



Memorandum

TO: City Council

FROM: Mayor Ron Gonzales

SUBJECT: Preliminary March Budget Message for Fiscal Year 2006-2007

DATE: March 2, 2006

A handwritten signature in black ink, appearing to read "Ron Gonzales".

Approved:

Date:

RECOMMENDATION

I recommend that the City Council direct the City Manager to submit a proposed balanced budget for Fiscal Year 2006-2007 that will be guided by the policy direction and framework of priorities outlined in the final March Message that will be considered for approval on March 21st. Proposals for budget reductions or augmentations should be developed with a level of analysis that includes performance measure and anticipated outcomes for Council consideration later this spring.

INTRODUCTION

As we approach the March Budget Message there are several key decisions that must be made prior to proceeding with detailed budget proposals. These key decisions include areas such as broad policy priority setting, use of one time versus ongoing funds to address the deficit and the relationship between public safety and non-public safety reductions as we move forward. With Council's emphasis on providing more input in this budget cycle, it is important that input on these broad areas be received before I develop and release specific proposals at the City Service Area level. This document focuses on broader policy level issues and the key decision areas mentioned above. The Council's first opportunity to discuss and provide input on these issues will be at the council meeting on March 7th.

Following the discussion at the March 7 Council meeting, I will release a more detailed Budget Message later in the week with proposals at the City Service Area level in accordance with direction provided by the Council.

This more detailed Mayor's March Budget Message will be the basis for our discussion at the March 16 study session. After the study session, I will release an addendum to the Budget Message based on the direction provided by Council on March 16. The Message will be considered for final approval at the March 21 Council meeting.

We are again faced with a budget shortfall for FY 2006-2007. Over the last four years, together we have continued to meet budget challenges and provide the excellent quality services expected by our community. In response to the continued economic slowdown, we have reduced the City's budget by \$263 million since 2002 through prudent financial planning and management, balancing our budgets through streamlining, vacancy savings, program reductions, sensible use of reserves, and other creative solutions.

As we prepare for the FY 2006-2007 budget process, we must do all we can to address current budget challenges, but also prepare for future budget deficits and take necessary steps to bridge the gap both now and in future years. The current projected budget shortfall threatens the City's ability to provide basic public services, jeopardizes our major initiatives, and limits our ability to stimulate the local economy. Current economic indicators suggest that the persistent local economic situation still has yet to fully recover and its impact on our revenues will require us to make tough choices and continue to think creatively about how we deliver services to our community. Recommendations are included in this budget message to incorporate alternative service delivery model ideas discussed in January that may help us find ways to deliver more or better services for less.

Preliminary forecasts suggested that the General Fund, which supports essential public services including police, fire, parks, youth services and libraries, might face a \$76 million shortfall next year. Our situation has improved and new indications suggest that the General Fund will face a \$36 million shortfall.

Understanding our budget challenges early, developing strategies that limit impacts to basic services, taking early steps to reduce costs, finding new ways to provide basic services to the community and delaying action again on the Redevelopment Agency capital program will help ensure that we can continue to have resources available to support San José's core services to the community and support strong neighborhoods, affordable housing initiatives, and economic development solutions.

This message is divided into several sections to facilitate the discussion scheduled for the March 7th City Council meeting and the March 16th City Council study session. I recommend at this time that there are several key decisions that the Council will need to make to provide final guidance to the Manager for budget preparations. The key decision areas are:

1. General Budget Recommendations
2. Mayor and Council Policy Priorities
3. Use of one-time versus ongoing funding solutions to overcome the projected deficit
4. City Service Area reductions
5. Redevelopment Agency and Department of Housing budget timeline

BACKGROUND

In accordance with Section 1204 of the San José City Charter, I present my FY 2006-07 Operating Budget Message for consideration by the City Council and the public. The Mayor's March Budget Message is based on several sources. These include my recent State of the City address and previous addresses; previous budget messages; input from the community and Councilmembers; and budget strategies already approved by the Council.

The goal of this memorandum is to provide an initial framework for the Council to give the City Manager specific directions on March 21st to prepare proposals for the Council's budget deliberations in May. The information in this document should be considered preliminary; more accurate and current information will be included in the proposed budget submitted by the City Manager. Further Council discussion and additional budget study sessions and public hearings will take place before the final budget is presented for adoption in June.

This year's Mid-Year Budget Report included some encouraging news about the City's economic situation, including anticipated growth in both property tax and sales tax generation, both of which exceed earlier projections. However, our costs to provide services to our residents and businesses continue to escalate.

For several years salaries have been frozen and we have severely limited hiring to fill vacancies reducing the size of our workforce. While negotiated salary increases have been approved this year, projected increase in expenses is driven less by salary increases or higher employment numbers than by other factors. Two of these factors include rising healthcare and retirement costs. Anticipated retirement costs for the Federated System are projected to increase by 28% for FY 2006-2007. Benefit costs continue to increase with next year's projections including a 16% increase in health insurance costs. This includes the recent contract agreements with employee groups to share the burden of these rising costs.

At this time, the State budget situation looks favorable in terms of local impacts. Voters approved Proposition 1A that provides constitutional protection for local revenues and prevents greater state take-aways in the future. This measure diverted \$11.1 million from our City's General Fund to the State last year. For FY 2006-2007, we will anticipate a restoration of this \$11.1 million and project no additional takeaways at this time.

In these still challenging economic times, we must continue to reduce costs and aim to maintain services, and we also must focus on our highest priorities, especially in this time of extremely limited resources. Governing means choosing – and we will have to make some tough choices again this year.

Finally, it is necessary for the Mayor and City Council to lead by example. I again ask each Councilmember for recommendations on spending reductions, current-year savings proposals, and other ideas to help reduce the deficit. Budget policy decisions set the stage for how we deliver services and establish what priority programs and services the city will provide to the

community. We have an opportunity this year to change the way we do business through Alternative Service Delivery model strategies. I look forward to this important effort.

In order to succeed, we must show the way by demonstrating our willingness to set priorities, make the difficult choices and stand with our City staff as we meet this challenge together.

GENERAL BUDGET RECOMMENDATIONS

1. As in the past, all proposals for budget reductions or augmentations should be measured against the following criteria:
 - a. Impact on essential public services
 - b. Adherence to Council-approved priorities
 - c. Relative importance to operational efficiency
 - d. Effect on fiscal integrity and flexibility
 - e. Economic impact and jobs

2. Because of the on-going budget challenges we continue to face, I reemphasize the following general principles approved by Council in past budget actions as we consider our direction to staff for preparing budgets for both the current and next fiscal year:
 - a. We must focus on protecting our vital core city services for both the short- and long-term.
 - b. We must use our resources strategically to stimulate our local economy and help create jobs.
 - c. We should continue to reduce vacant positions and redeploy staff as a response to our current budget deficit.
 - d. We must continue to streamline, innovate, and simplify our operations so that we can deliver services at a higher quality level, with better flexibility, at a lower cost.
 - e. We must be open to alternative ways to deliver services and reduce costs through appropriate community partnerships and public-private partnerships.
 - f. We must work together with our employee bargaining units to find ways to reduce costs that will limit the number of employee layoffs.
 - g. We must continue to move in the general direction of setting fees and charges that recover costs of service, but we also must include fee structures that charge higher fees to non San José residents to the extent legally possible.

- h. Budget reductions applied to City departments should be applied at generally the same level to our partner community-based organizations that receive General Fund support, with the goal of minimizing the impact on direct services to our residents and businesses.

3. The City Manager shall:

- a. Develop a proposed budget that is balanced based upon our current revenue expectations and expenditure reductions.
- b. Coordinate and aggressively pursue opportunities for the City (and community-based organizations with technical assistance from the City) to apply for grants to support programs in priority areas.
- c. Avoid budget cuts that would mean the City loses grants or cannot leverage other resources.
- d. Continue to include the Independent Police Auditor under the Public Safety CSA.
- e. Include all other Council Appointees' budget reduction proposals under the Strategic Support CSA for the May 1 budget release and include them in budget study session discussions during the Strategic Support CSA.
- f. Identify new proposed additions (e.g., new fire station personnel) within a CSA's department proposal, rather than only including it in the base budget.
- g. As we proceed on our decade of investment, we must move forward prudently. The Manager is directed to develop staffing plans with our first option being the use of existing staff. We must not be bound by traditional models of service delivery in anything we do.
- h. The Manager is directed to institute a policy that treats card room revenues as ongoing revenue if the future budget forecasts anticipates a deficit and converts to one-time revenue if a surplus is projected.

MAYOR AND CITY COUNCIL PRIORITY SETTING FOR FY 2006-2007

Councilmembers Campos and Williams had made an excellent recommendation that the Council take the time to have a more in-depth conversation about our priorities. I recommend that the City Council discuss in March the six core priorities that I have outlined in State of the City addresses and that have been endorsed by previous Council actions and the reorganization of our Council committee structure. After our discussion in March, I recommend that at the beginning of the May Study Sessions the Council participate in a facilitated review of the business plans and major strategies of each CSA (i.e. Economic Development Strategy) to confirm that we concur with current business plan priorities or provide input for revisions. These priorities are:

- **Building Stronger Neighborhoods (Committee chaired by Councilmember Chirco):**
We must continue to view our role through the eyes of our residents who see the direct impact of services from their driveways. Over the last several years we have made real progress in this direction as the City and residents have worked together to invest time, effort, and resources to improve neighborhoods and make San José a place we are all proud to call home.
- **Remaining the Safest Big City in America (Committee of the Whole chaired by Mayor Gonzales):** For the fifth year in a row, San José is the safest big city in America, and our residents feel safe in their neighborhoods. Additionally, for several years now, our city continues to be recognized as one of the cities best prepared for disasters. Regardless of our budget situation, the safety of our residents and businesses must remain our first priority.
- **Helping All Children Achieve (Committee chaired by Councilmember Yeager):**
Even in difficult budget times, we must strive to strengthen the role of city government in improving student achievement so that every child in San José can have the opportunity to succeed.
- **Building Better Transportation (Committee chaired by Councilmember Cortese):**
We must continue to support a transportation system that provides safe and efficient access for residents and businesses, enhances our neighborhoods, and preserves our street infrastructure despite difficult budget times.
- **Driving a Strong Economy (Committee chaired by Councilmember Williams):** We continue to make San José the best place in America to do business, work, and live. We are the statewide leader for creating housing affordable for residents at all income levels. Despite the current recession, we have maintained a remarkably broad industrial base. Our downtown and neighborhoods offer a full range of exciting entertainment, cultural, and shopping opportunities. Through prudent planning and with a strategic economic development effort, the City can have a very positive impact on economic recovery that will help address our budget challenges and support long-term prosperity.
- **Making Government Work Better (Committee chaired by Councilmember Reed):**
We must continue to make San José a user-friendly city that delivers high quality services to residents and businesses with the greatest efficiency.

USE OF ONE-TIME VERSUS ONGOING REVENUES FOR BALANCING THE BUDGET

Over the past seven years, the City Council has shown tremendous fiscal restraint when considering the use of one-time fixes to deal with ongoing budget problems. Our fiscal prudence is evident with the formation of our policies dedicating the Ending Fund Balance to future deficit

reduction and the creation of the Economic Uncertainty Reserve and the Future Deficit Reserve. Historically, the City's practice has been to use a mix of one-time and ongoing sources of revenues and reductions to balance the budget.

There are three options for consideration during this year's budget cycle related to this issue:

1. Utilize only ongoing reductions to address this year's budget deficit.
2. Utilize all available one-time funds to balance the budget.
3. Use a mix of both sources as we have in the past.

I recommend that for 2006-07 we direct the Manager to follow option #3 and utilize a mix of one-time funds and ongoing funds to balance the budget. I would also recommend that we leave to the Manager the discretion to recommend the exact ratio between one-time and on-going funds.

We must recognize as we proceed that two factors should be taken into consideration as the Manager attempts to find the right balance between one time and ongoing resources. First and foremost, by cutting a cumulative \$263 million from our budget since 2002, we have severely reduced the City's ability to provide the quality services that our residents and businesses deserve. We have reduced resources again and again asking our employees to do more with less for too long. I argue that we run the risk of stretching employees beyond their capacity and seeing the quality of our services reduced below an acceptable level.

Secondly, local economic indicators show signs of a recovery that is beginning to benefit the City. My experience has been that government lags two to three years behind the economy in both downturns and upswings. Understanding this served us well when the decline began and this Council wisely began to set aside reserves to deal with the downward trend that was sure to follow. We did this even though our revenue streams had not yet been impacted by the general economic downturn. We have now seen sales tax and other revenue sources begin to recover.

CSA REDUCTIONS

Over the last few years, non-public safety departments and programs have been severely impacted as a result of limiting reductions to public safety services. The Council has historically provided direction that public safety programs are to be reduced at a lesser rate than non-public safety programs. The actual percentage of reductions for CSA's depends on the Council decision relating to the use of one-time versus ongoing funding to reduce the deficit. There are three options for determining the reductions for City Service Areas:

1. All CSA's have identical percentage reductions.
2. The Public Safety CSA has no reduction and non-public safety CSA's bear the weight of all reductions.
3. The Public Safety CSA has a minimal reduction target (1-3%) and the remainder of the CSA's must implement the percentage reduction target necessary to overcome the projected deficit.

Table 1 provides an example of the implications for each of the three options. Scenario #1 assumes the entire deficit is made up of reductions. Scenario #2 assumes that only \$25.9 million of the deficit is made up of reductions and the remainder comes from new revenue or other one-time sources.

Table 1

Scenario #1 \$35.9 million needed to solve deficit

Option	Public Safety percentage	Public Safety dollar amount	Non Public Safety percentage	Non Public Safety dollar amount
#1	7.1%	\$22,564,000	7.1%	\$1,333,600
#2	0.0%	\$0	19.1%	\$35,900,000
#3	2.5%	\$7,938,000	14.9%	\$27,962,000

Scenario #2 \$25.9 million needed to solve deficit

Option	Public Safety percentage	Public Safety dollar amount	Non Public Safety percentage	Non Public Safety dollar amount
#1	5.1%	\$16,280,999	5.1%	\$9,619,001
#2	0.0%	\$0	13.8%	\$25,900,000
#3	2.0%	\$6,351,000	10.4%	\$19,549,000

I recommend to the Council that we direct the Manager to move forward using option #3. While I firmly believe public safety is our number one priority, we must acknowledge that this single CSA makes up a majority of our general fund expenditures. A small reduction will yield tremendous savings. No reductions in public safety would require cuts too deep in other important areas such as libraries and youth services. However, even with a small reduction to public safety it is important to point out that there should be no reductions to patrol services, our basic policing service and no layoffs of sworn officers.

REDEVELOPMENT AGENCY AND DEPARTMENT OF HOUSING CAPITAL BUDGET TIMELINES

Redevelopment is a critical catalyst for our economic development, affordable housing and SNI programs. Our Redevelopment Agency's revenue projection for the coming year is again uncertain due to potential actions that will be taken by the County Assessor's Office on Proposition 8 Assessment Appeals. The Council as the Redevelopment Agency Board approved my recommendations over the last two years to delay action on the proposed Redevelopment CIP until August, after the County Assessor has provided information on current year assessment rolls. This has allowed us to be as aggressive as possible with first year in our five-year expenditure plan because we are certain about our revenue stream. When we are investing in our economy it is critical to move as quickly as possible to provide immediate impact.

I recommend continuing deferral of the Redevelopment Agency budget discussion for FY 2006-07 with our usual budget provisions in June, which allow for ongoing spending to occur between July 1 and final budget adoption.

We must also continue to be aggressive with our expenditures in our housing program. Since redevelopment revenues primarily fund our program, I recommend that the Council consider moving the Department of Housing's capital budget to the August timeframe to coincide with Redevelopment Agency budget deliberations.

UPCOMING BUDGET PROCESS

As we develop this year's budget in the face of continuing economic uncertainties, our principal goals must be to maintain our core services, plan for future budget deficits, avoid layoffs, and stimulate our local economy as much as possible.

I again call on my colleagues to actively seek proposals and ideas that will help us close our budget deficit by reducing costs, eliminating or deferring projects, or obtaining outside resources from grants and partners. The Manager is directed to provide Councilmembers with a schedule for when their suggestions and ideas are needed in order for staff to accurately estimate the potential savings and impacts on services and the community.

CONCLUSION

The overall goal of this message is to direct Council Appointees to develop their budget recommendations that reflect the policy priorities of the Mayor and Council. I have outlined a strategy that will balance our ability to continue providing basic services to our community, help our economy, build strong neighborhoods, stabilize our budget, and as much as possible, prevent the layoffs of the dedicated employees who serve the people of San José. I look forward to continued dialogue about these preliminary budget recommendations and urge approval by my colleagues.

COORDINATION

This memo has been coordinated with the City Manager, Redevelopment Agency Executive Director, City Auditor, and City Attorney.