CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **2008-2009 CITY MANAGER'S BUDGET REQUEST AND 2009-2013 FIVE-YEAR FORECAST**

DATE: February 29, 2008

INFORMATION ONLY

EXECUTIVE SUMMARY

In compliance with City Charter Section 1204, and the City Council's adopted budget process, this document provides both the 2008-2009 City Manager's Budget Request and the 2009-2013 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program. Following are the major highlights of this report:

- The General Fund will continue to experience persistent shortfalls. In the 2009-2013 General Fund Forecast, deficits totaling $75.1 million are projected through the first four years, with a slight surplus of $2.5 million in the last year of the Forecast. These figures reflect the projected costs of delivering existing services and account for the majority of the City's General Fund structural deficit. At the Mayor's direction, however, the structural deficit definition has been expanded to include unmet/deferred infrastructure and maintenance needs and the unfunded liability associated with post-employment benefits, items that are not included in the Forecast model. The total General Fund structural deficit with these two components is estimated to total approximately $137 million.

- A General Fund deficit of $22.3 million is projected for 2008-2009, which is slightly below the $24.8 million projected in the 2009-2013 Preliminary Forecast released in November 2007 and the $25.5 million projected for 2008-2009 in the Five-Year Forecast released in February 2007. For the seventh consecutive year, budget actions will be necessary to address a General Fund shortfall.

- For 2008-2009, the slight improvement from November reflects the combined impact of downward adjustments to the revenue estimates of $10.5 million, reflecting the deteriorating economic environment, offset by improvements to the base expenditure estimates of $13.0 million based on net lower retirement and health contributions and new information from a thorough analysis of base costs. The lower retirement contributions reduce expenditures by $5 million annually in this Forecast. The 2008-2009 deficit would increase to $27.3 million if the $5 million in net savings generated from the lower retirement contributions were set aside to address the City's share of the annual required contribution associated with post-employment benefits. This approach would have to be evaluated in terms of the broader strategy to address this issue. The City Manager will bring forward a recommendation regarding this issue as part of the 2008-2009 Proposed Budget.

EXECUTIVE SUMMARY (CONT'D.)

- The second year of the Forecast (2009-2010) continues to have a sizeable deficit of $42.5 million, which has remained relatively consistent with the November 2007 figure of $41.8 million, but slightly above the February 2007 figure of $34.3 million. The majority of this shortfall reflects the scheduled sunsetting of the Emergency Communication System Support (ECSS) Fee along with the impact of a number of capital projects with sizeable operating and maintenance costs that are scheduled to come on line in that year. The variances in the last three years are minimal, ranging from a deficit of $5.5 million to a surplus of $2.5 million in the last year of the Forecast.
- Capital Program-related revenues are projected to decline slightly from the estimates provided in the Adopted Capital Improvement Program (2008-2012) due to the worsening situation for residential development activity and the dramatic decline in property transfers that impact the Construction and Conveyance Tax receipts.
- 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".
- It needs to be noted that the Forecast does not assume funding for several items, including: the liability associated with post-employment benefits; unmet/deferred infrastructure and maintenance needs; impacts associated with the planned annexations from the County and the expansion of North San José; and the potential impact on City revenues and expenditures if the San José Redevelopment Agency reaches it tax increment revenue cap and is unable to continue to fund various City support services.
- In approaching the 2008-2009 budget, the Administration proposes the use of the budget balancing strategy guidelines (2008-2009 City Manager's Budget Request) outlined in this memorandum. In addition, City Council priorities identified in prior policy sessions should guide the City's balancing strategy efforts. The Administration recommends City Council review and/or amend the proposed City Manager's Budget Request as part of the Mayor's March Budget Message review process.

BACKGROUND

The City Manager's Budget Request and Five-Year Forecast are key components of the City's annual budget process, and critical steps in the development of both the City's annual Operating and Capital Budgets and the Five-Year Capital Improvement Program (CIP). The City Manager's Budget Request includes the budget balancing strategy guidelines that the Administration recommends be used in developing the 2008-2009 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 fiscal status for 2008-2009 is an integral part of the Administration's proposed approach to preparing next year's budget, a detailed discussion of the key economic, revenue, and expenditure assumptions for 2008-2009, and the subsequent four years, is provided as part of the 2009-2013 Five-Year Forecast and Revenue Projections sections of this document.

ANALYSIS

This section includes the following: a discussion of the 2008-2009 City Manager's Budget Request, including a description of the proposed budget balancing guidelines; an overview of the 2009-2013 Five-Year Forecast and Revenue Projections; a summary of the 2009-2013 Five-Year General Fund Forecast; a summary of the Capital Revenue Forecast; and a description of the next steps in the 2008-2009 budget process.

2008-2009 City Manager's Budget Request

This document provides a set of budget balancing strategy guidelines (these encompass the 2008-2009 City Manager's Budget Request) as well as financial projections recommended by the City Administration for use in preparing the 2008-2009 budgets for the General Fund and selected Capital Funds. The recommended guidelines contained in the 2008-2009 City Manager's Budget Request have been formulated in the context of projections for a fiscal environment in which only modest growth rates for City General Fund revenues can be expected for the entire forecast period. Although we have provided two alternate Forecast scenarios that model the potential outcomes for more optimistic and more pessimistic conditions, the Administration recommends that the Base Case multi-year scenario be used as a backdrop for the City Council's immediate fiscal decision making.

The Forecast is built on the assumption that the deteriorating economic environment will result in lower revenue growth in 2008-2009 and 2009-2010 that will improve somewhat in the later years of the forecast. With only modest revenue growth, expenditure levels of existing General Fund programs are expected to exceed revenue sources in all but one of the five years covered by this Forecast. The result is projections for persistent General Fund shortfalls in four of the five years of the Forecast.

This forecast updates the November 2007 Preliminary General Fund Forecast that projected a $24.8 million shortfall next year. As discussed later in this Transmittal Memorandum and in greater detail in this document, these updated projections indicate a slightly smaller General Fund shortfall for 2008-2009 in the amount of $22.3 million, assuming that all of savings from the retirement contributions are applied to the 2008-2009 General Fund shortfall. However, if the retirement contribution savings of $5 million were set aside in a reserve to address the City's portion of the unfunded liability associated with post-employment benefits, the 2008-2009 shortfall would increase to $27.3 million. While the funding gaps resulting from these two options represent only 2.5% - 3% of the base expenditure level for 2008-2009, it will still present a significant challenge given the budget reductions that have already been sustained over the last six years.

In addition to the General Fund deficit presented in this Forecast that totals approximately $75 million over the next four years, there is a significant need for additional ongoing resources to address new and unfunded initiatives and programs. Of the many needs identified, unmet/deferred infrastructure and maintenance ($40.2 million ongoing need) as well as the unfunded liability in the City's two retirement systems associated with post-employment benefits

2008-2009 CITY MANAGER'S BUDGET REQUEST (CONT'D.)

($21.6 million annually – City's 50% of General Fund portion of remaining annual requirement for full pre-funding) have been incorporated into the General Fund structural deficit definition. These two funding needs alone would increase the General Fund structural deficit by almost $62 million, bringing the deficit figure to $137 million.

City-wide efforts are underway to develop strategies to address the General Fund structural deficit over a three-year period, with the first portion of the deficit ($22.3 million) addressed as part of the 2008-2009 budget process. To resolve the structural deficit, a multi-pronged approach will be necessary, including new and/or increased revenues, expenditure controls and shifts, service delivery model changes, and service reductions until such time as a structural balance can be achieved.

Projections for the selected Capital Improvement Program (CIP) revenues included in this Forecast have also been adjusted downwards from the last Forecast based on lower collection trends in these areas. For the major development-related capital budget revenues (which primarily support the Traffic Capital Budget), an overall decrease to the revenue estimates included in the prior CIP is forecasted, based on the lagging residential development activity projections provided by the Planning, Building and Code Enforcement Department and actual collection patterns. For the Construction and Conveyance (C&C) Tax, which supports a number of capital programs, it is anticipated that collections will continue to fall from the record setting levels experienced in recent years and will normalize at levels slightly below those assumed in the development of the last CIP.

As noted above, the Administration proposes the use of the budget balancing strategy guidelines (2008-2009 City Manager's Budget Request) outlined on the following page to approach the 2008-2009 budget development process. As part of the Mayor's March Budget Message, the Administration requests City Council consideration and confirmation, or revision, of these guidelines. These guidelines incorporate both short-term and long-term approaches to budget balancing efforts. These guidelines are similar to those adopted by the Mayor and City Council last year as part of the 2007-2008 Mayor's March Budget Message. The guidelines have been modified to strengthen the language on addressing the budget shortfall with ongoing solutions. This approach will help ensure that the budget actions approved for the upcoming fiscal year will not increase the General Fund structural deficit in future years.

In addition to the budget balancing strategy guidelines, City Council priorities and goals identified in prior policy sessions would guide the City's budget balancing efforts. Input from the community through community surveys, various City Councilmember and stakeholder outreach activities, the San José Neighborhood Association Priority Setting Session, and the work to-date on eliminating the General Fund structural deficit will also serve as an important tool in this process. It is anticipated that feedback from these efforts will also be incorporated into the Mayor's March Budget Message.

2008-2009 City Manager's Budget Request (Cont'd.)

Budget Balancing Strategy Guidelines

1. Develop a budget that balances the City's delivery of essential services to the community, including building strong neighborhoods and supporting economic growth, with the resources available.

2. Resolve the projected budget deficit with ongoing revenue and expenditure solutions to ensure no negative impact on future budgets. Use one-time funding sources only to address one-time funding needs to maintain the City's high standards of fiscal integrity and financial management.

3. Use fee increases, where possible, to assure that operating costs are fully covered by fee revenue and explore opportunities to establish new fees for services where appropriate.

4. Explore expanding and/or re-directing existing revenue sources and/or adding new revenue sources (i.e., special assessments, ordinance revisions, bond measures) for addressing both the structural deficit and unfunded needs, such as infrastructure maintenance backlog or the unfunded liability associated with post-employment health benefits.

5. Focus on protecting vital core City services for both the short- and long-term. Analyze all existing services and target service reductions or eliminations in those areas that are least essential.

6. Defer any new program commitments and initiatives or program expansions, unless those program commitments stimulate the local economy, job creation, new revenues and/or are funded through redeployment of existing resources.

7. Consider alternative service delivery mechanisms (e.g., appropriate community partnerships, public-private partnerships, working with other jurisdictions, outsourcing/insourcing services delivered by City staff, etc.) to ensure no service overlap, reduce and/or share costs, and use our resources more efficiently and effectively.

8. Focus on improving employee productivity and business practices, including streamlining, innovating, and simplifying City operations (e.g., using technology) so that services can be delivered at a higher quality level, with better flexibility, and lower cost.

9. Use the General Plan as a primary long-term fiscal planning tool and link ability to provide City services to development policy decisions.

10. Continue to make community and employee involvement a priority for budget balancing idea development.

11. Make every effort to eliminate vacant positions, rather than filled positions, to limit the number of employee layoffs. As programs are reduced or eliminated, ensure that management and administration are reevaluated accordingly.

12. Explore personal services cost savings, subject to the meet and confer process where applicable, by 1) considering further incorporation of total compensation bargaining concepts into the meet and confer process and focusing on all personal services cost changes (e.g., salary step increases, benefit cost increases), 2) civilianizing more sworn positions, 3) exploring alternate benefit structures for new employees, and 4) changing employee/retiree health care benefit plan designs.

2008-2009 City Manager's Budget Request (Cont'd.)

In light of the current forecasted budgetary situation, the Administration directed each of the six current City Service Areas (CSAs) (Community and Economic Development, Environmental and Utility Services, Neighborhood Services, Public Safety, Transportation and Aviation Services, and Strategic Support) to develop 2008-2009 budget proposals necessary to eliminate the projected General Fund shortfall using these guidelines. For planning purposes, budget reduction targets were set at 1.5% of General Fund Base Budget (adjusted for reimbursement-related costs and costs beyond control of CSA) amounts for the Public Safety CSA and 11.5% for the remaining five CSAs. These targets were set at a level to generate approximately $30 million in General Fund proposals.

The Mayor is scheduled to issue a proposed March Budget Message in early March, which will then be discussed and/or amended, and adopted by the City Council. The contents of that Message will provide specific guidance for the preparation of the City Manager's 2008-2009 Proposed Capital and Operating Budgets currently scheduled to be submitted on April 21, 2008 and May 1, 2008, respectively. As required by City Charter, those Proposed Budgets will contain comprehensive plans for how the City organization will meet the City Council's priorities and community service needs while maintaining the fiscal integrity of the City.

After the release of the Proposed Budgets, there will be a series of Proposed Budget Study Sessions and Public Hearings to discuss the budget proposals and the associated impacts on performance measures and service delivery. The Administration will also work with the City Council to provide informational meetings on the Proposed Budget in the various Council Districts. 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 2008.

2009-2013 Five-Year Forecast and Revenue Projections

The 2009-2013 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 the 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 a worksheet on the economic drivers (e.g., Gross Domestic Product, unemployment rates, etc.) that are expected to impact revenue collections over the next five years, and projections for each of the revenue and expenditure categories. The expenditure summary is divided into two sections:

2009-2013 Five-Year Forecast and Revenue Projections (Cont'd.)

- *Base Case without 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 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 considered in the forecast, including the financial impact in each year of the Five-Year Forecast.

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. These cases are compared with the Base Case, with committed additions, to show the range of growth rates for revenues and expenditures 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.

Two appendices are also included in this document. The first appendix, prepared by the Planning, Building and Code Enforcement Department, documents the basis for that department's five-year projections for construction activity. The second appendix provides descriptions of the City's major General Fund revenue categories.

2009-2013 Five-Year General Fund Forecast

The following table shows the projected revenues and expenditures for the General Fund Base Case over the next five years. The "incremental" shortfall (the amount which results assuming each preceding deficit is solved completely with ongoing solutions in the year it appears) for each of the four out years of the forecast is also included.

In addition to displaying the incremental shortfall for the Base Case Forecast, two additional Base Case options are presented. The first option shows the incremental shortfall that would result if the cost reductions associated with the retirement rate changes were not applied. This would increase the deficit by $5 million in 2008-2009. The second option shows the incremental shortfall that would result if the Emergency Communication System Support (ECSS) Fee did not sunset in 2009-2010. This would reduce the incremental shortfall in 2009-2010 by $23.4 million.

2009-2013 FIVE-YEAR GENERAL FUND FORECAST (CONT'D.)

2009-2013 GENERAL FUND FIVE-YEAR FORECAST

($ in Millions)

	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013
Projected Revenues	$ 856.0	$ 854.8	$ 881.6	$ 914.1	$ 950.5
Projected Expenditures	$ 878.3	$ 919.7	$ 951.9	$ 989.2	$ 1,023.0
Difference	($ 22.3)	($ 64.9)	($ 70.3)	($ 75.1)	($ 72.5)
Incremental Shortfall	**($ 22.3)**	**($ 42.5)**	**($ 5.5)**	**($ 4.7)**	**$ 2.5**
Incremental Shortfall w/o Retirement Rate Impact	*($ 27.3)*	*($ 42.5)*	*($ 5.5)*	*($ 4.7)*	*$ 2.5*
Incremental Shortfall w/ECSS Fee Extended	*($ 22.3)*	*($ 19.1)*	*($ 5.5)*	*($ 4.7)*	*$ 2.5*

The projected Base Case shortfall for 2008-2009 of $22.3 million is slightly improved from both the $25.5 million shortfall projected for 2008-2009 in the February 2007 Forecast and the $24.8 million shortfall projected in the November 2007 Preliminary Forecast, reflecting a series of updates to revenue and expenditure estimates. In the November Preliminary Forecast, both the revenue and expenditure estimates reflected increases from the February 2007 Forecast, with the increases in revenue slightly outpacing the increases in expenditures. The change from the Preliminary Forecast to this final Forecast, however, reflects a net downward adjustment of $10.5 million to the revenue estimate due to deteriorating economic conditions that is offset by a $13.0 million reduction to the base expenditure estimate.

The economically sensitive General Fund revenue estimates have been adjusted downwards based on a reexamination of all estimates in light of the worsening economic conditions. A downward adjustment to the Sales Tax category accounts for almost half of the decline, with a reduction of $4.7 million. Other categories impacted include Property Tax, Use of Money and Property (interest earnings), and Motor Vehicle In-Lieu payments. On the expenditure side, almost 40% of the reduction is the result of lower retirement contributions based on the latest actuarial studies. The remaining savings were based on a more in-depth review of the base costs. As discussed above, if the benefit from the lower retirement contributions was not factored into the forecast, this would increase the deficit by $5 million in 2008-2009. Recommendations regarding the potential use of these unexpected savings to address the City's long-term liability associated with post-employment benefits will be addressed in the 2008-2009 Proposed Budget.

It does need to be noted that the projected General Fund shortfall for 2008-2009 does not factor in impacts from the four Development Fee Programs (Building, Fire, Planning, and Public Works). These programs 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. It should

2009-2013 FIVE-YEAR GENERAL FUND FORECAST (CONT'D.)

also be noted that in two of these programs, Building and Public Works, there is a significant gap between the projected revenues and expenditures. The Administration will be working with the development community to develop recommendations to close these gaps through a combination of fee adjustments and cost reductions.

One-time funding of $7.3 million from the 2008-2009 Future Deficit Reserve that was established per City Council policy as part of the 2006-2007 Annual Report is also available for use in the 2008-2009 budget process. If this funding was used in its entirety to balance next year's budget, the 2008-2009 deficit could be reduced to $15 million. It is very important to reiterate, however, that this forecast uses an incremental approach to each year's projection. Under this approach it is assumed that the budget is completely balanced on an ongoing basis in each year. To the extent that a shortfall in any one year is closed using one-time measures such as the reserve referenced above, the shortfall in the following year would be increased by that amount. In accordance with the proposed budget balancing guidelines, the Administration will make every effort to use this and any other one-time funding sources to address one-time funding needs.

The incremental changes in this Forecast range from a deficit of $42.5 million in 2009-2010 to a small surplus of $2.5 million in 2012-2013. The large spike in the shortfall in 2009-2010 is based on the presumption that the Emergency Communication System Support Fee will sunset in that year, with a resulting loss of $23.4 million in revenue. The persistent shortfalls reflect the fact that revenue growth is projected to lag behind the expenditure growth in all but one of the Forecast years. In the last three years of the Forecast, the incremental shortfalls or surpluses are relatively small given the size of the City's budget. For instance, the incremental shortfall of $4.7 million in 2011-2012 of the Forecast reflects less than 1% of the projected expenditures in that year of almost $1 billion.

Some caution is in order, however, when considering the significance of out-year projections. 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.

Committed Additions

Reflecting previous City Council commitments, a number of specific "Committed" additions are included in this Base Case forecast in the years that they are projected to be required. The Committed Additions category primarily reflects projected maintenance and operating costs for new capital projects now in the Adopted Capital Improvement Program, including bond-financed libraries, community centers, parks and public safety facilities, and street improvements. Some of the larger facilities expected to come on line during this forecast period include the South San José Police Substation; Bascom, Solari, Roosevelt, and Mayfair Community Centers; and Willow Glen and Santa Teresa Branch Libraries.

2009-2013 FIVE-YEAR GENERAL FUND FORECAST (CONT'D.)

Three new items have been added to the Committed Additions section, when compared to the forecast released in February 2007. These include critical investments to replace cardiac monitors and defibrillators based on the product life-cycle, costs to maintain transportation infrastructure from planned County annexations, and the cost to retrofit the existing fleet of diesel powered vehicles based on State-mandated regulations.

Comparison of Base, Optimistic, and Pessimistic Cases

As has been the practice in these forecasts, in order to model the range of financial scenarios possible under varying economic conditions, two alternative forecasts have been developed. "Optimistic" and "Pessimistic" cases have been created to model economic scenarios considered possible, but less likely to occur than the "Base Case". In these scenarios, revenue collections and expenditure requirements can be seen to diverge from the Base Case over the five years. 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 for planning purposes. In developing these alternate cases, selected economic variables that are the primary drivers of the revenue estimates in the forecast model have been raised or lowered so that revenues are modeled at plausibly more optimistic or pessimistic levels. Salary increase assumptions have also been modified to model different potential compensation packages.

The Optimistic Case differs from the Base Case in that it is one in which general economic conditions are more favorable than those assumed by the Base Case. In the Optimistic Case, the local housing market begins to recover as a result of lower than expected interest rates. This housing market recovery affects property taxes directly through higher valuations and sales taxes and indirectly through higher consumer confidence and borrowing power. On the expenditure side, costs are lowered by assuming that salary increases would be 1% lower per year starting in the second year of the forecast when compared to the Base Case. By the end of the five-year period, revenues under this scenario would by $26.0 million higher and costs would be $26.9 million lower than in the Base Case. In the Optimistic Case, the City would experience deficits in the first two years of the Forecast of $9.2 million and $33.1 million, but would then have surpluses ranging from $4.4 million to $12.2 million per year in the remaining three years.

In the Pessimistic Case, a worsening of the housing market is assumed. Both home prices and home resale activity are much lower than in the Base Case. Typically, when home prices fall, consumer confidence tends to fall as does the ability to borrow in home equity markets. These events would have a significant impact on both property tax and sales tax. Local employment, one of the most important variables affecting local revenues, also falls in each year of this scenario. Lower local employment results from decreased demand for high tech goods at the national level and a lack of any significant innovation from the County's businesses. On the expenditure side, costs grow at a faster pace than in the Base Case. This scenario assumes that salary increases would be 1% higher per year starting in the second year of the forecast when compared to the Base Case. The Pessimistic Case also assumes that the Redevelopment Agency will reach its tax increment revenue cap and will be unable to continue funding various eligible City support services. Because the City would be unable to reduce all expenditures reimbursed

2009-2013 FIVE-YEAR GENERAL FUND FORECAST (CONT'D.)

by the Agency, such as funding for a portion of the Mayor and City Council and the Office of Economic Development, it is assumed that there is a net loss of approximately $6.1 million starting in 2009-2010. By the end of the five-year period, revenues under this scenario would be $63.0 million lower and costs would be $17.3 million higher than in the Base Case. In the Pessimistic Case, the annual deficits range from $15.8 million to $58.4 million.

Revenues/Expenditures Not Reflected in Forecast Model

There are a number of unfunded expenditure items currently being discussed as part of the City's overall General Fund Structural Deficit that are expected to impact the City's General Fund condition in the five-year period but are not fully reflected in this Forecast model. These include the impacts associated with any additional funding provided for unmet/deferred infrastructure and maintenance needs and the liability associated with post-employment benefits that are provided by the City. The Forecast model also does not include expenses associated with the planned annexations from the County, and the overall impact on revenues and expenditures that may develop from the expansion of North San José, and the potential impact on City revenues and expenditures if the San José Redevelopment Agency reaches its tax increment revenue cap and is unable to fund various eligible City support services.

As presented to the City Council previously, the estimated unfunded retiree healthcare liability for the City of San José is currently estimated to be well over $1 billion based on the most recent actuarial analyses. The Governmental Accounting Standards Board (GASB) Statements 43 and 45 now require public agencies to report the long-term liability for retiree health care and to record any portion of annual contributions that are not funded. It is currently estimated that additional funding of $21.6 million would be required annually to fund the General Fund portion of the City's 50% share of the remaining annual requirement for full pre-funding. A Retiree Health Care Team has been established to work with various stakeholder groups to develop potential strategies to address this liability.

The City's unmet/deferred infrastructure and maintenance backlog are also not reflected in this preliminary forecast. One-time needs of approximately $500 million in the General Fund ($900 million all funds) and ongoing General Fund needs of $40.2 million have been identified. These needs have been included as part of the work to eliminate the General Fund Structural Budget Deficit.

At this point, no revenue adjustments and minimal expenditure adjustments have been made to reflect the impact of annexations and the significant expansion associated with North San José. After additional analysis is completed, the projected revenue and expenditure impacts of these changes will be incorporated into the 2008-2009 Proposed Budget. In addition, if the Redevelopment Agency is no longer able to fund eligible City support services, the revenues and expenditures will be adjusted downward. As discussed above, it is unlikely that the City will be able to reduce all of the City services reimbursed by the Agency. The Pessimistic Case assumes the net loss in General Fund revenue associated with the Agency reaching its funding cap and discontinuing reimbursement of eligible City costs.

CAPITAL REVENUE FORECAST

Section Five of this report describes the 2009-2013 Capital Budget Revenue Forecast that will be used to formulate several major elements of the 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 Department and an analysis of actual collection patterns. The projections and their basis are described in a report prepared by that department, which is included as Appendix A of this document (Development Activity Highlights and Five-Year Forecast [2008-2013]). 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 2008-2012 Adopted CIP.

Forecast Comparison Summary
($ in Thousands)

	2008-2012 CIP	2009-2013 Forecast	Difference	Change
Construction and Conveyance (C&C) Tax	127,000	121,000	(6,000)	(5%)
Building and Structure Construction Tax	50,167	48,396	(1,771)	(4%)
Construction Excise Tax	72,203	70,026	(2,177)	(3%)
Residential Construction Tax	1,124	990	(134)	(12%)
Sanitary Sewer Connection Fee	6,305	5,599	(706)	(11%)
Storm Drainage Connection Fee	1,566	1,906	340	22%
TOTAL	**258,365**	**247,917**	**(10,448)**	**(4%)**

Real estate activity (primarily housing resales) determines the collection level of one of the major capital revenue sources, the Construction and Conveyance (C&C) Tax. The decline in the number of real estate transactions led by the recent sub-prime lending tightening continues to negatively impact collections. While a decline in Construction and Conveyance Tax revenues was predicted in the development of the 2008-2012 Forecast, recent information (October 2007 decline of 52% and December 2007 decline of 44%) indicates that collections have dropped quicker and further than previously anticipated, and likely will not improve in the near-future. Collections through January 2007 represented drops in 19 of the past 21 months when comparing to collections in the same month of the prior year. As a result, this category is projected to generate $121 million over the next five-years, a decrease of $6 million from the estimates assumed in the 2008-2012 Adopted CIP. The average annual collection level of $24.2 million projected in the 2009-2013 Forecast reflects a 10% drop from the 2007-2008 estimate of $27 million, but is well below the actual collection levels in recent years that reached a peak of $49 million in 2005-2006.

CAPITAL REVENUE FORECAST (CONT'D.)

The remaining five economically sensitive capital revenue categories are directly linked to development activity. Based on projections provided by the Planning, Building and Code Enforcement Department, construction activity is projected to remain relatively flat with valuation hovering around $1 billion in each of the next five years. These assumptions are slightly below those presented in the 2008-2012 Forecast. Construction activity peaked in 2000-2001 at $1.9 billion, followed by a sharp decline that reached a low point of $796 million in 2003-2004. From that low point, a modest recovery occurred in 2004-2005 with growth of 13% in that year. However, in 2005-2006, construction activity dipped again to $797 million, primarily due to a fall off of multi-family development to a ten-year low. A modest rebound driven primarily by commercial and industrial development and residential high rise construction in the downtown area occurred in 2006-2007 and is expected to continue in 2007-2008 and run through 2008-2009. This activity is then expected to flatten out at $1 billion and peak in 2010-2011, with slight decreases in activity projected for 2011-2012 and 2012-2013. Based on the construction activity estimates and a review of revenue collection patterns, a decrease in construction-related taxes and fees of $10.4 million, or 4%, is expected when comparing the 2009-2013 Forecast to the 2008-2012 Adopted CIP estimates.

NEXT STEPS

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

March 2008

- 2008-2009 Mayor's March Budget Message released with public hearing and amendments/ approval by City Council.

April 2008

- 2008-2009 Proposed Capital Budget and 2009-2013 Capital Improvement Program released.

May 2008

- 2008-2009 Proposed Operating Budget and 2008-2009 Proposed Fees and Charges released.
- City Council Study Sessions and initial Public Hearing on 2008-2009 Proposed Operating Budget, 2009-2013 Proposed Capital Budget and Capital Improvement Program, and 2008-2009 Proposed Fees and Charges

June 2008

- 2008-2009 Mayor's June Budget Message released and amended/approved by City Council.
- 2008-2009 Operating Budget, 2008-2009 Capital Budget and 2009-2013 Capital Improvement Program, and 2008-2009 Fees and Charges – City Council adoption.

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 Program. The estimated 2008-2009 General Fund deficit of $22.3 million is relatively consistent with the $25.5 million deficit forecasted for 2008-2009 at this time last year and the November 2007 deficit figure of $24.8 million if one does not assume that a portion of the $5 million in net savings from City retirement contributions are set aside to address the liability associated with post-employment benefits. While the figures remain relatively unchanged, this was the result of some sizeable offsetting revenue and expenditure adjustments. A softening economy that is verging on a recession provides the backdrop for this Forecast. This marks a shift from the November Forecast that had assumed that the economy would experience moderate growth while continuing to be impacted by the slowdown in the housing market. This Forecast assumes much slower growth in the economically sensitive revenue categories. It should be noted that the deteriorating economic conditions projected in this Forecast are still expected to be much less severe and of a shorter duration than the protracted slowdown experienced in the early part of this decade.

The revenue and expenditure projections for the 2008-2009 fiscal year will continue to be refined over the next couple of months as additional information becomes available. Any adjustments will be incorporated into the 2008-2009 Proposed Operating Budget.

Give the continuing fiscal challenges that the City faces, it is important that we remain committed to the sound fiscal policies and practices that has served the City well in the past. A combination of strong leadership from the Mayor and City Council, collaboration with the many stakeholders, and a strategic approach to delivering City services will be necessary to develop a budget that will continue to provide our residents and businesses with quality services.

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