ECONOMIC & DEVELOPMENT FORECAST

"…Like the nation and the state, we are wary and tentative, and yet optimistic."

National, State & Regional Context

The past year has been one of tremendous change and uncertainty, and it's not over yet. We saw California's energy crisis escalate, then subside a bit, and to this day new information about its causes continues to surface. The tragedies of September 11 threw the markets, already weak, into disarray, and had an impact on every conceivable area of the economy. Recession worries surface, or recede, with each cycle's economic indicator reports.

The State's budget surpluses appear to be a thing of the past, and local governments keep a watchful eye on each new budget-balancing strategy employed by the State. Of particular concern this year was the State's ability to continue backfilling the politically popular Vehicle License Fee Offset, but the Governor's May Revision to the State's budget has provided at least temporary reassurance. A reduction to the Offset amount is in fact planned for calendar 2003, but the burden will be placed on vehicle owners instead of local governments.

Like the nation and the state, we are wary and tentative, and yet optimistic. The national recession is proving to be much milder than originally feared, and may officially be over soon. The state predicts gains in personal income for 2002 and 2003, and the real estate market, both statewide and locally, continues to be amazingly strong in the face of soaring prices.

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 (2001/2002) 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 facilitates "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	01-02e	02-03b	03-04e	04-05e	05-06e	06-07e	07-08e
Single Family Units	225	50	35	35	35	35	35
Multi-Family Units	169	45	36	0	0	0	0
Non-Residential Sq. Ft.	199,000	63,346	39,554	39,554	39,554	39,554	39,555
Population	62,200	63,324	63,562	63,769	63,827	63,914	64,002
Population Growth Rate	3.3%	5.2%	0.4%	0.3%	0.1%	0.1%	0.01%
Total Housing Units	23,249	23,857	23,952	24,023	24,058	24,093	24,128
Inflation Rate	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Total Employment	11,153	12,387	12,624	12,808	12,991	13,175	13,349
Employment Growth Rate	N/A	5.4%	1.9%	1.5%	1.4%	1.4%	1.3%

b = budget e = estimate

Although we are pleased to see the national and state economies recovering, the City of Davis continues to face challenges of its own. The declining rate of growth in development and development-based discretionary revenues is in direct conflict with increasing demand for services. As a result, during the past year the City has undergone a Budget Realignment process, the goal of which is to balance revenues with expenditures in both the near-term and in the long-term.

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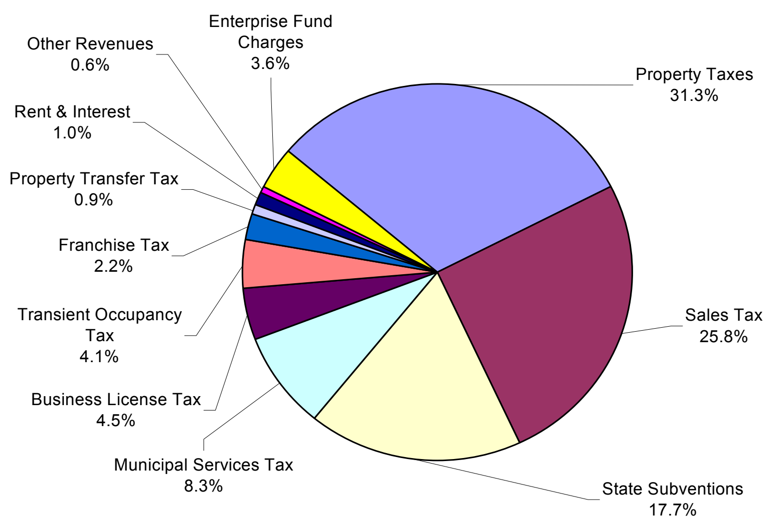
It appears that 2001-2002 General Fund revenues will exceed our estimates from last year by about 3 percent, led by modest gains in sales tax, property tax, and vehicle license tax revenues. These revenues track closely with general economic conditions and development activity, although receipt of such revenues tends to lag the activity that generates them by up to six months.

Significant components of the City's discretionary revenue are connected to development activity. Figure 3-1 illustrates the composition of General Fund discretionary revenue.

Figure 3-1

2002/2003 Preliminary Budget
General Fund Discretionary Revenue



About 83% 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.

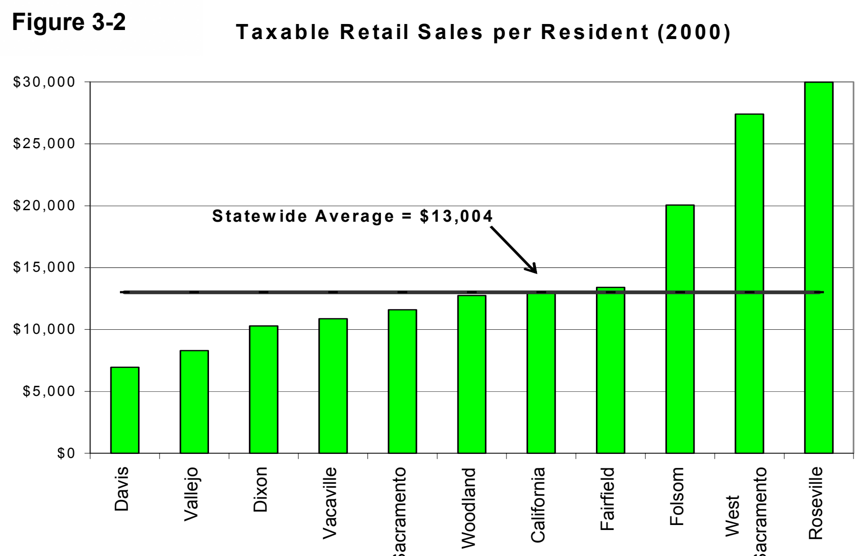
- ***Property Taxes***. Property tax revenue derives from a one-percent tax levy on the assessed valuation of real property within the city of Davis. The assessed valuation is equal to the market price when real estate is sold, but limited by the State Constitution (Proposition 13) to a 2 percent annual 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 2000, 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 development 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.

Figure 3-2



Source: California State Board of Equalization & California Department of Finance, 1999.

- ***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 within 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, and extended by voter approval of Measure D in March of 2002. 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 D 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.

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- ***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 2002/2003 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 budget, but are anticipated based on Council direction and/or planned service expansions.

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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 2003/2004 budget year. This will bring total police staffing up to 57 officers by 2005/2006.

- 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

Despite the passage of Measure D, the City faces continued difficulties attempting to maintain current service levels in the face of increasing costs. Highlights of the budget model projections include:

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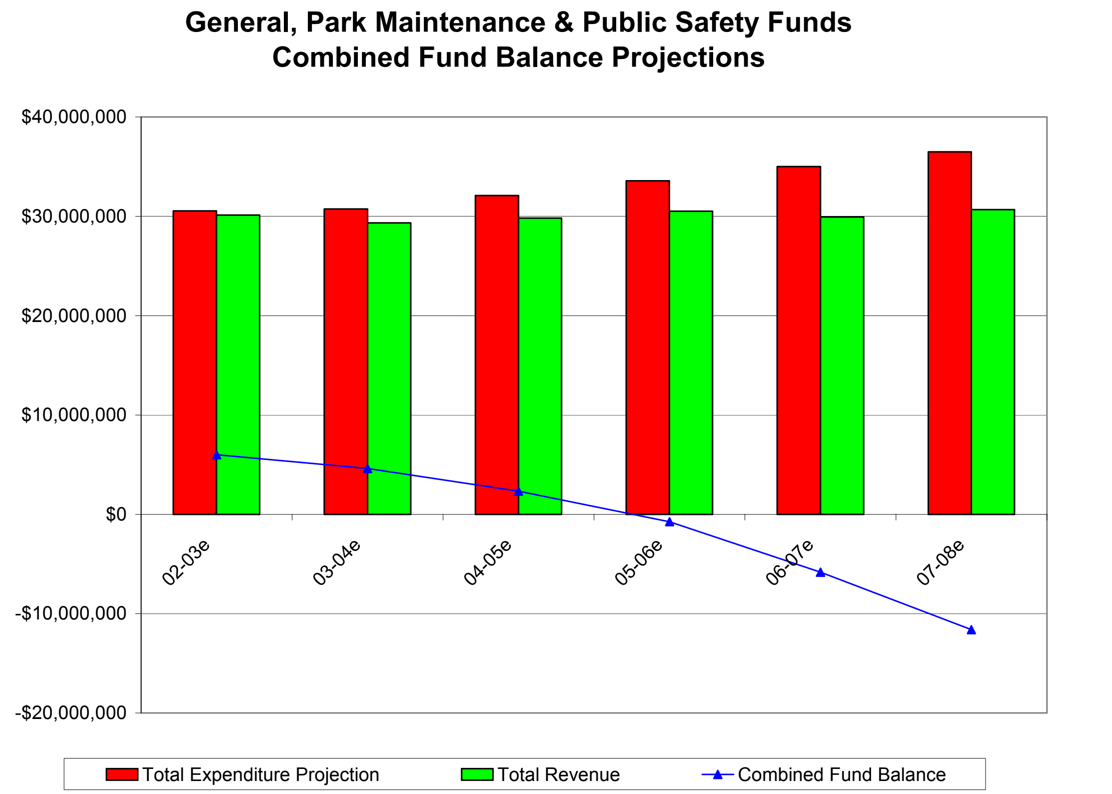
- Fund balances are expected to erode over the next couple of years as the expenditure growth is anticipated to outpace revenue growth. Assumed growth in the cost of maintaining the existing level of service coupled with new costs above the current base budget will exceed projected revenue growth. Figure 3-3 illustrates the budget model projection of the current baseline budget assuming that the current park maintenance tax, Measure D, sunsets in June 2006.

Figure 3-3



Budget Realignment Process

Last year the City Council initiated a Budget Realignment Process to solicit public input regarding potential restructuring of the City's budget. Workshops were held throughout the city last fall to explain the circumstances of the City's budget, and to solicit public input on solutions. As a result of feedback provided at these workshops, Measure D (Park Maintenance Tax renewal) was placed on the March ballot, and passed. Also as a result of public input, the Finance and Economics Commission is currently engaged in analysis of two new sources of discretionary revenue: a Utility User's tax, and a local Sales tax.

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 2001-02 year, we estimate receiving about $1.2 million; next year 2002-03 that figure is estimated at about $567,000, and is expected to decrease to about $200,000 in 2003/2004. 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.

- *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.

The City will be working closely with the Finance and Economics Commission to 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.