

Memorandum

TO: SUNSHINE REFORM TASK FORCE

FROM: Dan McFadden

**SUBJECT: Staff Response to Cost
Benefit Analysis Referral**

DATE: April 6, 2007

At the Sunshine Reform Task Force meeting on March 1, 2007, Task Force member Bob Brownstein presented a proposal to reform the public process for major public subsidies. Staff provided an overview of its proposed methodology to implement a pilot cost-benefit analyses program for projects seeking public funding in response to the Mayor's Transition Committee recommendations.

At this meeting, the Task Force approved to adopt "in concept" Bob Brownstein's proposal amended to: 1) add "Commissions" and "Council Committee" to Recommendation #2 allowing a first hearing on a proposed subsidy to also be heard by a Council Committee or City Commission, and 2) include non-economic benefits (non-monetary) in the cost benefit analysis.

The Task Force requested that the City and Redevelopment Agency staff return in April 2007 with an analysis of the anticipated impact to current projects and recommendations for the Task Force's consideration (Task Force members Williams and Pulcrano casting dissenting votes).

The attachments to this transmittal include memorandums from the City's Chief Development Officer, Paul Krutko, and Redevelopment Executive Director Harry Mavrogenes.

On a personal note, it is my experience that economic impact studies are more art than science. Outcomes are dependent on assumptions and values. The greater the effort to quantify social outcomes, the greater the potential to wander away from the primary mission of the Sunshine Reform Task force (which is transparency) into the quagmire of political agendas and pursuit of the ultimate economic model. The latter seems to be outside our particular purpose, and may consume time which is necessary to complete our work.

Staff looks forward to discussing the recommendations at the Task Force's next meeting on April 19, 2007.


Dan McFadden
Deputy City Manager

Memorandum

TO: SUNSHINE REFORM TASK FORCE

FROM: PAUL KRUTKO
Chief Development Officer

SUBJECT: STAFF RESPONSE TO COST-BENEFIT ANALYSIS RECOMMENDATIONS **DATE:** APRIL 6, 2007

The City of San Jose has developed and adopted a ‘pilot program’ to incorporate the principles of cost-benefit analysis into its decision-making process for unanticipated projects requiring substantial city resources. The Sunshine Reform Task Force has also grappled with these issues and developed a series of recommendations about the content of cost-benefit analyses and the process by which such information would be made available. In this memorandum, staff proposes to include several of the Task Force’s recommendations into the City’s ‘pilot program,’ responds to the recommendations of the Sunshine Reform Task Force and describes the cost-benefit pilot program proposal.

Staff Inclusion of Sunshine Reform Task Force Recommendations

Many of the recommendations of the Sunshine Reform Task Force had previously been proposed by staff in the cost-benefit analysis ‘pilot program.’ However, the clarity of the Task Force recommendations has helped strengthen the proposed model for analysis.

Based upon the Task Force recommendations, staff proposes incorporating many of the ideas advanced by the Task Force into the pilot program. Specifically, staff will attempt to incorporate the following recommendations into its ‘pilot program’ (listed in categories proposed by the Task Force):

- Fiscal Impacts
 - Net projected tax revenues
 - Present value of funds to be expended, source of funds, and original intent of funds
 - Additional service costs directly attributable to project/event receiving funds
 - Environmental and infrastructure impacts

- Economic Impacts
 - Net change in employment
 - Net change in housing stock

- Accountability
 - Defined timeline for developing and releasing after-action reports
 - Options for City if project fails to meet projections

Staff agrees that the inclusion of these specific recommendations will strengthen the pilot program by providing clear information to the Council and members of the public prior to decisions being made, without adversely impacting the City's ability to respond to unanticipated opportunities. Staff responds directly to the recommendations advanced by the Task Force in the next section of this memo.

Background

On January 8, 2007, the Government Reform and Ethics Subcommittee of the Mayoral Transition Committee released its final recommendations for improving the openness of San Jose City Government. The report contained a recommendation for staff to provide the Council and the public with cost-benefit analyses of projects requiring public funds:

Recommendation: A cost benefit analysis must be submitted for all projects, activities, and events seeking public funding. An after action report/analysis must be performed to determine whether or not the City's interests were met.

Staff was tasked with responding to this and other recommendations advanced through the subcommittee report and reporting back to the Rules and Open Government Committee. Through extensive conversations and the CSA and department head levels, staff developed a cost-benefit analysis 'pilot program' which attempted to balance the need for the public to have access to additional information with the ability of the City to have the flexibility to seize significant opportunities that will benefit the community. On March 7, 2007, Members of the Rules Committee reviewed staff's proposal and advanced the report for the consideration of the full Council. On April 3, Council unanimously approved the pilot program with the additional direction to staff to work with the ultimate recommendations of the Sunshine Reform Task Force and to re-examine the eligibility criteria.

Staff Responses to Sunshine Reform Task Force Recommendations

As staff developed its 'pilot program,' members of the Sunshine Reform Task Force proposed additional recommendations about the process of providing the public with cost-benefit analysis information and the content of the analysis. At the Task Force's meeting on March 1, 2007, staff presented the 'pilot program' and agreed to respond directly to the recommendations advanced by the Task Force.

The following section lists the recommendations and the responses of staff:

1. The full staff proposal for a major public subsidy must be made available to the public 30 days before the City Council hears the issue.

Response: The newly adopted distribution requirements, based on the Reed Reforms and approved by the full Council on January 30, 2007, require staff proposals recommending expenditures of greater than one million dollars to be distributed no later than fourteen days prior to each Council Meeting, with approved exceptions. Memorandums that are presented to the Council Committees are required to be distributed seven days prior to any given meeting. The minutes and items typically report to Council two weeks after each Committee meeting (for example, items for the March 26 Community and Economic Development Committee will report to Council on April 10). By following the new requirements and having the Committees review projects requiring cost-benefit analyses, staff reports on will be available for no less than three full weeks of public review prior to Council action.

2. Before the City Council holds its first hearing on the proposed subsidy, the staff report shall be referred to a City Council Study Session, a Taxpayer Review Panel or a Commission. A Taxpayer Review Panel will be composed of San Jose residents with particular interests or expertise in evaluating the proposal. The Study Session or the Review Panel shall afford the public the specific, focused opportunity to raise questions regarding the subsidy that staff will have the obligation to answer at the formal City Council hearing on the issue.

Response: Staff recommends that proposals that require cost-benefit analyses should be evaluated through the existing Council Committee and Commission structure. This will provide ample opportunity for the public to raise questions which the Council Committee members could then direct staff to respond prior to the full Council taking action. In some instances, study sessions are held on significant public policy items to inform the Council and obtain input before the item is brought forward to the Council with specific recommendations for consideration. By working through the existing Council Committee structure, members of the public will have ample time to familiarize themselves with the proposals and have at least two opportunities for public comment.

Further, Council regularly defers action on items where there is substantive public interest and/or the Council requires additional information or analysis. Council is in complete control of its agenda and can set items for final consideration at its sole discretion.

3. The Staff Report on the subsidy proposal must include the following minimum information:
 - a. Cost-Benefit Analysis
 - i. Net tax revenues: A calculation of tax revenues generated by the subsidy minus tax revenues lost. For example, if a subsidized project replaces one

business with another the taxes generated from the former business must be subtracted from the taxes generated by the new business.

Response: Staff supports this recommendation and will clarify existing language within the pilot program proposal to ensure inclusion of projected net revenues, including the net present value of projected revenues, as a component of the analysis.

- ii. Fiscal opportunity cost: A description of the types and scale of services or projects that could have been funded by the amount of the subsidy. The fiscal opportunity cost will vary depending on the source of funds for the subsidy – the general fund, redevelopment funds, etc.

Response: Staff proposes that the term 'opportunity cost' is a misnomer if the intention of this recommendation is to require the clear identification of the source of the funds proposed to be used and whether the funds were earmarked for a particular purpose. Staff recommends renaming this section 'source of and restrictions upon proposed funds.' Staff proposes that cost-benefit analyses should highlight the present value of the funds to be expended on the item, the source of the funds, and the designated purpose of the funds proposed to be transferred. However, staff believes that listing all potential uses of funds is highly subjective and speculative as to be non-productive. Therefore, staff does not propose including opportunity cost opinions.

- iii. Impact on City Services: An estimate of any increase in city services, such as police services or road maintenance, that will be required for the subsidized project.

Response: Staff will list the anticipated costs of additional service needs that can be directly attributed to the project within the analysis.

- iv. Impact on Neighborhoods: A description of the effects on neighborhoods in the vicinity of the project, such as noise, traffic, pressure on public infrastructure and facilities, etc.

Response: The California Environmental Quality Act (CEQA) requires projects that meet certain criteria to submit an Environmental Impact Report that describes the effects of a proposed project on its surrounding area. This information is easily accessible and a summary of the findings appears on every Council action memorandum. Staff will highlight relevant information in the cost-benefit analysis about potential impacts that projects may have upon neighborhoods, such as noise pollution, environmental degradation, air quality, etc.

In addition, projects that will increase the demands upon public infrastructure and increase traffic congestion are required to conduct a traffic analysis that projects the impacts of the project and proposes remedies to mitigate any impact. Staff will also reference these potential impacts in its analyses.

b. Economic Effects

- i. Net job impact (categorized by wage and benefit level): An analysis of the number of jobs to be gained and lost categorized by wage and benefit level. If a project replaces an existing business or directly competes with an existing business, job losses should be estimated and subtracted from the total impact.

Response: A health, vibrant economy requires a wide range of jobs that are as diverse as San Jose's population. Jobs in driving industries, business support industries, and household serving industries are each critical elements to the success of the regional economy because they provide individuals with various skill levels with employment opportunities at various wage and benefit levels. Facilitating the creation and expansion of driving industry companies leads to catalytic effects whereby one driving industry job creates two to three business support and household serving jobs, while bringing new aggregate wealth into the community which is then redistributed through consumption.

Staff concurs with the proposal to include 'net new jobs' within the 'economic impact' section of a cost-benefit analysis. However, due to limited access to precise wage data and virtually no access to benefit data for companies, analysis at the employee level is exceptionally difficult. As such, staff will likely only be able to estimate the anticipated net change in total wage values at an aggregate level. In addition, insufficient data will make it difficult to determine whether job replacement or competition with existing businesses will occur or can be causally attributed to government support. Staff will propose which existing companies and businesses may be affected positively or negatively within the immediately adjacent area and differentiate whether the jobs created are likely to increase the aggregate wealth of the community.

- ii. Net housing impact (categorized by affordability): An analysis of the number of housing units gained and lost categorized by level of affordability. This analysis would also include a determination of the project's effect on housing demand.

Response: The entire Bay Area is challenged by the extremely large undersupply of housing. Recent estimates propose that as many as

375,000 additional housing units are be required over the next fifteen years above current production levels to adequately meet the increasing demand and stabilize housing values. Recent economic analyses suggest that despite a significant increase in the supply of housing, demand has remained relatively constant (inelastic) for houses valued below \$1 million. The magnitude of the undersupply of housing within the region will preclude staff from being able to show any impact of the overall demand for housing as a result of a single project.

To the extent that conducting 'housing demand analyses' hinders our ability to meet housing goals, it is clearly counterproductive. For this reason, staff proposes including 'net housing' information within the 'economic impact' component of a cost-benefit analysis, but does not recommend requiring 'housing demand-analysis.'

When evaluating any new housing proposals, it should also be noted that San Jose has consistently exceeded its 'fair share' of housing targets set forth by the Association of Bay Area Governments (ABAG), as well as its recommended development of affordable units, while it is struggling to fund municipal services due to escalating costs and increasing demand.

c. Accountability

- i. Schedule of reports back on progress to meet projected returns: A statement of the times at which staff will report back to the city council regarding the extent to which the project is actually generating the outcomes predicted in the staff proposal.

Response: The City will benefit from rigorous after-action analyses, which will provide insight and improve decision-making in the future. Staff agrees with the recommendation of the Mayor's Transition Committee to require 'after action' reports to compare the projected returns with the actual impacts. Within each cost-benefit analyses, staff will propose a timeline for conducting such after-action analysis.

Staff has proposed a 'pilot program' to conduct cost-benefit analyses of up to six City projects within the next year. After the completion of these analyses, staff will report back to Council on the performance of the pilot program, the associated costs, and the validity of the projections to date.

- ii. Options available if projected returns do not occur: An evaluation of the options available to the city if the project fails to meet all or any of its projected objectives.

Response: Staff will clearly state in the Council action memorandum what recourse the City may have should the performance targets not be achieved. For example, in some cases, staff has developed contractual repayment schedules if companies do not achieve projected results in some development agreements and will continue to do so where appropriate.

Staff will also compare performance data with the projected benefits to refine the assumptions within the cost-benefit model, sharpen the analysis and accuracy of future report, and learn lessons from experience.

City Cost-Benefit Analysis Pilot Program

In response to the Mayoral Transition Subcommittee on Government Reform and Ethics, staff developed the following pilot program. The document has been modified to incorporate direction from the City Council on April 3 and recommendations from the Sunshine Reform Task Force.

Proposed Definition:

Cost-benefit analysis is the process of weighing the total expected costs against the total expected benefits over time. In order to analyze the City of San Jose's return on investment, cost-benefit analysis should include analysis of quantitative, as well as qualitative, indicators of fiscal, economic, and other impacts (community, environmental, media, etc).

Components of Cost-Benefit Analysis:

Fiscal Analysis: The base component of a municipal cost-benefit analysis is a fiscal impact study, which would compare the projected total cost to the City to the total projected increase in City revenues/cost-avoidance. Fiscal calculations require a comparison of the long-term value of City investment, through a time value of money calculation, and the net projected revenues, such as property tax, sales tax, utility tax, and one time fees. A clearly defined standard would be required to ensure that all analysis conform to an objective system of measurement, which could regularly be checked with after-action analysis.

Economic Impact: In addition to a fiscal analysis, an economic impact study forecasts the changes in direct and indirect spending, employment, earnings, etc. Economic impacts of programs and projects would require consensus on the appropriate methodology to capture the ripple effects of City action, such as the increased sales in adjacent businesses from employees of a new business that received City funds.

Additional Impacts: The most difficult cost-benefit calculations are accounting for the social impacts (e.g. community, environmental, media) of various projects/events. For example, the City supports events for their economic impact, but, as a public entity, the City also supports

events because of their social benefits, such as community building/ celebration, strategic positioning, and media exposure. However, social benefits would need to be weighed against social costs, including environmental degradation, opportunity costs, traffic congestion, and other quality of life impacts.

The process of quantifying social benefits is often a costly and controversial process, with little agreement among stakeholders about the appropriate methodology weights that should be attached to various factors. Rather than attempting to quantify these abstract costs, staff proposes listing other impacts in Council memos to allow Council Members to judge the weight that should be attached. For example, a project where the fiscal and economic cost-benefit analysis is slightly positive, but negative environmental impacts are anticipated, would require the City Council to make a value judgment of how heavily to weigh the social costs of the project.

Proposed Pilot Program

The complexity and expense of thorough cost-benefit analysis limits the feasibility of requiring a cost-benefit analysis for all City projects as proposed within the Government Reform and Ethics Subcommittee Report. Further, current City staff does not have the expertise or the capacity to undertake the workload associated with true cost-benefit analyses, which requires a highly specialized and labor intensive process to develop objective measures of the costs and benefits of proposed Council actions.

Staff proposes that many projects do not warrant the expense associated with a thorough cost-benefit analysis, and, as such, proposes a pilot program that would provide basic in-house cost-benefit analysis for up to six projects within the next year. The preliminary criteria for the selection of projects will include those items/projects that require significant City funds, or significant impact on neighborhoods, city services, jobs and housing. The types of projects selected for analysis will also include a diverse range of allocations. Per Council directive, staff will work with the Council to identify 'special allocations' for analysis and develop the final eligibility criteria from lessons learned through the pilot program. Proposed projects for evaluation may include the Convention Center expansion, Hayes Mansion, city-owned golf course usage, Arts Stabilization Fund, disposal of old City Hall, FMC RFP Responses, the Soccer Stadium, the San Jose Grand Prix, and energy efficiency initiatives.

Staff proposes conducting these modified cost-benefit analyses in-house and focusing heavily upon the fiscal and economic impact of policy proposals, which would be similar to a private sector 'return on investment' calculation. This in-house analysis would compare the value of City investment over time and the net change in anticipated revenues, such as increased property tax, sales tax, utility tax, and one time fees. In addition, staff will evaluate the net change in service costs in the area directly affected by a project or event.

Further, staff will work to include non-fiscal costs and benefits of the project into the analyses, such as changes in net employment and housing stock, as well as the environmental and infrastructure impacts. Staff will also list projected social benefits, but will not assign monetary values to these highly subjective impacts. Attempts to quantify economic or other impacts further would likely require the services of an expert consultant to help staff develop

SUNSHINE REFORM TASK FORCE

Due Date: April 6, 2006

Subject: Staff Response to Cost-Benefit Analysis Recommendations

Page # 9

methodology for analyzing major types of expenditures anticipated such as physical building projects and development subsidies. However, such investment may allow staff to apply the developed methodology to future analyses.

In addition to the modified cost-benefit analysis, projects included in the pilot program would require after-action reports, which would be submitted following the completion of the project/event at a date delineated in the original cost-benefit analysis. The after-action report would be presented in a format that compares the results to the projected benefit in an effort to benchmark performance and improve the accuracy of the cost-benefit analysis process. The constant improvement of cost-benefit standards will assist the Council in evaluating studies by various developers and entities requesting City funds.

Staff proposes a thorough review of the performance of the 'pilot program' following the completion of six analyses to evaluate whether the program as designed is achieving its intended results and what improvements are necessary.

A handwritten signature in black ink, appearing to read "Paul Krutko". The signature is fluid and cursive, with a large initial "P" and a long horizontal stroke at the end.

PAUL KRUTKO
Chief Development Officer