DATE ISSUED:	March 4, 2005	REPORT NO. 05-063
ATTENTION:	Honorable Mayor and City Council Docket of March 7, 2005	
SUBJECT:	Fiscal Year 2006 Budget Priority Workshop	

SUMMARY

THIS IS AN INFORMATION ITEM ONLY. NO ACTION IS REQUIRED ON THE PART OF THE CITY COUNCIL.

BACKGROUND

This report is designed to provide the Mayor and City Council with the significant budgetary issues and priorities that need to be addressed during the development of the Fiscal Year 2006 Proposed Budget. The Fiscal Year 2006 Proposed Budget will be developed using the principles advocated by the National Advisory Council on State and Local Budgeting (NACSLB), an organization whose mission is to improve State and local government budgeting through identification and dissemination of good budget principles and practices. The City's eight Principles of Budgeting and Finance will also be incorporated. These principles include standards such as:

- Ongoing expenditures should be supported by ongoing revenues. Accordingly, one-time revenues should not be used for ongoing expenditures on a continuous basis.
- The General Fund Reserve should be maintained at a minimum of three percent.
- Activities that are supported by user fees should be fully cost recoverable.
- Discretionary General Fund revenues should not be earmarked, thereby allowing maximum flexibility in funding decisions on an annual basis.
- Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.

The primary focus of the budget development process is to forecast revenues and account for expenditure requirements to meet the approved priorities of the Mayor and City Council and the citizens. The priorities of San Diego as a region are numerous and the City of San Diego's responsibility is to address many of these priorities through services provided. The struggle to meet these priorities is balanced with economic realities; there are not sufficient financial resources to fully fund every need.

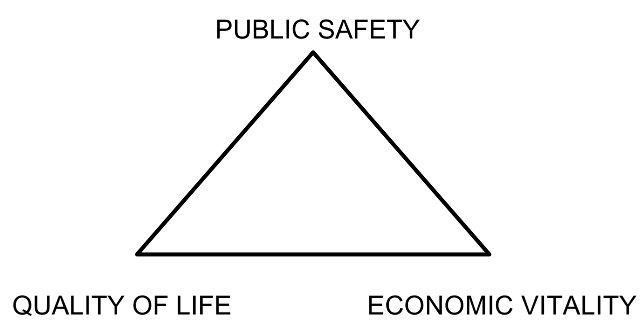
Specific priorities that were the primary focus during the Fiscal Year 2005 Annual Budget development included:

1. Maintenance and Enhancement of Public Safety
2. Adequate Fiscal Reserves
3. Increased Pension System Funding
4. Reduce Deferred Maintenance
5. Maintain Neighborhood Services (Parks/Libraries)

These priorities have remained constant throughout the development of the Fiscal Year 2006 Proposed Budget although impacts to all of these priorities are evident throughout the decision making process due to ongoing revenues not meeting ongoing expenditure requirements.

Specific priorities can be translated to three general budget priorities consistent with the principles endorsed by the National Advisory Council on State and Local Budgeting. For the City of San Diego, they are: Public Safety, Quality of Life and Economic Vitality. Each of these priorities compliments each other and reflects equity when priorities are discussed. This is represented by reflecting them as components on an equal sided triangle.

BUDGET PRIORITIES



Examples of City functions providing services to meet these priorities are reflected in the following table:

PUBLIC SAFETY	QUALITY OF LIFE	ECONOMIC VITALITY
Police Protection	Park and Recreation	Development Services
Fire Rescue	Library	Water Department
Risk Management	Environmental Services	Fiscal Reserves
Transportation	Community Services	Community & Economic Development
	Metropolitan Wastewater	

The purpose of the Proposed Budget Priority Workshop as envisioned by the Mayor and City Council and City Manager is to articulate the pressing needs of San Diego while determining the top priorities of the citizens. Until revenues are sufficient to meet expenditure requirements or expectations of services are in line with existing revenue sources, the City of San Diego will need to continue to balance priorities against each other.

DISCUSSION

The following list of Fiscal Year 2006 General Fund changes in funding requirements is not intended to be complete, but identifies the approximate change in expenditures or major revenue receipts currently projected in these categories for Fiscal Year 2006.

Note: All numbers reflected in the following chart are estimates and are subject to change based on policy decisions and ongoing analysis.

ESTIMATED GENERAL FUND REVENUE BUDGET ADJUSTMENTS
(IN MILLIONS)

	GENERAL FUND
Estimated Net Major Revenue Adjustments	\$20 – 25.0
Proposed Revenue Solutions (Including One-Time Revenue)	\$20 – 25.0

ESTIMATED GENERAL FUND EXPENDITURE BUDGET ADJUSTMENTS
(IN MILLIONS)

	GENERAL FUND
Estimated Annualization of FY 2005 Contracted Salaries and Wages	\$21.0
Estimated Employer Retirement Contribution	\$28.0 - \$30.0
Estimated Retiree Health	\$10.0 – \$11.0
Estimated Unemployment, Worker's Comp, Long Term Disability	\$5.2 – \$6.2
Estimated New Facility and Annualization Operating Costs	\$9.0 – \$10.0
Public Safety Overtime	\$6.0
Estimated Public Liability Requirements	\$1.0

Estimated Disclosure Ordinance Staffing and Support Requirements	$2.0
Estimated General Fund Reserve Contribution	$2.0 – $3.0
Estimated Non-Discretionary Operating Expenditures	$4.9 – $5.2
Estimated Department Expenditure Reductions	($18.0) – ($20.0)
Estimated General Fund Expenditure Requirement (Deficit)/Surplus	($20.0) – ($30.0)

The revenue growth estimate reflects the forecast of net growth in Major General Fund revenues of $20.0 - $25.0 million for Fiscal Year 2006. Major General Fund revenue includes Property Tax, Sales Tax, Transient Occupancy Tax, and Franchise Fees. The net growth forecast includes the elimination of approximately $15 million in one-time revenues that was used in Fiscal Year 2005. Examples of one-time revenues used in Fiscal Year 2005 include the Equipment Division Fund Rebate ($3.9 million), Storm Drain Fund Rebate ($1.9 million), State Contingency Reserve ($3.9 million) and NTC Fund Rebate ($1.4 million). One-time revenue may be identified and proposed to assist in balancing the Fiscal Year 2006 budget, however consistent with the City's Budget Principles, it will need to be tied to one-time expenditures.

Proposed revenue solutions, including new one-time revenues, are contemplated to provide $20.0-$25.0 million for Fiscal Year 2006. These sources may include but are not limited to delays in new capital or technology projects, revenue from cost recoverable charges for services, and additional fund transfers. The majority of these items may require the consent of the Mayor and City Council and will be brought forward for further review.

The expenditure obligations identified in the chart are high-level estimates based on negotiated labor agreements from Fiscal Year 2005, contractual debt service, and expenses for operating Mayor and City Council approved new facilities. Additionally, non-discretionary increases to the cost of operating expenses such as utilities and fuel are also included. Although departments are able to control the quantity or volume of the use of these items, they cannot control the unit cost of these on an annual basis. The estimated expenditure requirements do not assume any additional costs or reductions associated with the ongoing Meet and Confer labor discussions.

The estimated debt obligations for Fiscal Year 2006 are not included in the following chart as they are not directly budgeted in the General Fund. The estimated debt obligations are included for information purposes in Attachment 1.

As identified in the above chart, the forecasted revenue falls short of major expenditure requirements by approximately $20.0 - $30.0 million. As the cost of providing necessary services increases, the current major revenue growth is not sufficient to cover anticipated and committed expenditures. Due to this substantial difference, policy issues need to be discussed to identify both expenditure and revenue solutions. Staff is continuing to discuss and analyze solutions and alternatives for funding requirements.

FISCAL YEAR 2006 GENERAL FUND REVENUE PROJECTIONS

The following General Fund revenue forecast information is provided as a framework in which to solicit community input and conduct policy discussions. All estimated forecasts are subject to change as further data becomes available and is analyzed for impacts. Additional forecasting information will be included in the Fiscal Year 2006 Proposed Budget.

In Fiscal Year 2006, the City's four major revenue sources – property tax, sales tax, transient occupancy tax (TOT) and franchise fees – are projected to increase approximately $38.9 million over the Fiscal Year 2005 Budget. These same revenue sources accounted for approximately 64 percent of the General Fund revenue budget in Fiscal Year 2005. The growth of $38.9 million is offset by the reduction of approximately $15 million in one-time revenues used in the Fiscal Year 2005 Annual Budget. This brings the net major revenue growth to approximately $24.0 million. Additional revenue from other sources will provide an additional $20.0 - $25.0 million, bringing the total General Fund estimated revenue to approximately $867 million.

ESTIMATED GENERAL FUND REVENUE PROJECTIONS

FY 2006 Revenue	FY 2006 Applied Growth Rate	FY 2006 Estimated General Fund Revenue
Property Tax	7.0%	$288.6 million
Sales Tax (General Fund Allocation)	4.5%	$145.9 million
Transient Occupancy Tax	5.0%	$ 68.0 million
Franchise Fees		
SDG&E	7.5%	$ 37.1 million
Cable Television	5.0%	$ 14.1 million

Property Tax

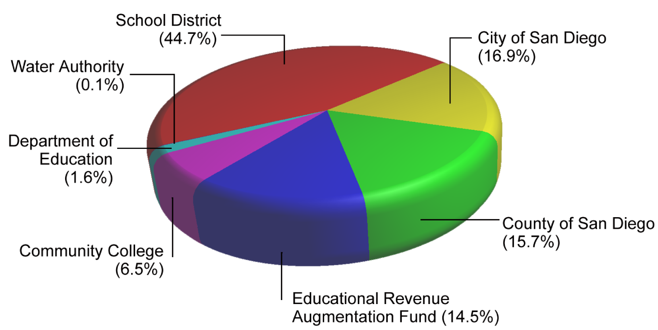
This revenue is projected to increase $19.5 million from the Fiscal Year 2005 Annual Budget, reflecting a real estate market that remains persistently strong. Home prices reached all-time highs in calendar year 2004, and the number of home sales approached record levels. Even though rising interest rates may limit the appreciation of home values in 2005, the strength of the market in 2004 should result in substantial growth in assessed valuation in future years. The property tax projection in Fiscal Year 2006 represents a 7.0 percent growth over Fiscal Year 2005 year-end estimates, and includes a reduction of approximately $16.9 million for the second part of the negotiated two-year, $2.6 billion contribution from local governments to the State.

Although Property Tax is estimated to increase by almost $20 million due to the continued increased valuation of properties, this revenue still does not provide the amount necessary to fund ongoing services provided to the City of San Diego. The following table illustrates the impact of State legislation over the years that has diminished the value of property tax directly related to City services. Although housing prices are experiencing record levels, the current median housing price of $580,220 contributes only about $986 annually to help fund Genera Fund activities including Police, Fire, Parks and Recreation, Library and waste removal services.

Given the County's assessed property tax rate of 1.00%, a home owner can be expected to pay an estimated $5,802 in property tax, of which only 16.9% is allocated to the City of San Diego. It is important to keep in mind that the figure used for the median price of a home in San Diego is based on newly assessed home values. The $986 figure decreases dramatically when homes that have not been recently assessed or re-assessed are added to the equation.

BREAKDOWN OF COUNTYWIDE PROPERTY TAX RATE (1.00%)

PROPERTY TAX ALLOCATION



Property Tax per Assessed Valuation	1.00%
Property Tax Allocation to the City of San Diego	16.9%
Median Price of an Existing Single-Family Home in San Diego [1]	$580,220
Assessed Home Value Property Tax	$5,802
Property Tax Dollars to the City of San Diego	**$986**

[1] California Association of Realtors, February 25, 2005

Sales Tax

General Fund sales tax revenue is projected to increase $10.1 million over the Fiscal Year 2005 budgeted amount, reflecting continued growth in consumer spending. The ULCA Anderson Forecast projects statewide taxable sales to grow by 2.5 percent in 2005, adjusting for inflation, while personal income is projected to increase by 5.2 percent. Consumer spending in San Diego County is expected to remain strong. According to Marney Cox, chief economist for SANDAG, San Diego is projected to realize a net gain of 25,000 jobs in 2005, compared to an estimated increase of 15,000 in 2004. According to the State's Unemployment Development Department, San Diego County's unemployment rate in December 2004 was 3.2 percent, the lowest rate since May, 2001. The Fiscal Year 2006 sales tax projection represents a 4.5 percent growth over Fiscal Year 2005 year-end estimates. Approximately 67 percent of total projected sales tax revenue is proposed to be allocated to the General Fund, with the remainder allocated to various non-General Funds such as the Special Promotional Program, Street Division, and the Police Decentralization Fund consistent with Municipal Codes and/or City Charter requirements.

Transient Occupancy Tax (TOT)

General Fund TOT revenue is projected to increase by $3.4 million in Fiscal Year 2006, reflecting a travel and tourism market that continues to grow, but faces increasing competition from other markets. In its 2005 San Diego County Travel Forecast, the San Diego Convention and Visitors Bureau (ConVis) projects that the County's travel and tourism market will fall to the fifth largest city in the country in terms of market share, down from number four in 2004. However, ConVis expects to see increases in all indicators, from total number of visitors to room demand. The Fiscal Year 2006 TOT projection represents a 5.0 percent growth over Fiscal Year 2005 year-end estimates. Of the 10.5 cents per dollar of TOT that is collected by the City, 5.0 cents are allocated to Special Promotional Programs, while 5.5 cents are allocated directly to the General Fund.

Franchise Fees

Franchise fees are projected to increase approximately $5.9 million over the Fiscal Year 2005 budgeted amounts, including a $4.8 million increase in SDG&E revenue and a $1.1 million increase in franchise revenue from the City's two cable franchisees, Cox and Time-Warner. Franchise revenues from SDG&E are derived from a three percent levy on gross gas and electric sales. Fiscal year projections are developed by applying a growth rate projection to SDG&E revenues on a calendar year basis. Due to projected high prices of oil and natural gas, SDG&E revenues are projected to grow 7.5 percent in calendar year 2005. Franchise revenue from Cox Cable and Time-Warner Cable are projected to increase 5.0 percent over Fiscal Year 2005 year-end estimates.

Other Revenues

Aside from these major revenues, several other revenue sources are expected to contribute to the Fiscal Year 2006 budget. Property transfer tax is projected to add approximately $4.1 million to the General Fund in Fiscal Year 2006, based on 10 percent growth over Fiscal Year 2005 year-end estimates. Safety sales tax is projected to grow 5.0 percent over Fiscal Year 2005 year-end estimates, increasing greater than $900,000 over the Fiscal Year 2005 budgeted amount. Revenue from vehicle license fees, which was greatly reduced in Fiscal Year 2005 due to the VLF-property tax swap and elimination of the VLF backfill by the State of California, is projected to decrease approximately $400,000 from the Fiscal Year 2005 budgeted amount. This projection is based on a 5.0 percent increase over Fiscal Year 2005 year-end estimate, which is currently projected to trend under-budget.

GENERAL FUND EXPENDITURE PRIORITIES

In Fiscal Year 2006, public safety has remained a top priority in the budget development process, but reliance on the annual growth of existing revenues, absent the provision of new revenue sources, greatly limits the City's ability to meet budgetary priorities and contractually obligated expenditures. The emphasis on public safety will impact most General Fund departments, and non-public safety service level impacts to the public may be unavoidable. Examples of additional priorities that should be addressed during the development of the Fiscal Year 2006 Proposed Budget include:

New Facilities Obligations ($9.0 – $10.0 million)

Facilities scheduled to open in Fiscal Year 2006 include:

Library –
Serra Mesa Branch Library
Otay Nestor Branch Library
College-Rolando Branch Library

Police –
Northwestern Police Station

Fire –
Fire Station #47 in Pacific Highlands Ranch

Parks and Recreation –
Community parks
Park maintenance improvements
Various joint-use areas

Operating expenses related to the annualization of Fiscal Year 2005 new facilities such as the North University Community Library and park projects such as the Otay Valley Regional Park (Phase I) have also been included in the General Fund requirement adjustments.

Our residents have a deserved expectation of new facilities which are typically constructed using funds from specific assessments or development fees. However, the same funding sources that pay for the construction expenses are usually precluded from being used to fund operating expenses. The operating expense burden falls to the General Fund which over the last decade has struggled to maintain enough revenue growth to fund existing operating requirements let alone new additional operating requirements.

Estimated Public Safety ($66.5 million)
The Fire-Rescue Department has identified $36.7 million in funding needs for Fiscal Year 2006, including the addition of 48.05 positions. $25.9 million of this is related to fleet replacement and deferred facilities maintenance. The Department has also identified possible alternatives for fleet replacement. Approximately $3.3 million is related to additional salaries and wage related costs. At a minimum, to maintain current levels of service, $4.9 million and 17.32 positions are required in the Fiscal Year 2006 budget.

In addition to maintaining the funding levels achieved in Fiscal Year 2005 and annualizing any necessary salary and retirement increases, the Police Department has identified $29.8 million in additional funding needs for Fiscal Year 2006. This includes $6.1 million in personnel expenses, which will restore funding for 120.00 positions removed in Fiscal Years 2004 and 2005. Also identified is approximately $9.4 for overtime, $3.5 million for Special Pays, $3.0 million for Data Processing, and $6.0 million for equipment. The Fiscal Year 2006 Proposed Budget will assume continued funding for four academies.

Estimated Unappropriated Reserve Requirements ($2.0 - $3.0 million)
The Unappropriated Reserve, also known as the General Fund Reserve, was established to fund major General Fund emergencies. Specific expenditures are not budgeted within this reserve. For the Fiscal Year 2006 Proposed Budget, approximately $3 million will be required to be added to this reserve to maintain the 4% level that is currently in the Fiscal Year 2005 Annual Budget. This will bring the total reserve to an estimated $35.9 million. No specific legal guidance or policy restrictions are placed on the use of these funds. However, Mayor and City Council authorization is necessary to expend these funds.

Estimated Public Liability Requirements ($3.0 - $5.0 million)
The City's Public Liability Fund provides funding for the City's self-insurance program for public liability claims, including claims for bodily injury, property damage, inverse condemnation, false arrest and errors and omissions, as well as other non-claim related expenses. Each year, the General Fund contributes a base amount of approximately $5.8 million to the Public Liability Fund. The Water and Wastewater Funds also contribute amounts to cover liability claims that are directly attributable to those respective funds.

Historically, the General Fund has been required to contribute additional funds throughout the fiscal year as liability claims and appropriate expenses are charged to the Public Liability Fund. These mid-year transfer amounts have grown over the past years and require an infusion of General Fund monies. It is suggested that the Fiscal Year 2006 Proposed Budget include an increase of $1 million to bring the total proposed General Fund contribution to $6.8 million; however based on historical expenditure trends additional funds beyond the increase of $1 million may be needed.

Estimated Disclosure Ordinance
Staffing and Support Requirements ($5.0 - $8.0 million)

Original estimates identified requirements of $5.0 - $8.0 million to meet the requirements set forth in the Public Disclosure Ordinance. This included staffing and support for the City Auditor's Office, the City Attorney's Office, the Financial Management Department, the Treasurer's Department and the Water and Metropolitan Wastewater Departments. It is suggested that the Fiscal Year 2006 Proposed Budget include $2.0 million to begin these efforts, however increased expenses will need to be included in future year budgets.

Unfunded Needs as of Fiscal Year 2004($531.6 million – Does Not Include Public Safety Departments)

The City's unfunded needs include items that have been reduced or not funded due to budgetary constraints. The previous two fiscal years have brought forth challenging issues for City management and as a result, difficult decisions concerning City operations were made. This does not mean that unfunded items were unimportant, but rather, due to limited revenues, not funding these items were found to have the least negative impact on the largest number of San Diego residents and visitors. Examples of these items include deferred maintenance, brush management, and storm drain maintenance. Also, the majority of the items listed within the Fiscal Year 2004 Unfunded Needs Report are within the General Fund. This illustrates the constant theme that the cost for providing services that are dependent upon General Fund dollars continues to outpace the growth and availability of General Fund revenues.

POLICY ISSUES AND SOLUTIONS

In preparation for the Fiscal Year 2006 Proposed Budget, there are key policy issues that may be considered in the context of forecasted revenue shortfalls and increasing expenditure requirements. Some opportunities to help achieve a balanced Fiscal Year 2006 budget may include the following:

Storm Drain Fee (Policy)

The City of San Diego currently spends $14.6 million annually on maintaining the City's drainage infrastructure and complying with the San Diego Municipal Storm Water Permit. However, currently funded expenses are not adequate to address the deferred maintenance of the City's infrastructure and/or compliance with the federal Clean Water Act related to storm water pollution prevention. This may result in the deterioration of the storm drain infrastructure.

An increase to the storm drain fee to adequately fund existing programs is currently in development. Any modifications to the existing Storm Drain Fee would need to meet Proposition 218 requirements and would require approval in an election by either a majority of property owners, or two-thirds of all voters. Initial estimates, based on the recommended revised fee schedule, indicate that approximately $18.9 million in total revenue could be generated based on a $2.00 per month fee for single family residences and a corresponding increase to other classifications; $28.4 million based on $3.00 per month; $37.9 million based on $4.00 per month; and $47.4 million based on $5.00 per month. Overall the current residential monthly fee of $0.95 per month was ranked 117 lowest out of 122 among cities nationwide.
The existing storm drain fee is inadequate to fund the current level of operations and address

additional needs to fix the City's aging infrastructure and comply with federal water quality mandates. The storm drain fee could be restructured and increased, in accordance with Proposition 218, to provide a level of funding to address unfunded needs.

Reductions in City Operations

In the Fiscal Year 2006 Proposed Budget, programmatic reductions are being identified throughout City departments. Due to the amount of department reductions necessary to balance the General Fund, reductions in public safety departments may be necessary although no sworn positions are identified at this time. Total reductions are currently estimated to be $18.0 -$20.0 million.

Existing Parking Meter Fee Increase (Policy)

A fee increase on existing parking meters in the City will require an amendment to the Municipal Code. Staff will be evaluating the impact and will bring a report forward to the City Council prior to the adoption of the budget.

Parking Tax (Policy)

The City of San Diego currently does not levy a parking tax. This is similar to a franchise fee that is charged to private operators of parking lots within City limits. This tax is used by other cities throughout California. If the City were to propose a ten percent parking tax, it would generate approximately $19.6 million in additional General Fund Revenue. A parking tax is considered a Business Tax and is thus treated as a General Tax. Imposing this tax may require a simple majority vote.

Property Transfer Tax (Policy)

The Property Transfer Tax, sometimes referred to as a documentary transfer tax, is paid on the sale of any real property. The tax is based on the purchase price of the property at the time of sale. Most cities levy a so-called "conforming" tax, whereby the county charges $1.10 per $1,000 and the city charges $0.55 per $1,000. The city tax is then credited against the county tax, such that both the city and the county receive $0.55 per $1,000 of the sale price. Some cities levy a "non-conforming" property transfer tax at a rate above $0.55 per $1,000. In these cases, the city tax is not credited against the county tax. The county receives the full share of the $1.10 per $1,000, and the city receives the amount generated from its own tax rate. Currently, San Diego levies a "conforming" tax rate of $0.55 per $1,000.

Based on Fiscal Year 2002 actual receipts, an increase in the property transfer tax to $2.75 per $1,000, a rate equivalent to that in Sacramento, would generate over $28.1 million a year in additional General Fund revenue.

Refuse Collection Fee (Policy)

The Refuse Collection Fee is a charge for the service of residential refuse collection and disposal. It is levied as a monthly charge per refuse container to each household that receives municipal refuse collection service. San Diego is the only major California city that does not attempt to recoup at least a portion of the cost of providing refuse collection service. A flat monthly rate of $10-13 per household is estimated to recover the cost of residential refuse collection. While instituting a refuse collection fee would not require a vote under Proposition 218, majority approval would be required to amend Municipal Code Section 66.0127, enacted by voters in 1919 to prohibit the collection of fees for residential refuse collection or disposal.

COMMUNITY INPUT PROCESS

To be responsive to the needs of the City Council and the residents of the City of San Diego, several mechanisms are in place to solicit public participation in the budget development process and to request citizen input in setting and revising the City's budget priorities. The collection of this information is an important component of the City's efforts to continually improve the total quality of service delivery and to be responsive to the City's customers. Citizen participation is facilitated through Community Budget Forums and Citywide resident and customer surveys. Community Budget Forums will be held in San Diego communities during March, through coordination by each Council Office. The schedule of Community Budget Forums will be available at http://www.sandiego.gov/budget by March 11, 2005.

CONCLUSION

Although major revenues are expected to increase in Fiscal Year 2006, existing revenue sources are not sufficient to fully fund current General Fund operations. This requires reductions in the budget in order to accommodate required expenditures such as salary and benefits adjustments, public safety needs, and other mandated necessities. This report has presented an overview regarding the development of the Fiscal Year 2006 General Fund Proposed Budget which will be presented to the Mayor and City Council on May 2, 2005.

Respectfully submitted,

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Mary Vattimo	APPROVED: Lisa Irvine
Financial Management Director	Deputy City Manager

MV/man

Attachment: 1. Summary of Fiscal Year 2005 Debt Obligations as of December 2004