

# ECONOMIC & DEVELOPMENT FORECAST

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## National, State & Regional Context

What a difference a year makes. This section of the budget one year ago contained the following excerpt:

*“[T]he State of California projects revenue growth to far exceed budget estimates. As of this writing, revenues are projected to be above the original budget forecast by \$5.7 billion in the current year, and \$5.5 billion in 2000-01, for a combined increase of nearly \$11.3 billion.”*

Since that time, the State’s experiment with deregulating the power industry has resulted in one of the most complicated and potentially significant political challenges in recent history. The following excerpt is from the State Legislative Analyst’s Office report on the Governor’s proposed 2001/02 budget:

*“One of the basic questions [the Legislature] faces involves the extent to which General Fund resources will be committed for such purposes as utility ratepayer relief, incentives for conservation, and increasing energy supplies. Given the enormous size of California’s economy and energy markets, and depending on the types of activities considered, General Fund fiscal exposure could easily surpass the one-time amount set aside in the budget for energy initiatives... In this regard, we recommend that the Legislature withhold consideration of \$2.3 billion of the Governor’s one-time proposals in the areas outside of energy until May, when the nature and costs of energy-related legislation are better known and the revenue outlook becomes clearer.”*

Combined with the significant uncertainty created by the energy crisis, economic indicators nationwide portend a slowing of the economy. The stock market has shown extreme volatility during the past year, with the high-technology sector particularly hard hit. Of course, many argue that the market was significantly overvalued for much of 1999 and 2000, and therefore the declines of the past six months reflect an expected correction. Regardless, the actions of the market may compound adverse effects of energy costs on the economy. These two issues provide cause for caution about future economic growth.

Current uncertainties notwithstanding, the greater Sacramento region continues to be a magnet for growth, with the San Francisco Bay Area supplying significant shares of such demand. Skyrocketing real estate prices, physical and political limitations to growth, and attendant growth-related issues such as traffic congestion have spurred significant migrations of state residents inland. The Sacramento region is expected to add another million residents over the next 20 years. Thus, growth pressures will be significant into the foreseeable future.

**City of Davis Outlook**

The City maintains a five-year forecasting model that focuses on the General Fund, Park Maintenance Fund, and Public Safety Fund, because the bulk of non-enterprise day-to-day operating expenditures are paid through these funds. The model begins with the current year (2000/2001) budget as the baseline. Assumptions about future growth in the community are added to provide the basis for estimating revenue growth. In addition to forecasting revenues, the model enables "what-if" analysis of various expenditure scenarios. The following table summarizes the key development assumptions that feed into the budget forecasting model.

**Key Budget Model Assumptions**

Variable	00-01e	01-02b	02-03e	03-04e	04-05e	05-06e	06-07e
Single Family Units	414	225	50	50	10	10	10
Multi-Family Units	194	169	100	100	0	0	0
Non-Residential Sq. Ft.	157,836	199,000	108,000	100,000	100,000	100,000	100,000
Population	60,200	62,200	63,185	63,560	63,935	63,960	63,985
Population Growth Rate		3.3%	1.6%	0.6%	0.6%	0.0%	0.0%
Total Housing Units	23,249	23,857	24,251	24,401	24,551	24,561	24,571
Inflation Rate	3.05%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Total Employment	11,153	11,755	12,387	12,788	13,159	13,530	13,900
Employment Growth Rate	NA	5.4%	5.4%	3.2%	2.9%	2.8%	2.7%

**b = budget    e = estimate**

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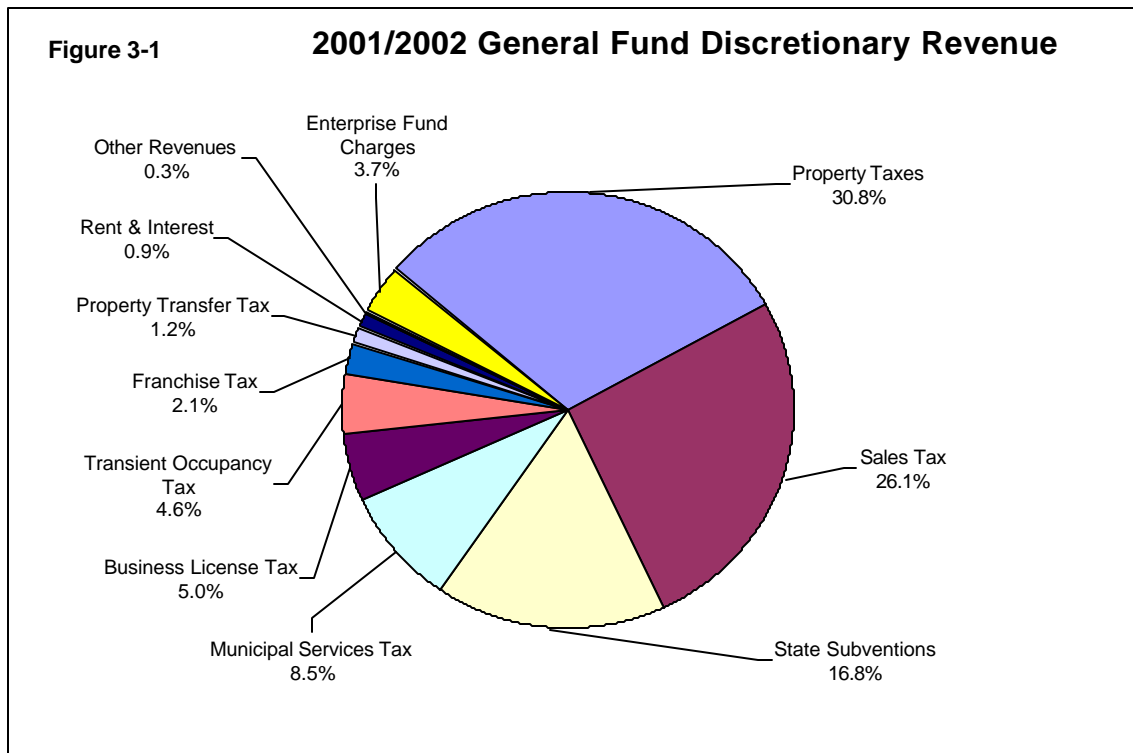
Although the national and state economic pictures provide ample cause for concern, the City of Davis faces challenges of its own. Several recent events suggest that with respect to real estate development, the Davis of the foreseeable future will differ significantly from the Davis of the past decade. First, the community voted in favor of Measure J, an initiative that requires voter approval for most General Plan amendments and/or annexations of land to the City that would enable significant new development. Second, Measure O created an Open Space tax that will enable the City to purchase and preserve open space lands around the City. Finally, the preliminary direction provided by the City Council in the General Plan update reduces the available land for residential development by removing the urban land use designation on the Covell Center property.

The bane of financial forecasters is the simple fact that we tend to underestimate revenues during good times, and overestimate revenues during bad times. The 2000/2001 budget year is no exception, as it now appears that General Fund revenues will outpace our estimates from last year by about 15 percent, led by large gains in sales tax, property tax, and business license revenues. These revenues track closely with general economic conditions and development activity, although receipt of such revenues tends to lag the activity that generates them by up to six months. Despite indications that both development and the economy are slowing, it is difficult to know when the corner will be or has been turned.

During the past decade, the City has issued an average of 366 single family building permits each year. Next year, that number is expected to be about 225 units, after which it is estimated that there will remain approximately 100 undeveloped lots within the City. While much more variable, an average of about 190 multi-family residential units have been built during the past decade. Similar to the potential for single family development, the remaining vacant land designated for multi-family development may generate another 200 units

or so. Finally, non-residential development potential, though less constrained by land availability tends to be more cyclical and thus more difficult to predict. We conservatively assume continuation of past average annual trends.

The discerning reader may wonder about the focus on real estate development in the context of forecasting City budget impacts. Significant components of the City's discretionary revenue are connected to development activity. Figure 3-1 illustrates the composition of General Fund discretionary revenue. About 82% of such revenues derive from the four largest sources of revenue; property tax, sales & use tax, state subventions, and the municipal services tax. All of these revenue sources are affected by development activity, as discussed below.

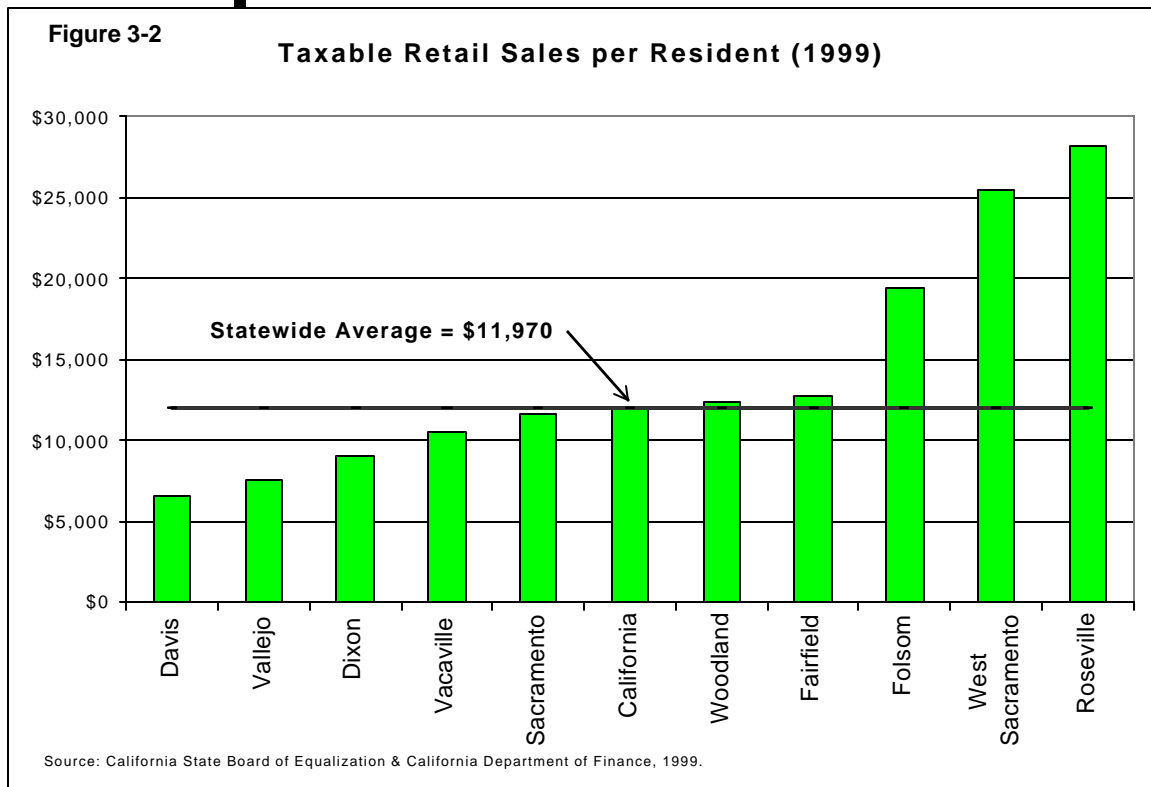


- Property Taxes.** Property tax revenue derives from a one-percent tax levy on the assessed valuation of real property within the city of Davis. The assessed valuation is equal to the market price when real estate is sold, but limited by the State Constitution (Proposition 13) to a 2 percent annual increase thereafter. During the past decade, inflation has averaged about three percent per year. Thus, Proposition 13 limits the growth in this revenue source to less than the average inflation rate unless, 1) significant new development activity serves to bolster the remaining stagnating tax base, or 2) property is resold in an appreciating real estate market.

The projected decline in new development activity is thus expected to result in much more moderate growth of this revenue source in the near future. First, new development will comprise a much smaller share of the existing property tax base. Second, resale (and thus reassessment) of existing property is expected to decline as the decrease in new development will afford fewer “move up” opportunities for existing property owners. Absent new housing stock, sales of existing property will be

largely limited to those units where residents are leaving Davis, or when rental housing is placed on the market.

- Sales Taxes** Sales tax revenue derives from one percent of the sale price on taxable products sold within the city of Davis. As is widely known, Davis' sales tax base is largely a local-serving one. That is, most of the city's retail base is aimed at supplying local goods and services rather than drawing customers from the larger region. In addition, a significant amount of local residents' purchases are made outside of the City. This so-called "sales leakage" results in lower average sales in Davis compared to other cities in the regions. Figure 3-2 illustrates this effect by comparing taxable sales in Davis to those in neighboring communities in 1999, the latest year for which complete data are available.



Because the Davis retail sales base is largely local-serving (with the notable exception of automobile dealers), future growth in sales tax revenue is expected to be tied to changes in local population. Given the projected decline in residential and presumed commensurate decline in population growth, sales tax growth is projected to be more moderate than in the past. Of course, regional economic conditions, to which the City is not immune, may likewise affect sales tax growth.

- Motor Vehicle In-lieu Fees** These revenues derive from registration of vehicles throughout the state, and are distributed by the State to cities and counties on a per capita basis. Revenues are up this year, reflecting the effect of rising incomes on people's choices to purchase more expensive cars, as well as recent population growth in Davis. However, when one examines the long-term trend, this revenue source tracks very closely to changes in population and inflation. Thus, our budget forecasting model projects this revenue based on current per capita multipliers applied to estimates of future population growth.

- **Municipal Services Tax.** The Municipal Services Tax is a parcel tax imposed on all property with the city. The rate varies with land use and parcel size. The implementing ordinance contains a three-percent annual escalator, which generally enables this tax to keep pace with inflation. However, as noted above, because the residential portion of the current General Plan is largely built out, we forecast relatively few new parcels being created in the next five years. As a result, relatively little new revenue beyond the three percent inflation factor is expected from this source.

As noted above, two other revenue sources supplement the General Fund in paying for the bulk of non-enterprise funded operating expenditures: the park maintenance tax and public safety tax. Each is described below.

- **Parks Maintenance Tax.** The Parks Maintenance Tax was enacted by voter approval of Measure M in June of 1998. It is imposed as a parcel tax on property owner's annual property tax bills, at a rate of \$49 per residential unit (non-residential properties pay different rates, though of similar magnitude). Measure M contains no escalator in the tax rate, thus the only growth in this revenue source comes from creation of new taxable parcels. Given that few new parcels are anticipated to be created within the current General Plan, little growth is expected in this revenue source. In addition, the absence of an inflator causes the constant revenue stream to lose purchasing power to inflation over time.

The current tax will expire in June of 2002. The City Council placed on the June 5, 2001 ballot a proposal (Measure S) to double the current tax rate, to generate an additional \$1.2 million for park and open space maintenance needs. Despite receiving nearly three "yes" votes for every two "no" votes (59.5%), Measure S failed to receive the 2/3 voter approval needed for passage. Per Council direction, the preliminary budget was built assuming passage of Measure S. Failure of Measure S required substantial budget reductions to maintain the City's fund balance policies.

- **Public Safety Tax.** The Public Safety Tax has been collected since 1986. As its name implies, the tax is a special purpose tax, with proceeds required to be spent on public safety services; it is generally split between the Police and Fire Departments. The Public Safety Tax is a parcel-based tax, with a rate calculated based on type of land use (e.g., residential versus non-residential) and lot size.

Unlike the Parks Tax, the Public Safety Tax has an escalator factor built into it. However, Proposition 62, which was enacted in 1986, imposed voting requirements on essentially all new local government taxes, and thus the inflator has never been invoked. Because the Public Safety Tax is parcel based and does not change with inflation, it has the same structural problem as the Parks Maintenance Tax in that it loses purchasing power over time.

### Expenditure Projections

The preceding discussion provides some context for understanding the revenue side of the budget model projections. On the expenditure side, the model begins with the preliminary 2001/2002 budget as a baseline, then applies growth assumptions to the various components of that base budget (e.g., salary costs, materials and supplies, etc.). In addition, the model includes estimates of future expenditures that are not part of the existing base

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***"... the model includes estimates of future expenditures that are not part of the existing base budget, but are anticipated."***

budget, but are anticipated based on Council direction and/or planned service expansions.

The primary components of existing expenditures are personnel costs (salaries, leave time, insurance, and retirement costs), operating costs (including supplies and materials, contractual services, etc.) and capital outlay (e.g., equipment, furniture, etc.). Based on currently adopted memoranda of understanding with employee bargaining groups, and historical data related to insurance and retirement costs, the budget model assumptions applied to the base budget include:

- Wages & leave time: 4% annual growth
- Insurance costs: 12.5% annual growth
- Retirement costs: 0% (except for police & fire, see following section)
- All other costs: 2% annual growth

Items assumed in addition to the current base budget include:

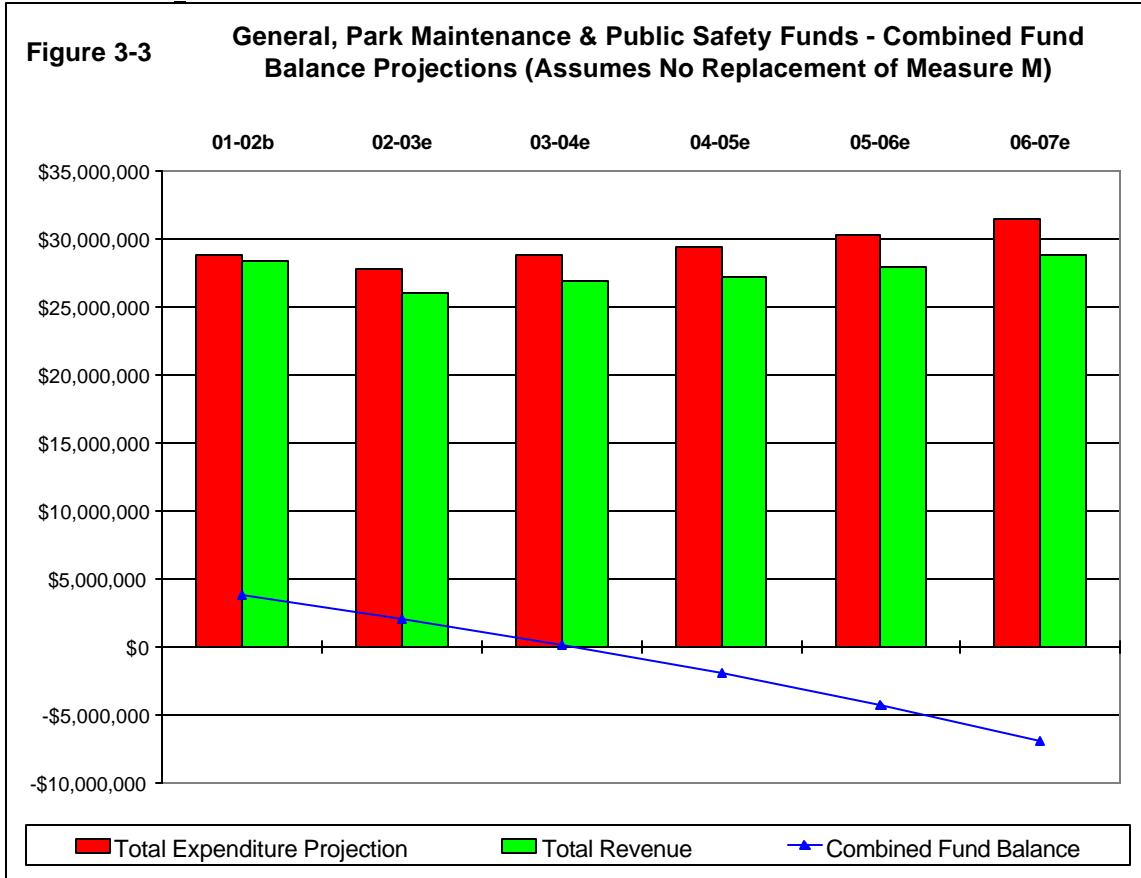
- An additional police officer position per year for three years starting in the 2002/2003 budget year. This will bring total police staffing up to 57 officers by 2004/2005.
- Increased costs for the implementation of the 3%@50 retirement package for public safety personnel. Based on the actuarial analysis provided by PERS, the cost of this package for fire and police personnel will increase from about 7 and 5 percent of salary costs respectively, up to nearly 17% over five years. The budget model assumes straight-line increases in these percentages over the next five years.
- Additional park maintenance costs associated with the completion of Walnut and Mace Ranch community parks, additional greenbelts and streetscapes and other facilities to be completed over the next couple of years.

**Budget Model Summary Projections**

The failure of Measure S portends great difficulty attempting to maintain current service levels in the face of increasing costs. Highlights of the budget model projections include:

- Short-term budget corrections implemented after failure of Measure S should enable fund balance goals to be met in the current budget year.
- However, fund balances are expected to erode over the next couple of years as the expenditure growth is anticipated to outpace revenue growth. Assumed growth in the cost of maintaining the existing level of service coupled with new costs above the current base budget will exceed projected revenue growth. Figure 3-3 illustrates the budget model projection of the current baseline budget assuming that the current park maintenance tax, Measure M, is not renewed prior to June 2002.
- Absent new revenue to replace Measure M funding, significant budget reductions will be necessary in the 2002/2003 budget if substantial fund balance reductions are to be avoided.

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**Budget Realignment Process**

In acknowledgement of the serious budget challenges facing the community, the City Council has initiated a Budget Realignment Process to solicit public input regarding potential restructuring of the City's budget. Whether by expenditure reductions, revenue increases, or a combination of the two, the simple fact is that the future indicated by the budget model cannot occur. The City must balance its budget.

The City Council and Finance & Economics Commission will conduct a series of public workshops during the months of September and October to gather citizen and business owner input on options to address the projected budget imbalance. All members of the community are encouraged to participate in this important process.

**Additional Financial Planning Issues**

Our budget modeling has attempted to estimate costs that we can reasonably foresee, or that prudence suggests should be anticipated. The current year should serve as example, however, of the simple fact that the future will vary from our projections. As noted above, as recently as a year ago few anticipated that energy issues would become so prominent and significant. Thus, it is important to bear in mind additional budget issues in the future. The following highlights some of these issues:

- *Construction tax funding replacement.* With the projected decline in development activity, construction tax revenue is likewise projected to decline. In the current year, we estimate receiving about \$2.05 million; next year that figure is estimated at about \$1.2 million, and is expected to decrease to about \$400,000 in 2002/2003. Historically, the City has used construction tax proceeds for one-time or non-recurring costs, although in recent years street maintenance and some facility rehabilitation costs have been funded with this revenue. Such costs will need to find alternative funding if they are to continue at recent levels. The effect of trying to maintain existing construction tax funding levels for these programs is illustrated in the attached budget summary tables.
- *Fourth Fire Station.* Council has directed that future financial planning consider the resources necessary to operate and maintain a fourth fire station in the northeast area of town. Based on current staffing levels, that cost is estimated to be about \$1.2 million per year.
- *Management Negotiations.* The final budget includes lump-sum assumptions relating to a revised memorandum of understanding (MOU) with management employees. Preliminary salary survey information indicates that some positions are significantly below market. Until negotiations are complete and a new MOU is signed, the financial magnitude of this package remains unclear.
- *Facility Replacement Plan.* The Parks & Community Services Department is partway through an analysis of facility maintenance requirements. Unlike our equipment replacement policies, whereby the replacement value of major equipment like a fire engine is amortized over the expected life of the equipment, no such replacement funding is being collected for most City facilities. As our facilities age and require major renovation, this will become an increasingly important issue.
- *General Fund support for public planning.* Most of the Planning & Building Department budget is funded with fees and service charges imposed on permit and project applicants. There is also a high demand for public planning services within the community. Given the dramatic changes in projected new development activity, an important policy question will be determining an appropriate level of General Fund support for the planning function.
- *NPDES permit issues.* Significant costs to upgrade the City's wastewater treatment facility may be required if issues with the Regional Water Quality Control Board cannot be resolved. Although not a General Fund issue, the cost of needed improvements would have to be funded through user charges, which of course will contribute to the total burden that residents feel in supporting City services.

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The fundamental challenge facing the community is how to reconcile the increasing cost of maintaining the current level of public services in relation to moderating revenue growth. Part of the reason for moderating revenue growth lies in the community’s apparent desire to dramatically slow the pace of new development activity. For better or worse, significant portions of the City’s discretionary revenue base are directly affected by new development activity.

This challenge is magnified by the pending expiration of Measure M in June 2002. The upcoming Budget Realignment process will provide an opportunity for the community to help establish options and priorities as the City struggles to continue providing the high levels of public services that residents have come to expect within tightening budgetary constraints.

