and the Fines, Forfeitures, and Penalties (Parking Fines) revenue estimates. When comparing expenditures (the third element), base costs are expected to increase by \$82.6 million from 2021-2022 ongoing budget levels, with the majority of the net cost increases associated with the allocation of revenues to corresponding reserves and employee compensation increases. Retirement contributions experience a net decrease from previously forecasted levels as a result of the strong market returns experienced in 2020-2021.

**2022-2023 General Fund Forecast
Reconciliation from 2021-2022 Adopted Budget**

2022-2023 General Fund Forecast Components (Ongoing)	\$ in Millions
Carry-Over from 2021-2022 Adopted Budget	(\$ 31.58)
Revenue Changes	
- Sales Tax	39.80
- Property Tax	31.50
- Real Property Transfer Tax	25.00
- Business Tax	11.50
- Utility Taxes	10.40
- Fees, Rates, and Charges (PRNS Fee Activity)	9.10
- Transfers and Reimbursements	8.50
- Fines, Forfeitures, and Penalties (Parking Fines)	3.50
- Other Net Revenue Changes	2.60
Total Revenue Changes (Increase)	\$ 141.90
Expenditure Changes	
- Revenue Loss Reserve	\$ 30.00
- Employee Compensation	26.30
- Measure E Allocations – Housing and Homelessness Prevention	25.00
- Workers’ Compensation Claims	3.31
- Non-Personal/Equipment (Vehicle O&M, Electricity, Gas, and Police Fleet)	2.93
- Living Wage/Minimum Wage Program	2.47
- Health Insurance Plans	2.23
- Homeless Rapid Rehousing	2.00
- Non-Management Step and Management-Pay-for-Performance Program	1.98
- FirstNet: Police Department Service Costs & Mobile Device Management	1.00
- Contingency Reserve	1.00
- Committed Additions: Operations and Maintenance	0.99
- Janitorial Services	0.78
- Insurance Premiums	0.77
- Deferred Infrastructure and Maintenance Reserve	0.75
- Unanticipated/Emergency Maintenance	0.50
- Retirement Contributions	(14.40)
- Library Branch Hours and Operations	(0.90)
- Community Service Officer Staffing	(0.73)
- Other Net Expenditure Changes	(3.37)
Total Expenditure Changes (Increase)	\$ 82.61
2022-2023 Projected General Fund Surplus	\$ 27.71

- For the 2022-2023 General Fund Forecast, personal services costs continue to account for nearly three-quarters of the total cost in the General Fund. The personal services category is broken down into three major components: salaries and other compensation, retirement, and health and other fringe benefits. Of the \$970.8 million projected personal services total for 2022-2023, salary and other compensation costs total \$563.1 million (58.0% of projected personal services), retirement costs total \$340.4 million (35.1% of projected personal services), and health and

other fringe benefits costs total \$67.3 million (6.9% of projected personal services). In the out years of the forecast, annual personal services growth ranging from 1.1% to 2.0% is projected.

- Committed Additions, expenses that address previous City Council direction, are included and total \$1.0 million in 2022-2023, rising to \$20.0 million by the end of the forecast period. The largest expenses in this category are the operating and maintenance costs for Measure T bond projects, approved by voters in November 2018, such as Fire Stations 32 and 36, the Police Training Facility, and the full activation of South San José Police Substation.
- In approaching the 2022-2023 Proposed Budget, the Administration recommends the use of the budget balancing strategy guidelines outlined in this memorandum (2022-2023 City Manager's Budget Request). The *City of San José Budget Principles* and *Service Delivery Framework* (Appendix A) combined with City Council approval of the Mayor's March Budget Message will also guide the City's budget development efforts. The Administration recommends City Council approval of the proposed 2022-2023 City Manager's Budget Request, with any desired revisions, as part of the Mayor's March Budget Message review and approval scheduled for March 15, 2022.
- As discussed above, the anticipated surplus for 2022-2023 does not include a range of existing service gaps that impact our community. There are also unmet/deferred infrastructure and maintenance needs that will have a long-term impact on the City. Looking forward, the Administration's goal is to ensure multi-year fiscal stability while also addressing, to the extent possible, the continued impacts from the pandemic, the City's basic service delivery needs, and the backlog of unmet/deferred infrastructure and maintenance needs.
- The attached *City Budget Program Guide* sets an initial baseline for how General Fund resources are currently allocated by City Service Area, Core Service, and Budget Program in the 2022-2023 Base Budget. The City Budget Program Guide will be refined and expanded as part of the 2022-2023 Proposed Budget development process to include budgeted expenditures of all funds, as well as the budget development direction contained within the Mayor's March Budget Message. This guide will serve as one tool to aid in the discussion of budgetary resource alignment with key City service delivery outcomes and performance as part of the 2022-2023 Proposed Operating Budget and 2022-2023 Proposed Budget Study Sessions.
- Projections for the selected CIP revenues are also included in this document. These revenue estimates of \$413.9 million are 11.6% higher than the estimate used to develop the 2022-2026 Adopted CIP (\$370.9 million), as the real estate market has remained strong in spite of the pandemic's impacts in other areas of the economy. When comparing the revenue estimates in this forecast to the 2022-2026 Adopted CIP, Construction and Conveyance Tax projections increased by \$46.0 million or 25.0%, Building and Structure Construction revenue estimates decreased by \$1.0 million or 1.0%, and Construction Excise Tax revenue estimates decreased by \$2.0 million or 2.3%. These three revenue estimates have a combined total of \$366.0 million.
- Consistent with past practice, as part of the preparation for the 2022-2023 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 2022-2023 City Manager's Budget Request and the 2023-2027 Five-Year Forecast and Revenue Projections for the General Fund and CIP. The City Manager's Budget Request and Five-Year Forecast are key components of the City's annual budget process and are critical steps in developing the City's annual Operating and Capital Budgets and the Five-Year CIP.

The City Manager's Budget Request includes budget balancing strategy guidelines that the Administration recommends for use in developing the 2022-2023 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 budgetary status for 2022-2023 is an integral part of the Administration's proposed approach to preparing the 2022-2023 budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2022-2023, and the subsequent four years, is provided as part of this document.

ANALYSIS

This section includes the following: a discussion of the 2022-2023 City Manager's Budget Request; an overview of the 2023-2027 Five-Year Forecast and Revenue Projections for the General Fund and CIP; and a description of the next steps in the 2022-2023 budget process.

2022-2023 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 2022-2023 Proposed Budget. These proposed guidelines were formulated in the context of General Fund projections that include incremental ongoing surplus that range from \$22.7 million to \$28.9 million (approximately 2% of the General Fund Base Budget expenditures), but are also mindful that the City needs to strategically allocate resources to address a service level/structural shortfall when considering community and economic recovery workstreams currently included in the American Rescue Plan Fund on a one-time basis and important community priorities currently funded in the General Fund on a one-time basis, as previously approved by the City Council.

The overarching goals of these guidelines are to align ongoing resources in the General Fund with the strategic allocation of limited resources to address the City Council's most important priorities. While approximately \$50 million of unallocated resources remains within the American Rescue Plan Fund and a sizeable amount of General Fund resources will be available on a one-time basis again in 2022-2023, it is critical to ensure that these resources are appropriately used to transition to a more sustainable service level that can be achieved on an ongoing basis without reliance on external resources.

In addition to City Council's approval of the Mayor's March Budget Message and priorities identified in prior City Council sessions, these budget balancing strategy guidelines will be used with the overall City Council-approved *City of San José Budget Principles and 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 2022-2023, a General Fund surplus of \$27.7 million is projected, representing approximately 2% of the General Fund Base Budget of \$1.3 billion. In the out years of the Forecast, General Fund surpluses ranging from \$22.7 million to \$28.9 million are projected. It is important to reiterate that these surpluses do not take into account a number of other important needs and services. When evaluating the annual General Fund surpluses projected in this Forecast, it is important to keep in mind that these figures do not incorporate impacts associated with:

- The costs to continue the community and economic recovery workstreams' services funded on a one-time basis in 2021-2022 by resources allocated from the American Rescue Plan Fund that totaled over \$100 million. Major items' workstreams funded on a one-time basis include, but are not limited to, the following: BeautifySJ Consolidated Model, San José Bridge Program, Expanded Dumpster Days, Vehicle Abatement, Continued Child and Youth Services, Digital Equity, Emergency Housing Construction and Operation, Continued Food Services, Eviction Help Center, Homeless Services Outreach Assistance + Resources (SOAR), Downtown Homeless Mental Health Response and Support, Resilience Corps, San José Abierto, San José Al Fresco, Small Business Outreach and Assistance Activities, and Supplemental Arts and Cultural Grant Funding.
- The costs to continue services funded on a one-time basis in 2021-2022 in the General Fund that totaled over \$20 million. Major items funded on a one-time basis that need to be evaluated for continued funding include the following: Police Sworn Hire Ahead Program, Beautify San José Landscape Maintenance Program, Parks Rehabilitation Strike and Capital Infrastructure Team, Foot Patrol in Downtown and High Needs Neighborhoods, San José 311 Enhancements, Community Service Officers, Urban Areas Security Initiative Grant Staffing, Library Branch Hours and Operations for Lower Resourced Communities, Police Public Records Team Staffing, Project Hope, Traffic Safety and Illegal Sideshows, Learning and Development Roadmap, Climate Smart San José Plan Implementation, Neighborhood Center Partner Program, Police Activities League Facilities Support, Proactive Legal Enforcement of Blighted and Nuisance Properties, Our City Forest, Park Strip Tree Planting, Language Access Coordination, Affordable Housing Portfolio Management Staffing, Santee Neighborhood Injunction Support, Accessory Dwelling Unit Ally Staffing, Blight Busters, and Disability Community Engagement and Service Evaluation.
- The costs associated with ongoing unmet/deferred infrastructure and maintenance needs that were updated and presented to the Transportation and Environment Committee on March 1, 2021 at \$19.0 million annually in the General Fund (\$92.8 million all funds). In addition, there is a one-time backlog of infrastructure needs totaling \$128.4 million in the General Fund (\$1.6 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.

Due to the above critical needs that are not captured in the \$27.7 million General Fund ongoing surplus projected for 2022-2023, the Administration considers that the General Fund is experiencing an ongoing service level/structural shortfall. To provide perspective on the relative size of the service level/structural shortfall for planning purposes, the \$27.7 million surplus is compared below with just 50% of the \$104.9 million allocated from the American Rescue Plan Fund in 2021-2022 and those services and programs funded on a one-time basis in the General Fund in 2021-2022.

**Estimated Service Level/Structural Shortfall in 2022-2023 for Planning Purposes
(\$ in Millions)**

	2022-2023
February 2022 Incremental Surplus/(Shortfall)	\$27.7 M
Community and Economic Recovery Workstreams in the American Rescue Plan Fund Continued at 50% of 2021-2022 Modified Budget Level	(\$52.5 M)
Programs Previously Funded on a One-Time Basis in the General Fund	(\$20.4 M)
Estimated Service Level/Structural Shortfall for Planning Purposes	(\$45.2 M)

The Administration looks to City Council’s upcoming approval of the Mayor’s March Budget Message to identify the most critical priority areas to allocate limited resources. The 2022-2023 Proposed Budget will focus on addressing those priority areas within available funding levels. While the positive outlook in the later years of the forecast allows for the opportunity to transition a portion of one-time funded initiatives to ongoing funded initiatives over a two to three-year period, achieving a structurally balanced budget from an ongoing service level perspective as soon as possible is critical to ensuring that the City remains nimble in future years to adapt to any unforeseen changes in the forecast.

As in past years, the Administration also 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, providing for limited technology investments, and/or building reserves to cushion against future budget uncertainties.

2022-2023 Budget Balancing Strategy Guidelines

The 2022-2023 Budget Balancing Strategy Guidelines, as shown below, provide recommended direction on the general approaches to use in the development of the 2022-2023 Proposed Budget.

2022-2023 Budget Balancing Strategy Guidelines

1. As directed by the priorities identified in the City Council-approved Mayor's March Budget Message, develop a budget that balances the City's delivery of the most essential services to the community with the resources available. Consider current needs in the context of long-term service delivery priorities.
2. Pose explicit questions of equity – including who benefits and who is burdened – when considering changes to City services to achieve a balanced budget.
3. As the City remains committed to balancing ongoing expenditures with ongoing revenues over the long term to maintain the City's high standards of fiscal integrity and budget management, use a combination of ongoing and one-time solutions to achieve a structurally balanced budget over a two to three-year period that prioritizes the incorporation of items previously funded on a one-time basis in the General Fund in 2021-2022 and community and economic recovery workstreams currently budgeted within the American Rescue Plan Fund.
4. To the extent possible, maintain or increase General Fund reserve levels to help address any unanticipated budgetary shortfall in the following year as a stopgap measure.
5. Evaluate program-level budgets and determine if there are opportunities to shift resources or reconfigure operations to improve service delivery, meet the objectives of the City Roadmap, generate new revenues, address truly significant community or organizational risks, fund services added on a one-time basis in 2021-2022, and/or respond to specific City Council direction. Review existing vacancies for opportunities to reorganize work groups to realize cost savings or to achieve current service level demands through alternative means. Factor in performance measure data in proposal development.
6. Focus on business process redesign to improve employee productivity and the quality, flexibility, and cost-effectiveness of service delivery (e.g., streamlining, simplifying, reorganizing functions, and reallocating resources).
7. Explore alternative service delivery models (e.g., partnerships with non-profit, public, or private sector for out- or in-sourcing services) to ensure no service overlap, reduce and/or share costs, and use City resources more efficiently and effectively.
8. Identify City policy changes that would enable/facilitate service delivery improvements or other budget balancing strategies to ensure equity and inclusion for how services are delivered.
9. Analyze non-personal/equipment/other costs, including contractual services, for cost savings opportunities. Contracts should be evaluated for their necessity to support City operations and to identify negotiation options to lower costs.
10. Explore expanding existing revenue sources and/or adding new revenue sources.
11. Establish a fees, charges and rates structure designed to fully recover operating costs, while considering the impacts on fee and rate payers whereby a cost recovery structure may be lower in certain circumstances, and explore opportunities to establish new fees and charges for services, where appropriate.
12. Focus any available one-time resources on investments that 1) continue high-priority programs funded on a one-time basis in 2021-2022 for which ongoing funding is not available; 2) address the City's unmet or deferred infrastructure needs; 3) leverage resources to or improve efficiency/effectiveness through technology and equipment or other one-time additions; 4) accelerate the pay down of existing debt obligations where applicable and appropriate; 5) increase budget stabilization reserves to address future budget uncertainty; and/or 6) provide for funding needs for non-bond eligible furniture, fixtures, and equipment associated with the continued implementation of Measure T.
13. Engage employees in department and/or city-wide 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.

City of San José Budget Principles, Service Delivery Framework, and Performance and Resource Alignment

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 effort when the City struggled with significant, persistent deficits. These principles, which were approved as part of the City Council's approval of the Mayor's March Budget Message for Fiscal Year 2008-2009 and subsequently amended on September 9, 2008, provide a meaningful framework for maintaining the fiscal discipline crucial to a large organization like the City of San José.

As the City Council is aware, it is important that the City take a holistic approach when either adding or reducing resources and programs. The Service Delivery Framework (included in *Appendix A*) provides a multi-pronged approach to delivering direct services to the community that takes into consideration various factors, including adequate strategic support resources, adequate infrastructure, service delivery methods to ensure efficient and effective operations, service delivery goals and current performance status, service sustainability, and staffing resources.

At the 2022-2023 Preliminary General Fund Forecast and Budget City Council Study Session held on January 14, 2022, the City Council expressed the desire to use the 2022-2023 budget development process to discuss how recommended resource allocations impact key City performance outcomes, measures, and programs. While the Proposed and Adopted Operating Budget documents contain an array of data related to City Service Area and Core Service performance and activity, there is certainly an opportunity to have a more direct discussion about how the allocation of existing and new resources may impact service delivery and outcomes for key priorities of the City Council and community. The 2022-2023 Proposed Operating Budget and 2022-2023 Proposed Budget Study Sessions will include this more direct focus. The City Budget Program Guide (included in *Appendix D*) will help set a baseline for how General Fund resources are allocated by City Service Area, Core Service, and Budget Program in the 2022-2023 Base Budget. The City Budget Program Guide will be expanded as part of the 2022-2023 Proposed Budget development process to also incorporate allocations for all funds rather than just the General Fund, and will include budget proposals and direction contained within the City Council-approved Mayor's March Budget Message.

The 2021-2022 City Council-approved City Roadmap identifies the most important programs, strategies, and policies to enact significant organizational change and drive service delivery improvement. The Administration recommends that development of the 2022-2023 City Roadmap be guided by City Council's approval of the Mayor's March Budget Message for Fiscal Year 2022-2023, to enable close alignment with policy direction, budget priorities, service delivery objectives, and available budgetary resources. A more detailed discussion on the process to adopt the 2022-2023 City Roadmap will be provided in a subsequent information memorandum.

2022-2023 Budget Process

As noted above, in addition to the forthcoming direction in the Mayor's March Budget Message, the Administration proposes the use of the general budget balancing strategy guidelines outlined above in the 2022-2023 City Manager's Budget Request combined with the overall City of San José Budget Principles and Service Delivery Framework to approach the 2022-2023 budget development process.

In December 2021, the Administration directed City departments to develop budget proposals using a draft version of the 2022-2023 Budget Balancing Strategy Guidelines. At that time, the Administration anticipated that the City's General Fund revenues and expenses would appear balanced in 2022-2023, but would experience an ongoing service level/structural shortfall. As a result, departments were directed to submit proposals to evaluate and recommend the continuation, where appropriate, of community and economic recovery workstreams and other high-priority programs currently funded on a one-time basis in the American Rescue Plan Fund and the General Fund.

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 priorities and needs. Budget proposals requesting a net addition of General Fund resources in addition to the initiatives previously funded on a one-time basis in 2021-2022 were to be limited to those that address truly significant community or organizational risks and/or respond to specific City Council direction. Departments overseeing special and capital funds were directed to develop proposals that balance within the total resources of the fund, identify the impact on fees or rates and, to the extent possible, minimize fee and rate increases. For those programs that have historically allocated resources equally city-wide, direction was given to work on enhancing or further developing a practice of place-based and equity-focused strategies to allocate these resources. The long-term goal is to fully align ongoing expenditures to ongoing revenues, prioritizing organizational stability as we build back capacity to address our significant service delivery and infrastructure needs.

The Mayor is currently anticipated to issue a proposed March Budget Message on March 7, 2022, which will then be discussed, amended if necessary, and adopted by the City Council on March 15, 2022. The contents of that Message will set forth key budget priorities for the preparation of the City Manager's 2022-2023 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 27, 2022 and May 2, 2022, respectively. As part of the 2022-2023 Mayor's March Budget Message, the Administration requests confirmation of the proposed 2022-2023 Budget Balancing Strategy Guidelines, with any desired revisions. As required by City Charter, those Proposed Budgets will contain allocations that 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 Budget Study Sessions and Public Hearings to discuss the budget and associated impacts on performance and service delivery. The Study Sessions will also include a focused discussion on key performance measures and on the development of the 2022-2023 City Roadmap. The Administration will also work with the Mayor and City Council to provide informational community meetings 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 2022.

2023-2027 FIVE-YEAR FORECAST AND REVENUE PROJECTIONS

The 2023-2027 Five-Year Forecast and Revenue Projections portion of this document is divided into five sections.

- I. **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.
- II. **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.
- III. **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.
- IV. **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.
- V. **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 CIP.

- VI. **Appendices** – Four appendices are also included in this document. *Appendix A* includes the following: 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. *Appendix D* consists of the City Budget Program Guide, that contains General Fund Base Budget expenditures and position allocations by City Service Area, Core Service, and Budget Program for each department.

2023-2027 General Fund Forecast

The following table displays the projected General Fund revenues and expenditures over the next five years and the total cumulative surplus. In addition to the cumulative surplus, the incremental surpluses (assuming each preceding surplus is expended completely with ongoing uses 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 attributed to a particular fiscal year. To the extent that a surplus is not expended on an ongoing basis, it is important to understand that the remaining budget surplus will carry over to the following year.

2023-2027 General Fund Five-Year Forecast
(\$ in Millions)

	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027
Projected Revenues	\$1,375.1	\$1,423.2	\$1,472.3	\$1,523.5	\$1,574.3
Projected Expenditures	\$1,347.4	\$1,369.5	\$1,395.0	\$1,423.6	\$1,445.5
Total Cumulative Surplus	\$27.7	\$53.7	\$77.3	\$99.9	\$128.8
Total Incremental Surplus	\$27.7	\$26.0	\$23.5	\$22.7	\$28.9
% of Budget (Based on Expenditures)	2.1%	1.9%	1.7%	1.6%	2.0%

Note: Does not include 1) costs associated with services that were funded on a one-time basis in 2021-2022; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) one-time revenue sources or expenditure needs.

In the 2023-2027 Forecast, a modest General Fund surplus of \$27.7 million is anticipated for 2022-2023, followed by incremental surpluses ranging from \$22.7 million to \$28.9 million over the next four years. These margins are relatively narrow when put into context of the size of the projected General Fund budget, ranging from 1.6% to 2.1% of the projected annual budget (based on expenditures), which ranges from \$1.3 billion to \$1.4 billion. However, as stated previously, there are significant expenditure components that are not incorporated into the Forecast, including programs funded on a one-time basis in 2021-2022, including funding to continue the City’s community and economic and recovery efforts, unmet/deferred infrastructure and maintenance needs, and one-time revenue sources or expenditure needs.

Given the decreasing level of precision to be expected in the later years of a multi-year forecast, the significance of the projections in the out years is not so much in terms of their absolute amounts, but rather in the relative size of the 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 2021-2022 Adopted Budget, the projected surplus of \$27.7 million for 2022-2023 is the result of carrying forward the \$31.6 million shortfall resolved in 2021-2022 on a one-time basis, improved revenues of \$141.9 million, and increased costs of \$82.6 million. General Fund revenues are estimated to improve by a net of \$141.9 million when compared to the ongoing revenue performance assumed in the 2021-2022 Adopted Budget. The largest increases include: Sales Tax (\$39.8 million), due to strong economic activity and relatively high levels of inflation; Property Tax (\$31.5 million), which is based off the most recent information provided by the County of Santa Clara; Real Property Transfer Tax (\$25.0 million), resulting from the continuation of a strong real estate market; Business Tax (\$11.5 million), due to the full resumption of cardroom operations and higher activity levels for Cannabis Business Tax; Utility Taxes (\$10.4 million), based on rate increases and usage projections; Fees, Rates, and Charges (\$9.1 million) due to a more normal level of fee activity from Parks, Recreation and Neighborhood Services Department operations; Transfers and Reimbursements (\$8.5 million), associated with various adjustments related to transfers from other City funds and overhead reimbursements; and Fines, Forfeitures, and Penalties (\$3.5 million), as parking fine revenues recover from pandemic lows. A description of major General Fund revenue categories is included as *Appendix B*.

On the expenditure side, a number of upward and downward adjustments have been incorporated into this Forecast resulting in a net increase of \$82.6 million in 2022-2023. The largest expenditure changes include: the continuation of the Revenue Loss Reserve, established as part of the 2021-2022 Mid-Year Budget Review, to set aside disputed revenues to address the potential negative impact to the General Fund in the event there is a final adverse determination regarding the ongoing allocation of tax revenues to the City (\$30.0 million); employee compensation increases (\$26.3 million) in accordance with existing labor agreements and estimation of future salary costs; increases for the allocation of Real Property Transfer Tax (Measure E) revenues toward affordable housing and homelessness prevention reserves and program administration (\$25.0 million); workers' compensation claims (\$3.3 million); city-wide vehicle operations and maintenance, electricity, gas, and police fleet replacements (\$2.9 million); compensation related to living and minimum wage adjustments (\$2.5 million); health insurance plans cost increases (\$2.2 million); non-management step and management pay-for-performance program (\$2.0 million); FirstNet service costs for the Police Department and mobile device management platform for FirstNet devices (\$1.0 million); operations and maintenance costs associated with capital projects anticipated to come online during the forecast period (\$1.0 million); contractual increases for city-wide janitorial services as previously approved by the City Council (\$783,000); an increase to the deferred infrastructure and maintenance reserve to be used as a funding source in the Proposed Budget to replace backlogged technology infrastructure and other public assets (\$750,000); an increase to address unanticipated and emergency maintenance and repair needs (\$500,000); a reduction to retirement contributions in accordance with calculated pensionable payroll and actuarial assumptions approved by the City's Retirement Boards (-\$14.4 million); the reinstatement of the reduction of Branch Library hours that was restored on a one-time basis in 2021-2022 (-\$900,000); and the expiration of five limit-dated Community Service Officer positions that were restored for a two-year period beginning in 2020-2021 (-\$730,000).

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

General Fund Committed Additions

Cost estimates for specific Committed Additions that address previous City Council direction are included in this Forecast in the years that they are projected to be required. The Committed Additions category, summarized in the chart below, reflects projected additional operating and maintenance costs for new or renovated capital projects in the 2022-2026 Adopted CIP, or for projects approved by the City Council during 2021-2022. The costs of the additions total \$1.0 million in 2022-2023 and increase to \$20.0 million by the end of the forecast period. Maintenance and operating costs in the first two years are largely due to the Fire Training Center and the Emergency Operations Center and Office of Emergency Management facilities that are scheduled to be completed and ready for use during the second half of 2022-2023. Starting in 2024-2025, costs are expected to increase significantly due to a number of additional Measure T bond funded projects, including new Fire Station 32, Fire Station 8 Relocation, Police Training Facility, and the 911 Call Center Expansion. Two additional fire station projects, new Fire Station 36 and Fire Station 23 Relocation, are scheduled to be completed in 2025-2026, further increasing the overall maintenance and operating costs.

**2023-2027 General Fund Committed Additions
Maintenance and Operations Costs**

	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027
New Parks and Recreation Facilities	\$248,000	\$512,000	\$1,486,000	\$1,666,000	\$1,785,000
New Traffic Infrastructure Assets	43,000	125,000	205,000	258,000	289,000
New Public Safety Facilities	204,000	513,000	932,000	2,668,000	2,767,000
Measure T Bond-funded Facilities	497,000	1,913,000	8,886,000	14,675,000	15,116,000
Total	\$992,000	\$3,063,000	\$11,509,000	\$19,267,000	\$19,957,000

A detailed listing of all committed additions with operating and maintenance costs are included in this 2023-2027 General Fund Forecast and can be found in *Section III - 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 shown in Chart A in *Section III - Committed Additions to the Base General Fund Forecast*.

Alternative Forecast Scenarios

To model the range of budgetary scenarios possible under varying economic conditions, two alternative forecasts have been developed in addition to the Base Case. Optimistic and Pessimistic cases model economic scenarios considered possible, but less likely to occur than the Base Case. These alternatives are presented in *Section IV – Alternative Forecast Scenarios* of the report to provide a framework that gives perspective to the Base Case. The Base Case Forecast is still considered, however, the most likely scenario and is being used for planning purposes for the 2022-2023 Proposed Operating Budget. It should be noted that the expenditure assumptions remain constant in each of these alternative scenarios.

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

	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	Five-Year Surplus
Base Case	\$27.7 M	\$26.0 M	\$23.5 M	\$22.7 M	\$ 28.9 M	\$128.8 M
Optimistic Case	\$51.7 M	\$28.8 M	\$5.4 M	\$29.3 M	\$38.0 M	\$153.1 M
Pessimistic Case	(\$1.0 M)	\$18.5 M	\$19.9 M	\$15.7 M	\$25.4 M	\$79.5 M

- *Base Case* – The Base Case Forecast is built on the assumption of the economy continuing to grow. The local region is anticipated to continue benefitting from a high level of venture capital investment in the technology industry, employment growth, moderating levels of inflation, and a strong real estate market. Over the forecast period, activity in most of these areas is expected to continue growing, but to a lesser extent than was experienced in 2021. Additionally, with the exception of the Transient Occupancy Tax, all economically sensitive City revenues are above pre-pandemic levels. Year-over-year growth for economically sensitive General Fund revenues such as Property Tax, Sales Tax, and Transient Occupancy Tax receipts will remain strong to moderate throughout the forecast period.
- *Optimistic Case* – The Optimistic Case Forecast assumes that the downward push on inflation from interest rate hikes occurs much later than anticipated in the Base Case. Venture capital investments, the key driver of the technology sector of the economy, are higher in each year of the forecast period in the Optimistic Case. As a result, the largest local technology employers are doing much better than in the Base Case. Local employment continues to expand at a high rate and, because of the solid employment growth, housing prices remain at higher levels through the entire forecast period. Higher inflation for a longer period of time is also expected in the Optimistic Case. This 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 Forecast assumes the adverse factor of rapidly increasing interest rates and lower inflation rates occurring much earlier than the Base Case. Slower growth is assumed for several of the key determinants of the City’s revenues; including, home prices and the number of property sales. However, this scenario does not assume an economic crash at the local, national, or international levels. In this scenario, economically sensitive revenues, particularly Property Tax and Sales Tax, are impacted by an economic slowdown.

Capital Revenue Forecast

Section V – Capital Revenue Forecast of this report describes the Capital Revenue Forecast that will be used to develop several major elements of the 2022-2023 Capital Budget and the 2023-2027 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 [2023-2027]). 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 2022-2026 Adopted CIP. As shown below, revenues are anticipated to increase by 12% compared to the Adopted CIP, from \$370.9 million to \$413.9 million.

**Capital Revenue
Forecast Comparison Summary
(\$ in thousands)**

	2022-2026 Adopted	2023-2027 Forecast	Difference	% Change
Construction and Conveyance Tax	\$184,000	\$230,000	\$46,000	25%
Building and Structure Construction Tax	96,000	95,000	(1,000)	(1%)
Construction Excise Tax	86,000	84,000	(2,000)	(2%)
Municipal Water System Fees	375	375	0	0%
Residential Construction Tax	1,000	1,000	0	0%
Sanitary Sewer Connection Fee	2,500	2,500	0	0%
Storm Drainage Connection Fee	1,000	1,000	0	0%
TOTAL	\$370,875	\$413,875	\$43,000	12%

Real estate activity (primarily housing sales) determines the collection level of the Construction and Conveyance Tax. After reaching a record setting high at the time of \$49.0 million in 2005-2006, tax collections continuously fell following the real estate slowdown and financial market crisis, dropping to as low as \$20.5 million in 2008-2009. Collections began rebounding again in 2009-2010 and have been steadily increasing, hitting a new all-time high of \$53.1 million in 2020-2021. Collections in 2021-2022 are projected to end the year at \$60.0 million. This estimated collection level is 13% above the actual receipts received in 2020-2021, which is reflective of the strong housing market despite the pandemic. Collections in this extremely volatile revenue category are conservatively forecasted to drop to \$50.0 million in 2022-2023 and then drop to \$45.0 million for the remainder of the forecast period.

Construction activity valuation is anticipated to be lower than the prior year with \$1.1 billion in 2021-2022, a 41% decrease compared to \$1.9 billion in 2020-2021. Construction valuation is projected to increase in the first four years of the forecast period, going from \$1.2 billion in 2022-2023 to \$1.4 billion in 2025-2026 and staying at the same level in 2026-2027. These valuations are based on slow but steady increases in new construction activities in the residential and commercial categories. While the pandemic led to some interruptions in the local construction sector, the market showed resilience last year and this year as projects already in progress re-started after the shutdown and other permits were pulled for the first time. Though these estimates may be conservative, they are reflective of the uncertain development environment in the future and an acknowledgement that the extremely high activity experienced over the last several years will likely not continue at the same level.

The five-year projection for the Building and Structure Construction Tax collections total \$95.0 million, \$1.0 million below the estimate included in the 2022-2026 Adopted CIP. It is projected that collection estimates will remain at \$19 million for the forecast period as projects are completed and activity levels remain steady. Construction Excise Tax collections are projected to total \$84.0 million over the forecast period, \$2.0 million below the estimate included in the 2022-2026 Adopted CIP. It is projected that collections will increase from the 2021-2022 estimate of \$15.0 million to \$16.0 million in 2022-2023 and to \$17.0 million for the remainder of the forecast period as projects are completed and activity levels increase.

NEXT STEPS IN THE 2022-2023 BUDGET PROCESS

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

March 2022

- 2022-2023 Mayor's March Budget Message Released with Public Hearing; Amended/Approved by City Council

April 2022

- 2022-2023 Proposed Capital Budget and 2023-2027 Proposed CIP Released

May 2022

- 2022-2023 Proposed Operating Budget and 2022-2023 Proposed Fees and Charges Released
- 2022-2023 Community Budget Meetings
- City Council Study Sessions and Initial Public Hearing on 2022-2023 Proposed Operating Budget, 2022-2023 Proposed Capital Budget and 2023-2027 Proposed CIP, and 2022-2023 Proposed Fees and Charges

June 2022

- 2022-2023 Mayor's June Budget Message Released with Final Public Hearing; Amended/Approved by City Council
- 2022-2023 Operating Budget, 2022-2023 Capital Budget and 2023-2027 CIP, and 2022-2023 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 CIP. A modest General Fund surplus of \$27.7 million, approximately 2% of the General Fund budget, is projected in 2022-2023, followed by surpluses ranging from \$22.7 million to \$28.9 million. These margins are narrow when considering the size of the General Fund budget that totals \$1.3 billion to \$1.4 billion annually over the forecast period (1.6% - 2.0% of the budget).

As with all forecasts, there is uncertainty regarding the revenue and expenditure estimates contained in this document, especially as the recovery from the pandemic may continue to vary from economic projections, and as the world is impacted by Russia's invasion of the sovereign nation of Ukraine. It is also 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 2021-2022, including the substantial resources to support the City's community and economic recovery efforts funded in the American Rescue Plan Fund; 2) costs associated with unmet/deferred infrastructure and maintenance needs; and 3) one-time revenue sources or expenditure needs.

The revenue and expenditure projections for 2022-2023 will continue to be refined over the next several months as additional information becomes available. This includes additional Property Tax roll growth data that is updated each month, or any new economic data that would substantially alter assumed revenue growth across economically sensitive categories. Based on this additional data, any necessary adjustments will be incorporated into the 2022-2023 Proposed and Adopted Operating Budgets, as appropriate.

HONORABLE MAYOR AND CITY COUNCIL

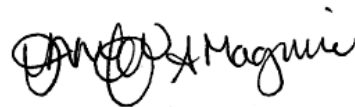
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This document also provides the recommended 2022-2023 City Manager's Budget Request (Budget Balancing Strategy Guidelines) for consideration by the City Council as part of its review of the Mayor's March Budget Message. The over-arching goals of these guidelines are to continue operational and fiscal stability while delivering services to our community in a cost-effective manner.

Over the past many years, the Mayor and City Council have remained committed to ensuring the fiscal health of the City while delivering essential services in the most cost-effective manner. Continued commitment to these strategies will help ensure a responsible approach to budgeting to ensure that the City can sustain critical community services into the future.

A handwritten signature in black ink, appearing to read "Jennifer A. Maguire". The signature is stylized and cursive.

Jennifer A. Maguire
City Manager