



**TOWN OF LOS GATOS
COUNCIL AGENDA REPORT**

MEETING DATE: 02/20/2024

ITEM NO: 14

DATE: February 14, 2024
TO: Mayor and Town Council
FROM: Laurel Prevetti, Town Manager
SUBJECT: Review the Five-Year Forecast (Fiscal Year 2024/25 -FY 2028/29) and the Finance Commission Recommendations, Determine Key Assumptions for the Five- Year Forecast, and Provide Direction for the Preparation of the FY 2024/25 Operating Budget

RECOMMENDATION:

Review the Five-Year Forecast (FY 2024/25 -FY 2028/29) and the Finance Commission recommendations, determine key assumptions for the Five- Year Forecast, and provide direction for the preparation of the FY 2024/25 Operating Budget.

BACKGROUND:

An important aspect of the Town's budget development process is taking a multi-year approach to understand revenue and expenditure trends over time. Serving as the foundation of the budget planning process, the Town develops a Five-Year Financial Forecast ("Forecast") beginning in the winter of each year. The Forecast enables the Town to evaluate the Town's fiscal condition and to help guide policy, programmatic planning, and budget decisions. Development of a financial forecast as part of the budget development process has been identified as a best practice by the Government Financial Officers Association (GFOA).

The Forecast takes a forward look at the Town's General Fund revenues and expenditures and is updated regularly. Its purpose is to identify financial trends, potential shortfalls, and other issues so the Town can proactively address them and budget accordingly. It does so by projecting out into the future the fiscal results of continuing the Town's current service levels and policies. This process helps to provide a snapshot of what the future may look like as a result of the decisions made to date.

PREPARED BY: Gitta Ungvari
Finance Director

Reviewed by: Town Manager, Town Attorney, and Assistant Town Manager

BACKGROUND (continued):

Attachment 1 contains the staff report to the Finance Commission with Attachments 1 through 6. The report to the Finance Commission outlines the major assumptions and their sensitivity to more optimistic or pessimistic outlooks. The analysis also includes historical information, particularly pertaining to the elements of property tax revenue.

DISCUSSION:

The initial Forecast (FY 2024/25 – 2028/29) is predicated on estimates derived from the FY 2023/24 Mid-Year review and includes updates to Town revenues and expenditures based on the Mid-Year end of year projections. Like any forecast, the Forecast's revenue estimates for the first year is the most critical in the process as they ultimately define the expenditure limitations for the upcoming budget year.

The Five-Year Financial Forecast is not a budget, nor a proposed plan. The Five-Year Financial Forecast sets the stage for the upcoming budget process and is a tool in facilitating both the Town Council and Town Manager in establishing priorities and allocating resources appropriately. The forecast based on a point in time information and has to be updated periodically and will differ from final actual numbers.

Base Case

The base case Five-Year Forecast (FY 2024/25 – 2028/29) as presented to the Finance Commission identifies deficits for all future years, using a 2% salary increase assumption, a 4.6% vacancy saving factor as approved by the Town Council for the FY 2023/24 budget, and other assumptions as outlined further in this report.

5 Year Forecast "Base Case" with 4.6% Vacancy Factor	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)	2026/27 Forecast (\$M)	2027/28 Forecast (\$M)	2028/29 Forecast (\$M)
Total Revenues & Transfers and Use of Reserves	\$54.5	\$56.3	\$58.1	\$59.6	\$61.4
Total Expenditures & Reserve Allocations	\$56.8	\$58.1	\$60.1	\$61.7	\$63.8
Surplus/Deficit	(\$2.3)	(\$1.8)	(\$2.0)	(\$2.1)	(\$2.4)

The deficits are on the order of approximately \$2M per year and can currently be resolved through expenditure controls and the use of one-time funds.

DISCUSSION (continued):

Finance Commission Recommendations

The Finance Commission discussed the Five-Year Forecast at its February 12th meeting. The Finance Commission unanimously passed the following motion with no specific guidance on the assumptions:

Motion: The Finance Commission recommends the Town Council not accept, nor rely upon, the current version of the FY 2024/25 – 2028/29 5-Year Plan. Given the importance of the Five-Year Forecast in establishing tax policy, the Finance Commission makes a finding that the draft forecast of a 2.9% Compound Annual Growth Rate (CAGR) in total tax revenue is too conservative compared to historic growth rates and the 4.9% CAGR in operating expenditures needs to be reduced through cost containment and productivity measures. The Finance Commission does not agree with staff's conclusion that "the persistent presence of a deficit indicates that the Town needs to consider new revenues ensures if it wants to maintain high levels of municipal services" as stated on page 1 of the staff report.

The Commission's general observation was that the base forecast is too conservative.

Forecasting Approach Consistent with Government Finance Officers Association (GFOA)

A "conservative" forecast as described by GFOA is conservative with revenue assumptions and builds in a layer of contingencies for expenditures. This approach might make it harder to balance the budget but reduces the risk of an actual shortfall. The Town's past forecasting practice represents this conservative approach.

During the last couple of years, staff changed elements of the budgeting and forecasting methodology. Starting FY 2020/21, the salaries are budgeted and forecasted at actual salary plus one step higher. Beginning FY 2023/24 the budget and the forecast included a 4.6% vacancy factor, moving toward less conservative approach.

An "objective" forecast as described by GFOA seeks to estimate revenues and expenditures as accurately as possible, making it easier to balance the budget, yet increasing the risk of an actual shortfall.

It is very important that the approach to the forecast and the underlying assumptions are clear, analyzing the risk between being objective versus conservative. While one-time solutions can solve near term shortfalls, the best practice is to build a structurally balanced forecast where recurring revenues (the portion of the Town's revenues that can reasonably be expected to

DISCUSSION (continued):

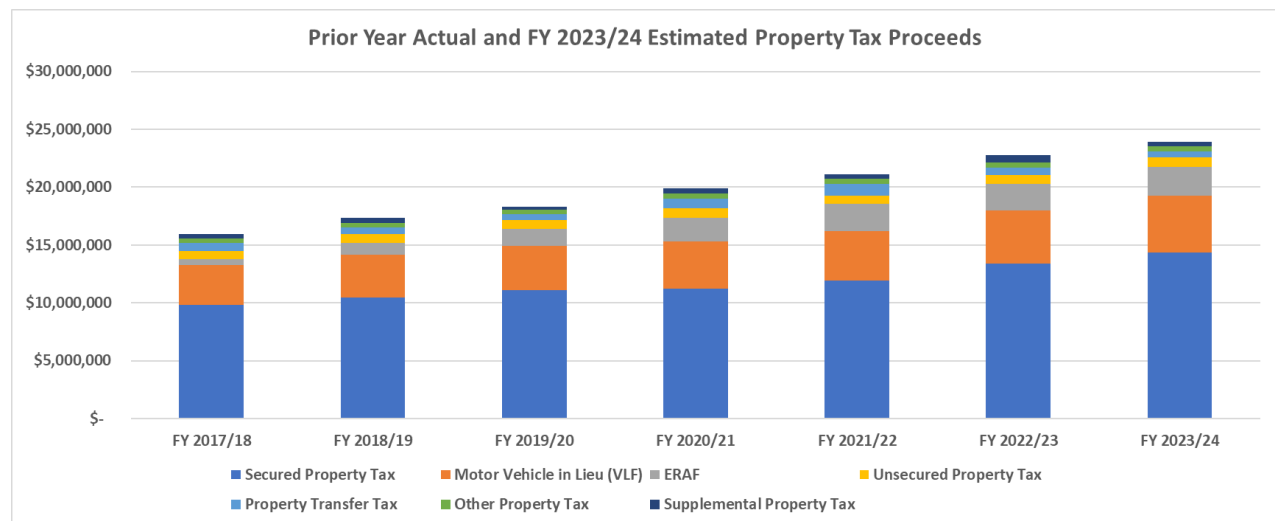
continue year to year with some degree of predictability) equal or exceed recurring expenditures (salaries, benefits, and other operational expenditures).

Modifying the Forecast from Conservative to Objective by Changing the Property Tax Assumptions

Given the Finance Commission’s recommendations, this section focuses on the property tax revenue assumptions that would move the forecast from conservative to objective.

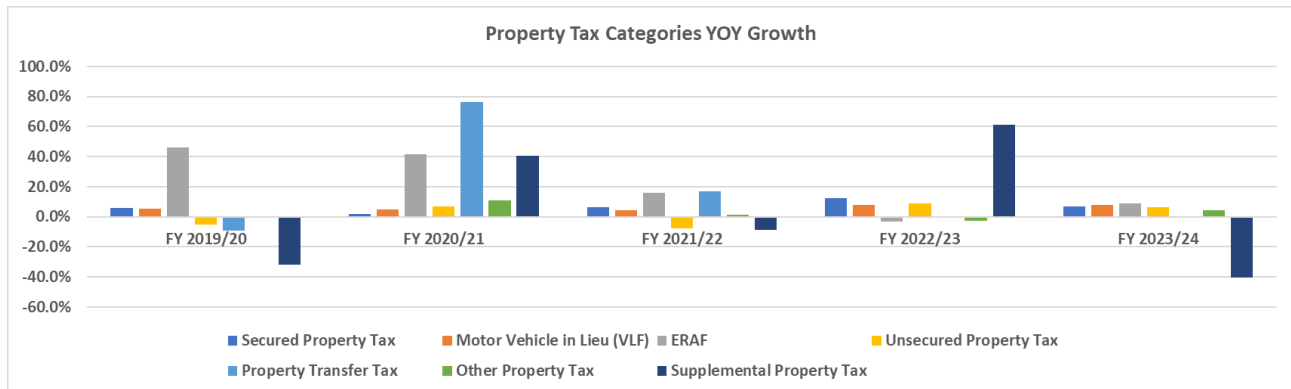
The Town is highly dependent on five economically sensitive revenues comprising 70% of General Fund forecasted revenues. The Finance Commission staff report (Attachment 1) includes detailed analysis (Attachment 1, pages 4 to 14) of the Town’s major revenues including property tax, sales tax, business license tax, franchise fees, and transient occupancy tax (TOT).

Property tax is the single largest revenue source for the Town and comprised approximately 42% of total Town estimated General Fund revenues for FY 2023/24. **Secured Property Tax, Motor Vehicle in Lieu (VLF), and Excess Education Revenue Augmentation Fund (ERAF)** constitutes 91% of the current year property tax proceeds. The following table and graphs illustrate how is the actual year-over-year (YOY) performance for the different property tax categories varies from fiscal year to fiscal year.



DISCUSSION (continued):

Percentage of Total Proceeds	Property Tax Categories	FY 2018/19 Actuals	FY 2019/20 Actuals	FY 2020/21 Actuals	FY 2021/22 Actuals	FY 2022/23 Actuals	FY 2023/24 Estimated	Average YOY Growth
60%	Secured Property Tax	6.9%	5.6%	1.6%	6.1%	12.3%	7.0%	6.6%
21%	Motor Vehicle in Lieu (VLF)	6.9%	5.2%	4.6%	4.4%	7.7%	7.7%	6.1%
10%	ERAF	90.5%	46.1%	41.4%	16.1%	-3.1%	8.8%	33.3%
4%	Unsecured Property Tax	16.4%	-5.1%	6.9%	-7.8%	8.8%	6.1%	4.2%
2%	Property Transfer Tax	-21.8%	-9.2%	76.0%	17.0%	-37.8%	-23.2%	0.2%
2%	Other Property Tax	-11.1%	-0.2%	10.7%	1.0%	-2.6%	4.1%	0.3%
1%	Supplemental Property Tax	17.7%	-31.8%	40.3%	-9.0%	61.1%	-40.5%	6.3%



Secured Property Tax and Motor Vehicle in Lieu (VLF) Property Tax are usually increasing by the growth of the Total Assessment Rolls. The Total 2024 Assessment Roll will be published in July 2024 from the Santa Clara Assessor's Office. In addition to the annual assessment increases and the reassessed Proposition 13 properties as they changed ownership, the historical growth includes the annexation of 24 pockets from Santa Clara County and property sales from the First Phase of North Forty development. VLF collection based on the assessed roll is included as well. Property Tax and VLF are considered recurring revenues. The base case forecast includes the normalized 5.1% growth rate throughout the forecast years.

		FY 2024/25 Assumptions	FY 2025/26 Assumptions	FY 2026/27 Assumptions	FY 2027/28 Assumptions	FY 2028/29 Assumptions
Secured Property Tax	Option A - Lowest YOY over the Last Six Year Period	4.3%	4.3%	4.3%	4.3%	4.3%
	Option B - Normalized for County Annexation and Other One Time Roll Growth ~\$1.5 M	5.1%	5.1%	5.1%	5.1%	5.1%
	Option C - Average YOY Property Tax Roll	6.6%	6.6%	6.6%	6.6%	6.6%
Motor Vehicle in Lieu (VLF)	Option A - Lowest YOY VLF Revenue Growth over the Last Six Year Period	4.4%	4.4%	4.4%	4.4%	4.4%
	Option B - Normalized based on Property Tax Roll	5.1%	5.1%	5.1%	5.1%	5.1%
	Option C - Average YOY VLF Revenue Growth	6.1%	6.1%	6.1%	6.1%	6.1%

DISCUSSION (continued):

If Council selects Option C for both Secured Property Tax and VLF, the estimated deficit is reduced as displayed below.

Alternative Scenario Selecting Secured Property Tax Option C and VLF Option C (Greater Growth)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)	2026/27 Forecast (\$M)	2027/28 Forecast (\$M)	2028/29 Forecast (\$M)
Total Revenues & Transfers	\$54.9	\$56.9	\$59.0	\$60.9	\$63.1
Total Expenses & Allocations	\$56.8	\$58.1	\$60.1	\$61.7	\$63.8
Surplus/Deficit	(\$1.9)	(\$1.2)	(\$1.1)	(\$0.8)	(\$0.7)

Excess ERAF is not tied to the Total Assessment Roll. A portion of property tax revenue goes to the ERAF to support local school districts. When the amount contributed to ERAF is more than the minimum cost of funding local schools, excess funds have traditionally been returned to the county, cities, and special districts.

While Excess ERAF grew significantly in the recent fiscal years, there is no guarantee for funding in the future. Santa Clara County has only provided projections for the current fiscal year. FY 2024/25 Excess ERAF projections will not be available until March 2024 and the County has recommended the jurisdictions set aside 30% due to pending litigation. FY 2025/26 estimates will be available in March 2025. The Town has been monitoring and providing periodic updates to the Finance Commission and to the Town Council on the ongoing developments regarding the distribution of excess ERAF funds. Additional information can be found Attachment 1.

If Council assumes 70% of the FY 2024/25 Estimated Excess ERAF proceeds and assumes greater growth (option C) for both the Secured Property Tax and VLF, the estimated deficit is displayed below.

Alternative Scenario Selecting 70% of the Excess ERAF and Secured Property Tax Option C and VLF Option C (Greater Growth)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)	2026/27 Forecast (\$M)	2027/28 Forecast (\$M)	2028/29 Forecast (\$M)
Total Revenues & Transfers and Use of Reserves	\$55.4	\$57.4	\$59.5	\$61.4	\$63.6
Total Expenditures & Reserve Allocations	\$56.8	\$58.1	\$60.1	\$61.7	\$63.8
Surplus/Deficit	(\$1.4)	(\$0.7)	(\$0.6)	(\$0.3)	(\$0.2)

DISCUSSION (continued):

If Council assumes 100% of the FY 2024/25 Estimated Excess ERAF proceeds and assumes greater growth (option C) for both the Secured Property Tax and VLF, the estimated result is displayed below.

Alternative Scenario Selecting 100% of the Excess ERAF and Secured Property Tax Option C and VLF Option C (Greater Growth)	2024/25 Forecast (\$M)	2025/26 Forecast (\$M)	2026/27 Forecast (\$M)	2027/28 Forecast (\$M)	2028/29 Forecast (\$M)
Total Revenues & Transfers and Use of Reserves	\$55.4	\$57.4	\$59.5	\$61.4	\$63.6
Total Expenditures & Reserve Allocations	\$55.9	\$57.1	\$59.1	\$60.7	\$62.7
Surplus/Deficit	(\$0.4)	\$0.3	\$0.4	\$0.7	\$0.9

Other Scenarios

As demonstrated, the Forecast is highly sensitive to the assumptions. If Council were interested in modifying other assumptions as outlined in Attachment 1, the Forecast would change accordingly.

Risk Considerations

It is not unusual for the State to take revenue from local government, such as occurred with the dissolution of the former Redevelopment Agencies (RDA), or for the County to redistribute property tax retroactively based on court rulings. In the recent past (FY 2020/21 and FY 2021/22), the County of Santa Clara withheld approximately \$1.6 million over the three fiscal years to recapture excess RDA residual property tax revenues distributed to the Town. This action was necessary to comply with an appellate court decision involving the City of Chula Vista (49 Cal. App. 5th 539 (2020)) that held that any funds remaining in each RDA Property Tax Trust Fund (RPTTF) must be distributed in accordance with the taxing entities' pro-rata shares without any caps or reductions to the distributions of RPTTF residuals to taxing entities that received pass-through payments. Calculating the redistribution went back three years retroactively.

The Governor's most recent budget assumes the approval of legislation allocating ERAF to charter schools, potentially reversing the recent appellate decision that charter schools do not get ERAF.

CONCLUSION:

The Council should review, discuss, and select the assumptions for the initial Five-Year Forecast and provide direction on other budget considerations.

The preparation of the FY 2024/25 Operating and Capital Budgets is taking into account the Town's current economic reality and long term fiscal picture, as well as maintaining the Town's high level of municipal services. This is considered a "status quo" approach with no major new initiatives or staffing. Key budget principles include:

- Develop and recommend a balanced budget that maintains service levels;
- Address projected deficits;
- Continue to make progress on Strategic Priorities identified by the Town Council; and
- Identify opportunities to maintain or enhance service delivery through new revenue sources and technology.

The Draft FY 2024/25 Operating and Capital Budgets will be available on April 22, 2024 for the Finance Commission's consideration and the Council's budget hearing is tentatively scheduled for May 21, 2024.

Staff looks forward to answering the Council questions and receiving any recommendations for Council consideration for the preparation of the proposed FY 2024/25 Operating Budget that results from the discussion.

COORDINATION:

This Report was prepared in coordination between the Finance Department and the Town Manager's Office.

ENVIRONMENTAL ASSESSMENT:

This is not a project defined under CEQA, and no further action is required.

Attachments:

1. Five-Year Forecast Report to the Finance Commission with Attachments 1 through 6
2. Public comment received after the Finance Commission's February 12, 2024 meeting and prior to 11 a.m. on February 15, 2024