

# ECONOMIC & DEVELOPMENT FORECAST

***“.....Proposition 13 shifted power over local budgets to the state and forced cities to create a complex system of special fees to finance services.”***

## National, State & Regional Context

### ***- The Lingering Effects of Proposition 13 Surface ...Again and Again***

Though Proposition 13 is often blamed for clobbering local governments, the blow was far from fatal. It was, however, life-changing for all levels of government in California in ways both intended and unforeseen, and predominantly for the worse. Proposition 13 shifted power over local budgets to the state and forced cities to create a complex system of special fees to finance services both of which disconnected residents from their local government.

The time has passed for reform and a special advocate group established to protect Cities and Counties has taken on the State Bureaucrats. During last year's local revenue raid by the State, LOCAL (which stands for Leave Our Community Assets Local) matured into a viable political arm of the League of California Cities. Over the course of the last year, City and County representatives and the staff at LOCAL, created the following list as focus points for coalition efforts to stabilize funding and reverse the negative effects of Proposition 13, specifically:

- Local governments need protected and predictable sources of revenue.
- Cities and counties should receive a greater percentage of the property tax, as opposed to the sales tax, to encourage them to develop more housing and business parks.
- The super-majority requirement to pass taxes should be eliminated in most cases.

All of these reforms could be enacted without diminishing Proposition 13's property tax protection for homeowners. Proposition 13, by design, limited local revenue, requiring a popular vote for any general local tax, and a two-thirds vote for any special tax. It wrote into law a suspicion of taxes that lingers to this day.

But total government revenue today is not dramatically less than in the days before Proposition 13 (though there is considerable debate about how to measure this). To replace lost property tax, cities turned to an array of developer fees, utility taxes and assessment districts to pay for new streets, schools, parks and sewers. School funding, likewise, has become a muddle of property taxes, general state funds and special grants, all determined by complex formulas.

Proposition 13 has not been the only force in this evolution, but one overwhelming development can be traced to it — the transfer of power to the state. By authorizing the state to allocate local property taxes among counties, cities and schools, Proposition 13 — passed partly with the aim of smaller government — eviscerated local control. Local governments soon were subject to the whims of the Legislature and the governor for funding.

One result is that local residents have become detached from their school districts and city councils. Before Proposition 13, schools and cities planned a level of services and set tax rates accordingly. Residents had an immediate stake in those decisions. Now schools and cities can only wait for Sacramento

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to send money. To be sure, the failure of many local governments to ease ever-rising tax burdens led to Proposition 13. But the transfer of power from local to state government has not been healthy for civic involvement in cities, counties or schools.

Proposition 13 also has altered the way cities develop. With cities receiving little property tax, they have become more dependent on sales taxes. In zoning decisions, cities have an incentive to favor sales tax generators — shopping malls, big-box retailers — over housing or office parks. Addressing this skewing of land-use decisions is part of what is meant by “structural reform” in discussions of the state budget and state-local finance.

To correct these problems, local governments need stable sources of revenue, independent of the annual moods of the Legislature. Many of the reforms that are being recommended today could be enacted without touching the heart of Proposition 13, tax protection for homeowners, which was what voters were after when they passed Proposition 13 two and a half decades ago. One such measure being contemplated, AB 1221, Steinberg/Campbell, would swap sales tax for property tax, and reduce the negative impacts of “the fiscalization of land use” over time. While the bill has merit, its late arrival in the process and the variation in the impact on Cities doesn’t allow for much hope in its ultimate success.

**- Predicting the State Budget Impacts ...Again and Again.**

Communities wrestling with their fiscal problems got some welcome news in Gov. Gray Davis’ revised state budget proposal Wednesday, May 14. The governor dropped plans to eliminate a key funding source for municipal programs and shift major welfare responsibilities to counties.

The new state plan assumes vehicle license fees will be raised automatically by July if economic woes persist. The action would ensure \$4.2 billion would continue to flow next year to cities and counties, which have relied on the State to make up those revenues since the fee was cut by two-thirds in 1998.

The VLF increase — which is expected to mean an additional \$124 to register the average car — brought a deep sigh of relief from local officials. A plan by Davis in January to halt state reimbursements without raising the fee drew strong opposition from Assembly Democrats, resulting in an impasse that was resolved when officials concluded that a shortage of state money could trigger an automatic increase in the fees. The potential loss for the City of Davis could be as much as 8% of General Fund Revenues or \$1.6 million for FY 2003-2004.

In addition, Davis wants to transfer \$1.7 billion in foster care and child welfare services to counties, significantly less than an \$8.2 billion “realignment” he proposed in January. The programs would be funded by raising the cigarette tax and creating a 10.3 percent income-tax bracket for single filers earning more than \$150,000 and joint filers more than \$300,000. “This realignment proposal ... is a step toward structural reform,” Davis said. “It is moving responsibilities now partially administered at the state level to local government, which is closer to the people.”

The revised budget also brought good news for other local services, including public protection. The plan preserves a total of \$232.6 million for juvenile crime prevention and for the Citizens Options for Public Safety program, which supplements funding for local law enforcement agencies. The City of Davis

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receives approximately \$127,000 per year that is used to upgrade its technology-based systems.

On another front, officials expressed strong concern about a plan by Davis to shift \$250 million in city and county redevelopment funds to the state. The amount would increase annually to \$1 billion over 15 years, which critics said would cripple efforts to revitalize older communities and attract economic development. People in the Capitol don’t understand redevelopment and how it works,” Sacramento Mayor Heather Fargo said. “It’s such a basic economic tool for cities and counties.”

The City of Davis Redevelopment Agency (RDA) is currently diverting \$142,000 to the State in Fiscal Year 2002-2003. If the State increases the total amount statewide to \$250 million, the RDA portion could grow to as high as \$470,000, an increase of \$328,000. The impact would surely halt all of the capital improvement projects planned by the agency this year of \$255,152.

City and county LOCAL advocates called on Gov. Davis and state lawmakers to include safeguards on funding for local services among provisions for government and fiscal reform. It’s apparent that constitutional protections are needed to prevent future state raids on local treasuries during tough economic cycles.

**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 FY 2002/2003 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**

<b>Variable</b>	<b>02-03b</b>	<b>03-04e</b>	<b>04-05e</b>	<b>05-06e</b>	<b>06-07e</b>	<b>07-08e</b>	<b>07-08e</b>
Single Family Units	64	96	30	15	8	6	0
Multi-Family Units	304	164	0	0	0	0	0
Non-Residential Sq. Ft.	137,685	61,184	39,554	39,554	39,554	39,554	39,554
Population	63,324	64,244	64,894	64,969	65,007	65,027	65,042
Population Growth Rate	5.2%	1.5%	1.0%	0.1%	0.1%	0.0%	0.00%
Total Housing Units	25,412	25,780	26,040	26,070	26,085	26,093	26,099
Inflation Rate	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Total Employment	10,465	10,990	11,215	11,360	11,505	11,649	11,794
Employment Growth Rate	2.4%	5.0%	2.0%	1.3%	1.3%	1.3%	1.2%

**b = budget e = estimate**

We have yet to see any significant improvement in the economy. Unfortunately, the effects of the War in Iraq have had an adverse effect on the U.S. and California economies and there are numerous statistics pointing to a slow economy through the summer, especially in the greater Sacramento region.

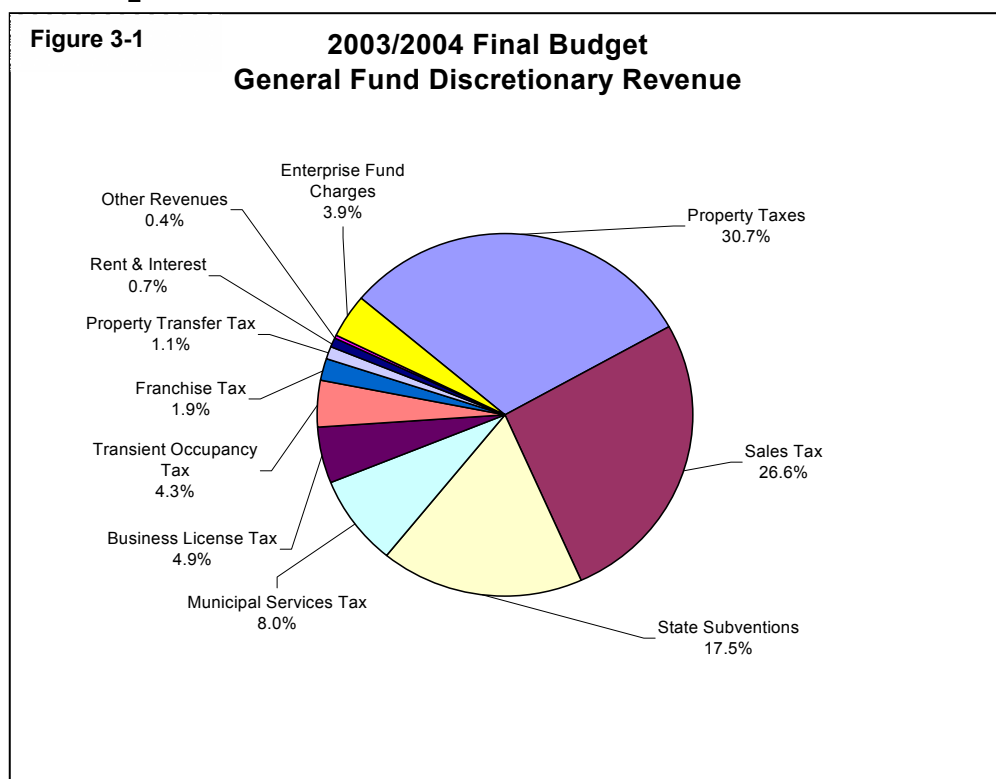
The City of Davis has experienced several years of building expansion for both residential and non-residential growth and the “difficult funding years” that have been predicted in the past are approaching. First, the declining rate of growth in development and development-based discretionary revenues is in direct conflict with increasing demand for services that resulted from the residential growth.

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As a result, during the past year the City has not ventured far from the Budget Realignment process that set out several strategies for dealing with the delicate balance of shrinking one-time revenues and increasing ongoing expenditures in both the near-term and in the long-term.

It appears that 2002-2003 General Fund revenues will exceed our estimates from last year by about 1.5% percent, led by modest gains in sales tax, property tax, vehicle license tax revenues, and a pleasant 6.5% increase in local motel lodging transient occupancy tax. 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.



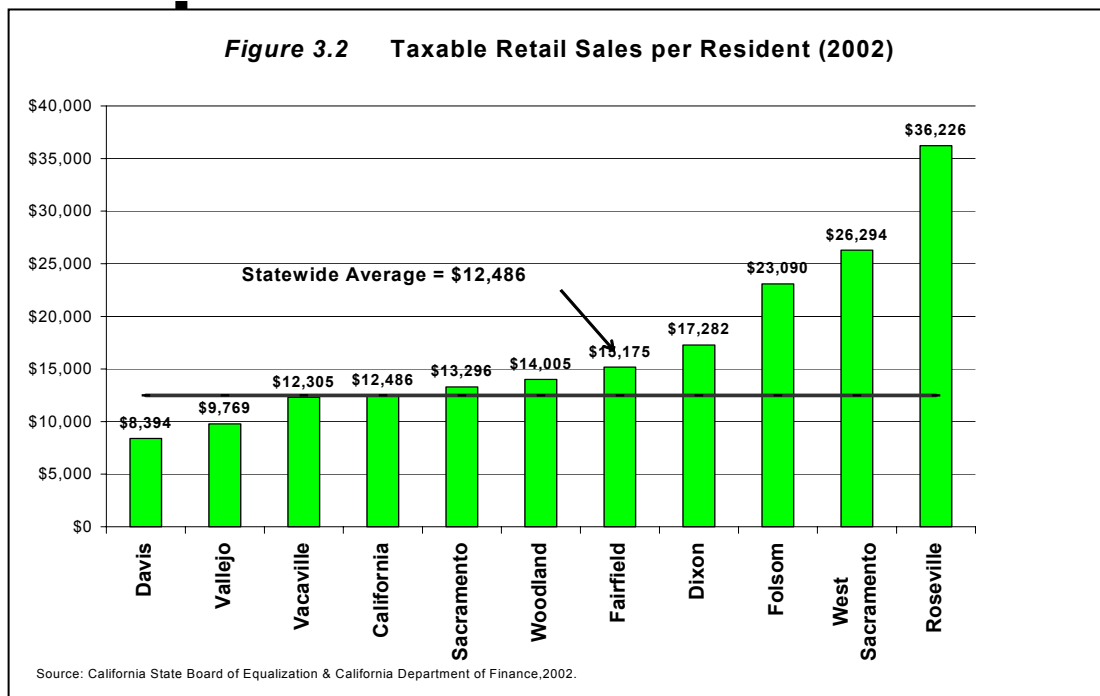
About 83% of such revenues derive from the four largest sources of revenue; property tax, sales & use tax, state subventions, and the municipal services tax. All of these revenue sources are affected by development activity, as discussed below.

- **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 and the current 6% growth in property tax receipts is expected to taper to 2.5% to 3.0% depending on the rate of supplemental property tax receipts generated by market turnover. 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.

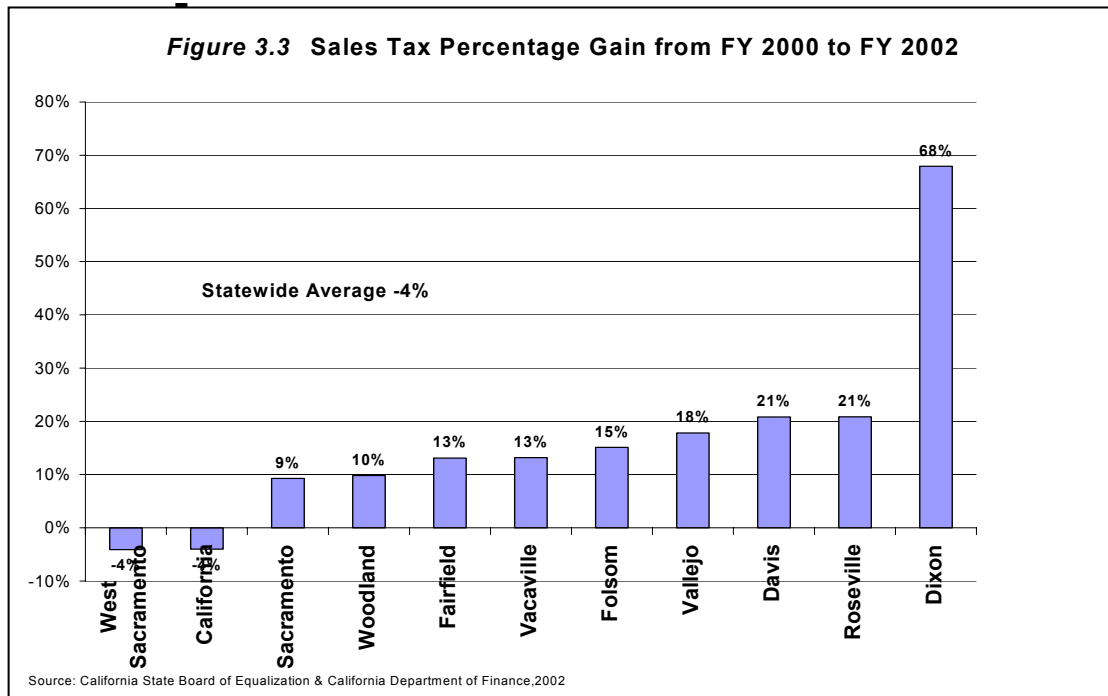
- Sales Taxes.** Sales tax revenue derives from one percent of the sale price on taxable products sold within the city of Davis. As is widely known, Davis’ sales tax base is largely a local-serving one. That is, most of the city’s retail base is aimed at supplying local goods and services rather than 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 Fiscal Year 2001-2002, 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.



A glance at *Figure 3.2* above doesn't provide the viewer with a good perspective of the changes that have occurred in Taxable Sales in the two

year period as the City has gone from 53% of the statewide average to 67% last year. The increase has come from a number of sources, foremost of which, is the expanded auto sales sector and the replacement of the recreational boating dealership on Olive Drive. As you can see from *Figure 3.3* below, the City of Davis experienced a 21% increase in sales tax receipts from FY 1999-2000 to FY 2001-2002 or a total dollar gain of \$1.1 million. Overall, all of the Cities in the comparison group have experienced gains above the State average from 2000 to 2002, except for West Sacramento, which has a high percentage of distribution warehouses.



- 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.

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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.

The extension of the Parks Maintenance Tax has provided a small amount of breathing room as the City continues, via the budget realignment process, to explore options for new and sustainable discretionary revenues.

- ***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 split 50-50 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 that was invoked for the first time on January 1, 2003 when the rate was adjusted by 3%. The Public Safety Tax is expected to bring in \$1.552 million next year, of which \$44,000 of the \$62,000 increase is due to the escalator, the balance to residential and non-residential expansion.

### **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.

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: 3% annual growth equal to anticipated inflation
- 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:

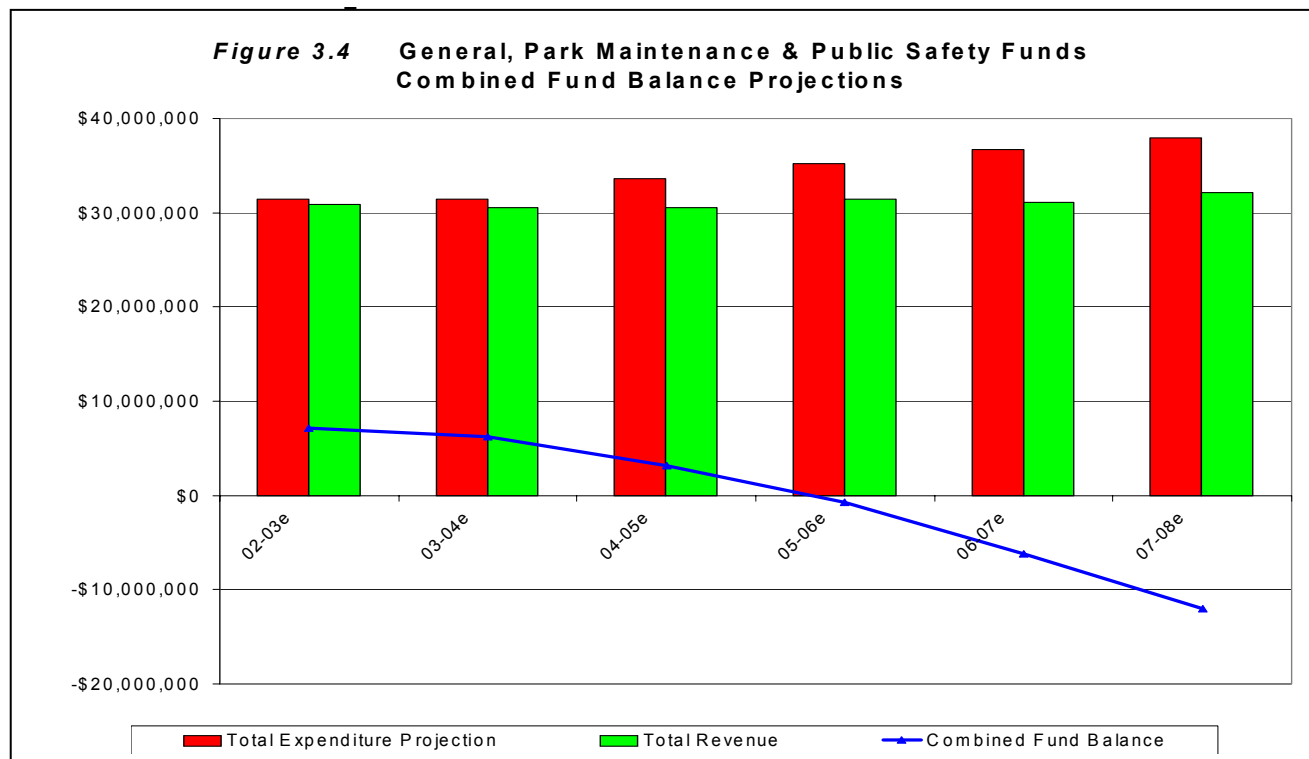
- An additional police officer position per year for three years starting in the 2004/2005 budget year. This will bring total police staffing up to 57 officers by 2006/2007.
- Increased costs for the implementation of the 3%@50 retirement package for public safety personnel. Based on the actuarial analysis 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 29% 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:

- 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 3-4 illustrates the budget model projection of the current baseline budget assuming that the current park maintenance tax, Measure D, sunsets in June 2006.

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### **Budget Realignment Process**

Two years ago, 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 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 2002 ballot, and passed. Also as a result of public input, the Finance and Budget Commission engaged in an analysis of two new sources of discretionary revenue, a Utility User's tax and a local Sales Tax Override, and recommended to the City Council to proceed with the placement of the Sales Tax Override on the March 2004 general election ballot.

### **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 in the City Manager's transmittal letter, as recently as two years ago few anticipated that health and retirement costs would become so 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 2002-03 year, we estimate receiving about \$567,000; next year 2003-04 that figure is estimated at about \$930,000, and is expected to decrease to about \$204,000 in 2004/2005. 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.

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- *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 are now required as 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.

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 Budget 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.